Expanding Microfinance for Housing

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The purpose of this article is to briefly describe microfinance for housing: the institutions involved, typical loan products, the constraints on its expansion to more meaningful scale, and the greater role it might potentially play in relieving the shelter problems facing the poor, especially the urban poor.[1]

1.0 What is Microfinance for Housing?

Microfinance for housing (MFH) is a subset of microfinance, designed to meet the housing needs of the poor and very poor, especially those without access to the banking sector, including to formal mortgage loans. MFH is designed for low-income households who wish to expand or improve their dwellings, or to build a home in incremental steps, relying on many small loans. MFH differs from formal mortgage lending in two key ways: the loans are smaller and shorter term, but more importantly they are usually not collateralized by the property. MFH clients generally cannot qualify for formal mortgage loans, for a variety of reasons, including low income, informal sources of income, lack of land title (although some microfinance institutions make this a precondition) and a dwelling that does not meet formal building standards. Relative to micro enterprise loans - namely working capital and fixed assets loans to micro entrepreneurs - MFH loans are, in some cases, somewhat larger and of longer duration. Finally, however, housing and micro enterprise loans may sometimes be indistinguishable. First, many micro businesses are conducted in whole or in part from the home, and secondly, many micro lenders have learned that some portion of their loans are being used for housing.

2.0 Who Offers MFH?

The institutions that offer MFH that were surveyed for this MicroNote are listed in Table 1. There are many other institutions, some of which are noted in *Housing Microfinance: A Guide To Practice*, and some of which are included in other tables or in the discussion. MFH is offered by a wide variety of institutions, including MFIs (microfinance institutions), banks, NBFIs (nonbank financial institutions), cooperatives, credit unions, and NGOs. A major distinction can be made between financial institutions whose main product line is micro enterprise loans (MFIs, banks and NBFIs) and institutions whose main purpose is improving the shelter situation of the poor. These are discussed in turn.

Micro Finance Institutions. The MFI group from Table 1 includes **BRI** (Bank Rakyat Indonesia), **SEWA** (Self Employed Women's Association), the **ACCION** network in Latin America, **UML** (Uganda Microfinance Limited), Fundacion, and **FAMA** (Fundacion Para el Apoyo a la Microempresa. **K-Rep**, which offers construction loans for low income housing, and **Jamiibora**, whose main concern is improving the live of slum dwellers overall, would also be included here. Many of the microlenders in the Accion network are banks.

Micro Housing Lenders. The second group, whose primary focus is improving shelter, are often NGOs or NBFIs that have evolved from housing NGOs as "sister" financial institutions conducting the savings and lending operations. This group includes **Kuyasa**, **SPARC**, and **NACHU** (National Cooperative Housing Union) and its housing cooperative members. SEWA and SEWA Bank provide a "sister" example, and although it is a micro lender, SEWA Bank has included housing lending for well over a decade.

There are also several network NGOs providing low income housing solutions, including **Habitat for Humanity** (HFH) and **CHF International**. These groups use business models that seek to offer affordable pricing to the end customers, relying on both sweat equity and continual capital inflow from donations. This model has a strong technical assistance component for the construction of the house. One key challenge for these business models is to achieve financial

[1] This article was prepared under contract to Development Alternatives Inc. for submission to the United States Agency for International Development (USAID). We wish to acknowledge the excellent assistance of Catherine Johnston of DAI and Sashi Selvendran of USAID. Our methodology is first of all, to summarize key findings from an overview published in 2004. See Daphnis, Franck and Bruce Ferguson, eds., *Housing Microfinance: A Guide to Practice*, Kumerian Press, 2004. The MicroNote draws in particular from chapter 3, Alejandro Escobar and Sally Merrill, "Housing Microfinance: The State of the Practice". Second, in order to update this information, we have carried out brief surveys of selected institutions involved in MFH; ACCION surveyed selected institutions in Latin and Central America, while the Urban Institute addressed institutions in Asia and Africa. The views expressed here are not necessarily those of USAID.

Table 1: Institutions Contacted for this MicroNote

Latin America and Central America		Asia and Africa	
Mibanco (Peru)	Bank	SEWA Bank (India)	Cooperative Bank
Banco Solidario (Ecuador)	Bank	SPARC (India)	NGO
BancoSol (Bolivia)	Bank		
Finamerica (Colombia)	NBFI	BRI (Indonesia)	Large MFI
Sogesol (Haiti)	Pilot phase	UML (Uganda)	MFI
Integral (El Salvador)	Bank	Kuyasa (South Africa)	NBFI
El Comercio (Paraguay)	Financial institution	NACHU (Kenya)	Apex for Housing Coops
Fundacion (Santo Domingo)	MFI	Jamiibora (Kenya)	Foundation
Compartamos (Mexico)	Pilot phase	K-Rep (Kenya)	Bank
FAMA (Nicaragua)	MFI,	PRIDE (PRIDE Tanzania)	MFI

FINCA and **PRIDE** are major international networks of microfinance institutions that are thinking of initiating housing lending, and their branches in several countries have recently done so. A recent research project undertaken by FINCA revealed that their clients often use a substantial percentage of their loans for home improvement. To better track the performance of these different segments, FINCA is considering the introduction of housing microfinance products. Similarly, PRIDE is examining the potential for adding housing loans to their product line and acknowledges that some of the money it lends for micro enterprise goes into housing.

sustainability and reduce the dependence on subsidies. HFH is undertaking a strategic reorientation in an effort to increase scale and outreach, focusing on microfinance products such as home repairs/improvement, expansion, and land purchase/titling

3.0 Loan Products, Underwriting, and Funding

Loan Products. As noted above, MFH loans are used for home improvement, incremental building, new construction, at-home production and storage, or home purchase. Accordingly, they differ greatly in value and term. Table 2 illustrates loan terms for selected institutions.[2]

Clearly, loan sizes and terms vary considerably across institutions.

- Based on ACCION's data, home improvement loans in Latin America and the Caribbean typically are short to mid-term loans from 3 months to 36 months, although many institutions offer a wider range of terms up to 60 months or more.
- Average loan size in the Latin American region for 2005 was US$2,800 and ranges from $900 to $3,500.
- Interest rates are in some cases below those for working capital loans and vary greatly from one market to another (for example 24% to 36% per annum is typical).
- Fixed interest rates are the most common; however, BancoSol diversified its housing loan products to include a variable rate product for loans with terms of 36 months or more.
- In Asia, SEWA and Grameen offer up to 10 year loans, but the typical loan is generally of shorter duration, usually 1 to 3 years.
- Housing loans are almost always to individuals, while micro loans may be group-based.

Underwriting. Institutions rely on a variety of additional means to increase the probability that the loans will be repaid, including mandatory savings over a specified period, mandatory membership in savings groups, co-signers, and previous success with one or more micro enterprise loans. Whereas underwriting for a microenterprise loan rests in large part on the institution's assessment of the income stream that is derived from a micro enterprise, not all MFH borrowers may be entrepreneurs, and thus underwriting generally includes a variety of approaches to reducing credit risk. Because South Africa has a credit bureau, Kuyasa is able to undertake a full credit assessment and history. Fortunately, a number of emerging markets are in the process of establishing credit bureaus, which are especially important to microenterprise and housing institutions.

Funding. Table 3 illustrates funding sources for various institutions that offer MFH. Institutions that are registered as banks rely on demand deposits, while NBFIs seek savings accounts. Importantly,

[2] This table is derived from our surveys, from *Housing Microfinance: A Guide to Practice*, and from Franck Daphnis, "Housing Microfinance: Current Issues, Opportunities, and Challenges", a presentation made at the World Bank Housing Finance Conference, March 2006. A "linked" loan refers to the requirement that the borrower must have already successfully completed a microenterprise loan. Housing technical assistance usually refers to construction planning and/or implementation assistance, but for groups like SEWA and Jamiibora, non-housing types of assistance may be offered.

Table 2: MFH Loan Features and Underwriting Requirements

Loan Feature /Institution	SEWA Bank	Grameen Bank	CARD	ADEMI	FUNHAVI	Kuyasa Fund	ACCION Latin America
Loan Size	$333 average; $4,444 max	$100 - $600	$359	$4000	$3000	$700	$300 to $3,500
Maximum Term	120 months	120 months	12 months	36 months	20 months	24 months	120 months
Security	1 yr savings; 2 co-signers	5 co-signers	5 co-signers	Collateralized	2 co-signers	6 months savings	Mostly co-signer
Savings Required?	Yes	Yes	Yes	No	No	yes	No
Linked or Stand Alone	Linked	Linked	Linked	Stand alone	Stand alone	Stand alone	Stand alone
Time with Organization	1 year minimum	2 years minimum	1.5 years	Not required		Not required	Not required
Gender-based?	Women only	Mostly women	Mostly women	No	No	Mostly women	No
Land Ownership	Not required	required	required	Not required	Not required	required	Mostly not
Housing Technical Assistance	Assistance for Illiteracy	No	No	No	Yes	No	Mostly not

Table 3: Sources of Funds

Type of Funding	Banco Sol	SEWA Bank	SPARC	CARD Bank	BRI	Grameen Bank	Mibanco	NACHU	Kuyasa	FAMA
Mandatory Savings		X	X	X		X			X	
Deposits	X			X	X	X	X	X		X
Commercial Credit	X		X				X		X	
Donor Funds		X	X	X		X			X	X
Foundation Funds		X	X	X		X			X	X
Public Funds		X	X							
International Finance Corporation						X				
Credit Enhancement			X						X	

Lines of credit from commercial banks and other financial institutions are increasingly important. PRIDE Tanzania receives commercial lines of credit from the National Microfinance Bank and Azania Bankcorp, both in Tanzania. In other cases, the commercial borrowing is facilitated by credit guarantees. SPARC pioneered the use of a credit enhancement to provide a partial guarantee for a loan from a major international bank in India; SPARC has continued in this approach and currently receives assistance from USAID's credit enhancement mechanism, the DCA (Development Credit Authority). Many of the shelter-focused institutions receive a fair amount of grant and donor assistance in an attempt to make their products more affordable. Kuyasa, as one example, is not yet commercially self sufficient, although it claims to be aiming toward this status; among its sources of funds is a line of credit from a major Pan-African Bank, which is similarly guaranteed by a USAID DCA credit enhancement.

the table illustrates another type of distinction that can be made among institutions offering MFH: (1) microfinance institutions that fund themselves on strictly commercial terms, at market rates, and (2) those that are also subsidized through various combinations of donations, grants, and donor or government funds. Many large microfinance institutions, such as BRI and the ACCION network in Latin America, are self sufficient. Grameen, in contrast, has always received some level of subsidy from donors and foundations.[3] Subsidy funding may take the form of infusions of capital or funds to increase liquidity. K-Reps shareholders, for example, include the IMF, Shorebank, the African Development Bank and two commercial banks based in the Netherlands. Finally CARD, the Center for Agricultural and Rural Development, includes the CARD NGO and CARD Bank, with the goal of providing a group of mutually reinforcing institutions.

4.0 MFH: Demand and Supply

Housing Lending in Perspective. The potential "effective" demand for MFH – that is, loans to households who have the ability to service them as opposed to the need of low income families for shelter - is assumed to be very large. There have been a few efforts to understand customer demand for MFH; for example, **SEWA Bank** began providing housing loans over a decade ago after a customer survey indicated a significant proportion of microenterprise loans were used for housing purposes and other lenders have conducted similar market research. No widespread or definitive study of demand has been undertaken, however. Tentatively, we offer three conclusions:

- There has been significant growth in housing lending by institutions who were already offering housing microfinance, in response to customer demand;
- the number of institutions now offering MFH has been growing steadily, similarly, in response to customer demand;
- overall, however, housing microfinance remains a relatively small portion of the microfinance industry and is still far from reaching a scale that approaches potential demand.

Table 4 offers some figures on MFH portfolios. It is illustrative to look at the recent record of ACCION's network in Latin America. For those institutions offering MFH, loans, ACCION's network achieved a notable advance over the past 3 years, as the housing portfolio jumped from US$38 million in December 2002 to US$117 million in December 2005, an annual compounded growth rate of 49%. For the same period, the growth rate for home improvement loans (which is the primary housing microfinance product) was 51%. By the end of 2005, home improvement lending represented 62% of the housing portfolio of ACCION's network, the remaining 38% being mostly mortgage backed loans or loans linked to government programs, which are usually directed towards somewhat higher income groups.

Those who have been in the business of home improvement lending for more than 5 years, such as **Mibanco** and **BancoSol**, have continued to experience significant growth. BancoSol's total housing portfolio reached 35% of its total portfolio and Mibanco's reached more than 15%. In both cases, home improvement lending makes up around 50% of the housing portfolio. Putting these figures in perspective, within the ACCION Latin American network, however, the aggregate total housing portfolio of all ACCION affiliates is still only 8.7% of total portfolio, which is comprised primarily of working capital credit. The home improvement portfolio (taking out mortgage lending) relative to the total portfolio of ACCION's network worldwide is 5.4 and represents 2.3 percent of total active customers.

SEWA Bank also notes that housing loans have grown rapidly – 55 % in 2005. SEWA continues to maintain a special focus on housing loans, as many low income clients use the house for conducting their business. For **BRI**, although MFH represents only 1 percent of BRI's total portfolio, the magnitude is very large ($85.6 million) as compared with many other lenders, as BRI is one of the world's largest micro lenders, with a total portfolio of over $8 billion. **UML** in Uganda introduced a pilot housing loan project in 2004, and launched the product in 2005. It has already grown to represent 10.6 percent of UML's portfolio. UML feels that its housing lending is limited by lack of medium-term funds. Similarly, **Kuyasa** reports that demand for MFH is very high and it is only lack of access to sufficient funds that prevents faster growth. Kuyasa's new housing lending was over $1 million in 2005, and expectations for 2006 are $1.7 million.

[3] Muhammad Yunus, founder of Grameen Bank in Bangladesh, received the Nobel Peace Prize for 2006, an award which has led to much greater awareness of the microfinance sector. It has also sparked debate about the virtues and drawbacks of strictly "for-profit" commercial microlenders and those who seek to improve affordability by utilizing grant funds or funds obtained at below market cost.

Table 4: Micro Institution Portfolios and MFH Loans

Institution	Total Portfolio 2005	Total MFH Loans	Percent in MFH Loans	% Home Improvement in MFH Loans
ACCION Network offering housing loans	$624,324,129	$116,784,223	18.7%	62%
ACCION Total Network	$ 1,340,000,000	$116,784,223	8.7%	60%
Mibanco	$206,729,374	$30,864,706	20%	50%
BancoSol	$130,106,032	$45,083,923	35%	50%
SEWA	$5,415,555	$1,638,812	27%	80%
BRI	$8,572,000,000	$85,300,000	1%	na
UML	$11,325,366	$1,223,204	10.8%	na
Kuyasa Fund	$2,970,000	$2,970,000	100%	50%

The Supply of MFH: Why Offer MFH? From the perspective of the microfinance industry, the goal of MFH may be primarily to strengthen the institution's business both by expanding its customer base and fostering higher customer loyalty via multi-product financial services. Newcomers to housing within the ACCION Network are also committed to making housing microfinance an important part of their product portfolio such as **Sogesol** (Haiti) currently in pilot phase, **Compartamos** (Mexico) which plans to start a pilot by early 2007 and **El Comercio** (Paraguay), which plans to increase MFH stemming from the results of its successful pilot for house improvement product (Cherogara)

Grameen Bank in Bangladesh also recognized the customer demand for MFH some years ago, and began offering housing loans as "rewards" for successful completion of micro enterprise loans. Grameen recognized the emotional attachment that customers have to their homes for being both the family's shelter and their key asset; thus, MFH builds stronger emotional bonds between the customer and the lending institution, which impacts favorably on the customer loyalty and life time value to the institution. Similarly, **BRI** initiated a study in 2001 in order to determine customer demand for housing loans and the implications for its branches and staff. As a result, MFH has now been solidly introduced by BRI, an institution that takes pains to test and develop its new products and train its regional and branch managers in the new products.

For HFIs concerned primarily or solely with improved shelter and urban development, the entire aim of MFH is to improve the housing of lower income households, to provide loan products to meet the needs of incremental building and home improvement, and to provide an improved base for at-home provision of products and services. **The Kuyasa Fund** in South Africa falls into this category as do the housing co-op members of **NACHU** in Kenya.

Finally, in some cases funding for low income housing is just one part of a broader effort to improve the lives of slum dwellers. **SPARC** in India, for example, seeks to provide assistance for broad efforts in provision of basic infrastructure, multi-family housing, slum upgrading, and informal settlement regularization. It is this latter goal that is now increasingly being designed and piloted by both governments and donors, particularly UN-HABITAT. Finally, **Jamiibora** in Kenya is now introducing housing development into its broad-based efforts to improve the overall well being of slum dwellers; Jamiibora contends that some slum upgrading efforts in Kenya have failed to improve the lot of the very poor, and that land purchase and greenfield construction for these slum and pavement dwellers may be a better answer.

In sum, the major suppliers of MFH include:

- MFIs primarily focused on enterprise loans, that respond to demand from their customers for housing loans and thus develop specific loan products for housing microfinance;
- MFIs that recognize that work and business activities often take place in the home, and that their micro enterprise loans are frequently used for these housing purposes; and
- NGOs and other groups dedicated to shelter, especially those that have evolved to include a sound financial structure or sister financial organization, so that saving and borrowing activities are formalized.

In all three categories, the demand for micro housing loans is apparently growing rapidly. The constraints on its growth are discussed below.

5.0 Constraints to the Expansion of MFH

Has MFH been "over-hyped"? Can MFH be a scale product or will it remain relatively "boutique"? What are the issues in increasing scale? Issues in the supply of MFH and constraints on its growth are discussed here.

Barriers to MFH at the Individual Institution Level

- Lack of awareness of how to implement housing loan products among MFIs;
- Need for increased commercial financing for both MFI and shelter-focused institutions. MFIs should not need to choose between supplying microenterprise loans and as opposed to micro housing loans. MFH may be viewed as risky compared with micro enterprise loans. Shelter focused institutions, many of whom rely on grants and donor assistance, need assistance in designing financially sustainable models. Microenterprise lenders need to obtain sufficient funds so that they are not be forced to make a choice between supplying micro enterprise loans as opposed to micro housing loans;
- Shelter-focused NGOs without an effective financial arm, are too often relegated to a project-by-project approach and the supply of grant funds, and thus fail to achieve scale.

Some Solutions to Institutional Barriers

- Provide technical assistance to help institutions develop housing loan products;
- Demonstrate to MFIs the profitability of housing loans and product diversification;
- Assist housing NGOs and foundations build financial management skills and capacity to engage in housing lending. **Jamiibora**, for example, is just in the process of taking this step;
- MFI friendly regulatory framework, including not setting interest rate ceilings;
- Train loan officers, add multi-product officers and specialists, improve operational efficiency to allow loan officers more time for the credit evaluation process needed in housing.

Barriers to MFH in the Financial Sector.

Major constraints for scaling up housing finance may include:

- A weak financial sector and very limited mortgage finance sector;
- Scarcity of liquidity for most or all segments of the market;
- Asset-liability mismatch. As microloan products are generally fixed rate and short-term for small amounts, institutions have difficulty accessing longer term funds at a fixed rate, given the interest rate risk and duration mismatch;
- A lack of linkages between microfinance institutions, commercial banks, mortgage lenders, and capital market institutions, such as pensions and insurance companies.
- Lack of secondary market financing from capital markets;
- Lack of a conducive regulatory framework for micro lenders that would help strengthen MFI profiles and enable them to obtain lines of credit;
- Legal constraints on borrowing in foreign currencies;
- Lack of resources to hedge currency risk where foreign borrowing is permitted for microfinance institutions.

Increasing competition among mortgage lenders in the upper and middle markets has lead some lenders to begin to look downmarket for portfolio expansion and market share. Latin America and South Africa offer examples of links between commercial banks and microfinance institutions. A major bank in India – ICICI – now securitizes MFI portfolios. Lines of credit help supply liquidity to the micro lender, who is best suited to perform the outreach, underwriting, and servicing in low income communities, while the “formal” sector bank may be better suited to raise funds. Regulation of MFIs is also important, providing more assurance of the viability of the MFI to banks offering lines of credit. The regulation needs to be MFI friendly, however, as too onerous capital requirements, for example, will defeat the intended purpose.

Barriers to MFH at the Policy Level: The Shelter Policy Context

Demand for, and supply of, MFH seem inextricably intertwined in the shelter policy context.

Numerous problems face a country’s ability to supply low income housing, infrastructure, urban land, and proper land titles. However, ***MFH cannot take place in a shelter policy vacuum, most especially without regard to tenure security***. Lack of access to urban land, scarcity of government-supplied infrastructure, government failure to provide timely planning and zoning, and inadequate land titling and registration processes are all major depressants to both supply and demand of MFH. This is nowhere more evident that in the proliferation of urban slums and in the seeming inability of governments to prevent the squatting that leads to major slums.

Tenure Security. From the demand perspective, it is a phenomenon recognized worldwide that households will spend to improve housing if they have land with a sound title. Similarly, lack of infrastructure and a permanent dwelling inhibit incentives for households to improve their own shelter situation. Lack of title and lack of effective title registration systems are serious problems in almost all emerging markets, and in some, these barriers inhibit demand for formal sector mortgage finance as well as MFH. From a supply perspective, many institutions will not lend unless the borrower has adequate title. Note that unlike formal sector mortgage finance the title is not always required; however, demand for MFH is understandably inhibited if a household fears being bulldozed or otherwise relocated.

Without sufficient land and without government supplied infrastructure, low cost housing is especially limited. If the housing supply constraints are extremely serious, housing prices quickly become out of reach of low income households. Often, the middle class “outbids” lower income households for housing actually intended for lower income groups.

6.0 MFH Potential in Slum Upgrading and Shelter Provision.

How Can Microfinance for Housing Make a Difference? The low income shelter problem continues to defy solution from a wide variety of approaches. UN_HABITAT has estimated that one-sixth of humanity – 1 billion people – live in slums.[4] Slum upgrading is now the focus of many national governments, mega-cities, donors, and international organizations, with major efforts being made by UN-HABITAT via SUF – the Slum Upgrading Facility, Cities Alliance, USAID and many other donors. Slum upgrading, however, has its own pitfalls, especially in the context of severe shortages of both housing and serviced land. So-called "rent seeking" behavior results in higher income households simply buying out the lower income groups that the slum upgrading program was designed to assist, while the targeted households often move and once again begin the slum and squatting process. For this reason, Jamiibora's planned housing project will be greenfield, to avoid the turnover process experienced in some of Kenya's slum upgrading programs. Historically, this has been a classic failure of sites and services programs.

What role can microfinance for housing play in this difficult environment? That the private sector, and individual low income households need to play a bigger role - and can play a bigger role - in housing themselves, is now widely accepted. However, MFH is hardly a panacea for lower income groups, especially given the problem of reaching meaningful scale. And, most importantly, MFH needs to be built into a context where its usefulness can be maximized. MFH will be more effective when combined with policies that increase the incentives of households to make the maximum possible inputs into solving their own housing problems. Major synergies can emerge when MFH is combined with secure land title, and basic infrastructure provision in order to maximize household incentives to save and to borrow. Where feasible, government subsidies can greatly assist, but only if provided in a manner that does not conflict with the financial incentives.

Thus, if the problems of land supply, land title, and infrastructure are being addressed with government help, then MFH can potentially play a significant role in supporting the housing portion of the shelter equation. Next, the question should be placed in the context of effective demand: what type of dwelling is involved and what are the affordability constraints of the would-be borrowers? If the stated goal is a *modest dwelling including basic infrastructure*, the ability of MFH to help address the affordability gap could be meaningful for modest income households. It could be somewhat helpful for lower income households. However, MFH could only be supplemental for the poorest of the poor, as they will not have the resources to afford an adequate loan and would need an intervention of public or donor funds to supplement private funding via MFH. Nevertheless, even small loans could be used to upgrade simple dwellings.

Broad-based Shelter Programs with Private, Public, and/or Donor Involvement. MFH has been discussed thus far in a somewhat narrow context - that is, loans to individual borrowers, and for the most part, to improve single family housing. The majority of MFIs provide direct loans to individual borrowers and much of MFH lending is as a stand alone product, not necessarily connected to slum upgrading or green fields housing programs. However, there are also groups that focus on the supply side, for example, working with developers, providing multi-family low income housing, providing construction finance, and providing infrastructure. In our sample, **SPARC** has led the way in this regard, and SPARC's leaders continue to look for ways to increase scale, as well as to provide land and basic services. In the case of **K-Rep**, construction finance is the focus. In the case of **Jamiibora**, there are plans to provide very modest income housing – outside the slums of Nairobi - for which members can offer sweat equity and ultimately purchase or rent. Jamiibora's approach is "holistic", addressing issues of income generation, education, health, and insurance for the very poor.

Should Microfinance Institutions participate in Government Programs? ACCION notes that part of the growth in MFH lending has been fueled by government programs channeled through the microfinance industry. The "Techo Propio" program of the Peruvian government's Mivivienda fund target lower income families and complements the original Mivivienda product which tended to reach higher low to middle income segments. Techo propio showed a potential for success in mortgage loans for affordable houses, with 10,000 customers. However, many microfinance institutions prefer not to rely on government programs mostly due to the risk of being interpreted by end customers that the loans do not need to be repaid and also due to bad experiences dealing with the additional bureaucratic procedures associated with these programs. For example, when residents learned that funds for the Hanna Nassif slum upgrading effort in Tanzania had been provided by the Ford Foundation, there was massive default. It may also be costly for MFIs to comply with the bureaucratic procedures associated with these programs.

7.0 What Can Policy Makers and Donors do to Reduce Constraints on MFH?

Three types of barriers were discussed above: decisions by individual microfinance institutions, the ability of the formal financial sector to help address constraints on liquidity, and failures of overall urban housing policy. In the context of these constraints, there is an immense amount that government policy makers and donors can continue to do to increase the involvement of the private sector, including MHF institutions.

Expanding the Number of MFH Institutions. Policy makers and donors can play a huge role in the process of expanding MFH. First is assistance in publicizing MFH in order to bring more micro institutions into this field. Demonstration projects, toolkit materials,

[4] UN-HABITAT, Human Settlements Financing Division, SUF Brochure: A Guide to Working with the Slum Upgrading Facility.

From the learning obtained about the barriers of getting to scale, we can draw a number of policy implications:

- Private sector actors, including banks and regulated microfinance institutions, have demonstrated their ability to deliver tailored housing products for mid-level economically active poor segments, if the regulatory framework allows free decision about loan product features conditions and credit methodology, particularly about product pricing.
- In particular, housing microfinance based on progressive building fills a critical need for the non-indigent poor and is commercially viable, when done correctly. There are examples of successful housing finance programs that do not rely on any government subsidy and came from private sector innovation growing out of an institution's deep understanding of its clients.
- Government subsidies on the other hand play a critical role in making infrastructure available for the low income households (very poor economically active and the non-economically active), and can be especially effective when done in partnership with private sector actors. Successful government initiatives in low income housing, again, are those that strategically use subsidies to encourage private sector participation.
- As noted above, land titling is a crucial issue: although not all lenders require title, studies are now showing that households are reluctant to improve their units without secure tenure.

training, and technical assistance can help the process.

Improving Formal Sector Mortgage Markets will Assist MFH. A first step is to link formal sector mortgage lenders with MFIs that can benefit from lines of credit. Improving the primary mortgage market, and especially increasing competition, will assist in incentives for these linkages. Second, assist formal sector mortgage lenders to increase their own access to liquidity and longer-term funds through development of secondary market funding capacity; at the simplest level this involves the legal framework for mortgage-backed debt, such as mortgage bonds, and legislation permitting capital market institutions to hold a reasonable proportion of their assets in this form. Alternatively, or in addition, strong microfinance institutions can be assisted in obtaining funds directly from the domestic capital market through bond issuance; as discussed below, credit enhancements can assist this process by sharing risk with the MFIs and providing some comfort to the market.

Improving Microfinance Regulation. Regulation can play an important role. Central banks in a number of emerging markets are establishing regulatory regimes tailor-made for MFI. Regulation and supervision of micro MFI necessitates that they have a prudent and sound capital base as well as transparent reporting and auditing procedures. Both will greatly facilitate lines of credit. For example, **PRIDE** in Tanzania is soon to be registered under the Central Bank's new guidelines for micro institutions and is now undertaking a major reorganization under this regulatory framework, dividing itself into the PRIDE NGO, and PRIDE Microfinance Corporation (MFC). This will begin at the end of 2006 or beginning of 2007. Funding is being sourced from the National Microfinance Bank and other banks in Tanzania and from donors and other sources internationally. PRIDE has specifically stated its interest in microfinance for housing. PRIDE MFC will offer small MFH loans; funding will consist of short-term resources, largely savings deposits. In contrast, the NGO will provide larger housing loans ($20,000 for example).

Credit Guarantees. Credit guarantees can be used in many ways to expand both middle market and low income MFIs or HFIs –from commercial banks, formal sector mortgage lenders, and pension and insurance funds – via guarantees. USAID, IFC, OPIC and others all utilize guarantees to leverage funds and provide financial sector incentives to kick-start a process that should be viable in the long-run. USAID's DCA has been widely used to leverage funds, including in the mortgage market context. IFC may introduce a secondary mortgage market development scheme – the Mortgage Funding Trust - into a number of African countries to kick start the capital market funding process for local institutions. Guarantees could also assist with swaps for interest rate risk or foreign exchange risk to address the issues in fixed vs variable rate lending and borrowing in foreign currency.

Comprehensive Shelter Policies. The discussion in section 6.0 above emphasized the importance of placing MFH in the context of a comprehensive shelter policy,

Azania Bankcorp in Tanzania supports low income lending in a number of ways, lends both directly to micro lenders, including PRIDE, and indirectly via low income housing initiatives, such as the **UN - HABITAT/TWLAT** project. Azania is now the bank facilitating this HABITAT project. In order to implement this project, the Tanzanian Women Land Access Trust (TWLAT) was established by Habitat to assist low-income women to purchase their own home. TWLAT will act as the intermediary between Azania Bank, which has agreed to house a $100,000 guarantee from Habitat, and the women that will be borrowing money from the bank to participate in the project. Houses have been designed for different price ranges, but the intention is for each unit to have 3 bedrooms so that the owner can rent out a room for income generation.

including title, and infrastructure. As mentioned, the **UN-HABITAT SUF** is one key initiative – SUF is described below along with an example from Tanzania. The central objective of the SUF is to mobilize domestic capital for slum upgrading by facilitating links among local actors and by packaging the financial, technical, and political elements of upgrading and low income housing development so that they can attract domestic commercial finance. Along with national and municipal governments, NGOs, and CBOs (Community Based Organizations), SUF's partners include banks, mortgage lenders, MFIs, and institutions making up domestic capital markets. MFH can play an important role in this context, if, as discussed above, the land, title, and infrastructure issues can also be addressed. SUF is now being piloted in Ghana, Kenya, Tanzania, Sri Lanka, and Indonesia.

Viable Structures for more Complex MFH. Finally, it should be noted that the projects that involve building multi-family housing, such as those of SPARC and UN - HABITAT/TWLAT, clearly complicate the process and the role of MFH relative to single family housing. Construction finance must first be secured, and then a number of issues may arise concerning the legal framework of ownership, condominium and coop law, and whether the project's status is for purchase, rent, or rent-to-purchase. Again, policy makers can be of assistance in helping design viable structures.

Scaling Up Housing Microfinance for Slum Upgrading[1]

By Regina Campa Sole, Consultant, Laura Moser, Vice President both at Shorebank International, and David Painter, Senior Finance Adviser at TCG International

"Achieve a significant improvement in the lives of at least 100 million slum dwellers, by 2020." (UN Millennium Development Goals)

To achieve the U.N. Millennium Development Goals, it is essential to scale up slum improvement programs to a level commensurate with the rapid growth of slum populations. To eliminate slum conditions over the next 15 years will require a sustained effort on a global scale. This is a challenging proposition since it is clear that scaling up slum improvement will require very substantial financial resources. Central and local governments will never have enough money to do the job entirely by themselves. Only by mobilizing private capital and enabling slum dwellers to improve their own housing conditions on a financially sustainable basis will it be possible to achieve such large scale results.

This paper is organized in a series of questions concerning microfinance for housing in slum upgrading. This paper will examine cases where housing microfinance and other sources of private sector housing finance were leveraged to improve housing conditions in slum communities on a financially sustainable basis. The answers to these questions support our assertion that housing microfinance is potentially the most effective way for slum dwellers to improve their own housing and their livelihoods.

What is Slum Upgrading and why is it important?

Slum upgrading is a programmatic response to existing slum communities that focuses on keeping the community intact while improving the quality of housing, infrastructure and services in the slum. Slum upgrading minimizes physical and social dislocation of the urban poor compared to alternative programs of "slum clearance" or "slum eradication" that typically drive the urban poor from their homes, bulldoze their shacks (and their belongings), and make inadequate efforts to provide alternative housing that takes into account the economic and social realities of the slum dwellers themselves.

What are the main constraints that slum dwellers face to build or improve their homes?

Housing is not only a shelter for slum families – it is their social security. It is estimated that 75% - 90% of all new housing is built informally through incremental housing rather than new home construction. More than half of the population in the world is not served by mainstream housing finance. This is particularly true for those living in slum communities.

Furthermore, it is estimated that fewer than 25% of people in developing countries can afford to purchase the least expensive developer-built unit with traditional mortgage finance because of the entrenched factors in the developing world[2]. Some of these factors are:

1. High real interest rates
2. Lack of long term funding on domestic markets in developing economies which creates interest rate risks for mortgage lending and greatly limits the funding for mortgages.
3. Expensive and costly formal sector systems including those for property registration, land use development and property transfer taxes
4. Instability of household income especially from the informal sector, making long term debt risky for households
5. Many affordable housing projects often poorly fit the needs of low income families.

Due to the above constraints, most slum dwellers do not attempt to build homes and

[1] This paper is excerpted from a larger work by the authors entitled "Scaling up Slum Improvement", presented by the authors in an interactive session at the 2006 World Urban Forum in Vancouver. The full article is available upon request.

[2] Fergusson, Bruce. Scaling up Housing Microfinance: a guide to practice, Housing Finance International (feature),International Union for Housing Finance, Vol. 19, Issue 1, p3-13, September, 2004.

access finance from informal money lenders at rates of interest as high as 120% to 150% a year. These loans have the potential to keep slum dwellers permanently in debt, which may actually destroy whatever security they may have had.

What are the Benefits of Housing Microfinance for Slum Dwellers?

- **Flexibility and Outreach:** Housing microfinance can reach low income households in developing countries, including slum dwellers. HMF provides a flexible form of finance for a wide range of uses, including home improvement, construction of a small unit on a lot already owned by a family or provided by a low-income developer, the purchase of tenure regularization of a lot, expansion of the core unit provided by local governments or to fill the gap between a public subsidy and a household's down payment for a home.[3]
- **Incremental Financing:** As discussed above, incremental housing construction is the norm in most of the slums around the world, which is best served by incremental housing finance. As most slum dwellers have irregular incomes, they are averse to taking on loans with maturities over five years. Housing microfinance offers smaller, more accessible loans with shorter tenures. This type of financing helps the poor establish credit histories, thereby reducing the risk to lenders and ultimately lowering interest rates.
- **Formal title not required:** Another major hurdle for slum dwellers' access to finance is their lack of legal title to their properties. Housing microfinance accepts alternative forms of collateral, such as co-signers, forced savings, home appliances and other non-mortgage forms of guarantee. While housing microfinance providers do need some kind of assurance about right of occupancy, they accept tax receipts and other substitutes.

What are specific common themes among successful models to help practitioners glean lessons learned?

SBI (ShoreBank International Ltd.) conducted an inventory of sustainable models for channeling private sector finance to slumdwellers as part of its Global Financial Innovations Partnership, a Global Development Alliance with USAID. Below are summary lessons learned from the analysis of successful housing microfinance models[4].

- **Targeting the poor and having high repayment rates are compatible:** Microfinance providers have shown that a legitimate traditional system of small savings can be applied to provide access to credit to the poorest of the poor. The social capital inherent in the local traditional systems can be modified and leveraged for use in microfinance. These systems are easily adapted to the tools of microfinance as they are well suited to the existing structures of the local community.

INSTITUTIONAL PROFILE: THE KUYASA FUND

The Kuyasa Fund is a non-profit MFI in Cape Town specializing in the provision of housing loans for un-banked and under-banked low income households with secure occupational rights in Khayelitsha. South Africa's fastest growing township.

With an outstanding loan portfolio of $1.2 million and a repayment rate of 93%, Kuyasa targets low income households whose incomes are just below the poverty datum line for the average urban South African households (around $310 for a family of six).

Product Characteristics:

- Kuyasa uses collective peer group dynamics to mobilize savings and assess potential.
- Loan size from R1,000-R10,000 ($140-$1400). The maximum loan granted is limited to three times the savings or a maximum of R10,000. The average loan is R5,000 ($720).
- Loan Terms: repayable over 6 to 30 months.
- Conditions: 32% interest rate per year.
- Loan uses: (1) Purchasing houses on serviced sites; (2) Home and/or property improvements to existing housing, such as storage, roofing, etc; (3) Improving and extending developers houses; (4) Purchasing sectional title units in undeveloped land,
- Life insurance (fee based product): Non-repayment risk life insurance is included in the fee structure of the loan products.

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3 Fergusson, 2003.

4 SBI carried out a comparative analysis of existing slum upgrading financial models and financing strategies to find and analyze which of them could be most effectively brought to scale to broaden their impact. SBI had interviewed 19 practitioners that are experts in urban and slum upgrading, microfinance, housing and social investments; as well as collected and reviewed 29 case studies. This thoughtful research and analytical exercise was part of the Global Financial Innovations Partnership, a Global Development Alliance (GDA) with USAID.

- **A properly managed loan process, visibility of loan officers and peer pressure from community members can sustain high repayments:** Microfinance providers have also shown that the ability of the poorest of the poor to repay loans can be predicted through a strict analysis of saving patterns and past loan records.

- **Importance of savings groups as risk management strategy:** The risks of loans can be considerably decreased in a group lending method as clients are pressured by their peers to repay their loans. These groups also fulfil an important social function, as group savings are a form of security for emergencies for poor people. The savings group activities also give them the chance to prove their financial and organizational skills.[5]

- **Right of occupancy as permanence proof:** Formal title is only one of the ways to recognize the permanence of slum dwellers on their plots, probably not the most effective or suitable in many cases (titling registration is expensive and burdensome, no updated registration system, etc). It is more important to recognize permanence, than to recognize ownership. Thus, the home itself is often not the collateral and the lender relies on alternative forms as security (described below).

- **The best collateral for housing loans need not always be the mortgage:** Savings, co-signers and household articles as collateral can be as effective for housing micro finance.

- **Expansion and scaling up requires profitability:** the greatest priority is to ensure that operational scale and efficiency is developed to enable operations to be financially sustainable. Once the financial sustainability is achieved, alternative sources of sustainable wholesale financing (loans from banks, access to financial markets) can become available. In the case of micro enterprise MFIs, Principal Debt Outstanding growth is possible by deepening loan activities with existing clients. However, in housing microfinance growth requires expansion, because even though there may be some repeat borrowings, sustained growth means new clients, new areas of operation, and new products.

- **The private sector can play a crucial role in slum upgrading by recognizing low income families as clients** (*Approach from the Bottom of the Pyramid*[6]). In fact, a program developed by the Mexican cement company CEMEX called Patrimonio Hoy (PH), demonstrates that the low-income population can be indeed a reliable and profitable segment of the market. PH is a profitable initiative, and provides a comprehensive housing solution for poor people at market prices, with no subsidies, and exclusively relying on private funding. However, corporations need to invest heavily on the front end by understanding the low income segment of the market, and designing products and services tailored to their needs and cultural values (it took PH some seven years to design and roll-out the program).

- **Buy-in by stakeholders is a prerequisite of success:** Even though the program was designed as a win-win solution for all stakeholders, PH faced internal reluctance from CEMEX Corporation to serve low-income households, as well as initial distrust from this segment of the market. On one side, launching PH required CEMEX corporate funding for years, which clashed with the short-term business vision prevalent in many corporations. In fact, PH reached the break even point in October 2003 (after 42 months), and all the investment was paid back to CEMEX in April 2005 (nearly seven years from the initial concept). Top management's leadership and support to the program was crucial to overcome the internal reluctance. On the other side, PH invested in building trust among the community by fulfilling all of the program's promises, providing high consumer service standards, having local presence, and enrolling members of the community as promoters.

- **Knowing the borrower is essential:** Instead of strict credit evaluation and collateral, PH preferred to minimize risks by extending a minimum credit to people who sign up to be "members" in the first phase of the program and testing their commitment as the program progresses. This strategy ensures that business volume increases without exposing the company to big risks. This not only helped the company build a credit history of its own clients for future transactions, but also minimized administrative costs. It is also very easy for the new client to understand the rules, thereby lowering access to financial barriers for the low-income market.

- **Long term customer retention in this market segment is challenging:** Even though customer enrollment is growing at a rapid pace, many members in the PH program take a break from the rigors of repayment once one room is complete. In many cases people cannot afford to pay both the installments and the masonry fees, so they buy the materials at one time, and then after 70 weeks, start building houses. The customer retention problem could also spring from the cultural belief that fate determines outcomes, leading to the conclusion that long term planning is worthless. PH is working to overcome both problems, by creating a "club experience" that motivates productive behavior, and by establishing masonry training facilities for "self construction" for members.

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[5] This point emphasizes the importance of a savings group as a risk mitigant and skills building vs. the way microfinance leverages these groups to provide financial services. I've reworded it slightly.

[6] Prahalad, C.K. (2005) *The Fortune at the Bottom of the Pyramid. Eradicating Poverty Through Profits.* Wharton School Publishing.

INSTITUTIONAL PROFILE: PATRIMONIA HOY

Patrimonio Hoy (PH) offers micro-credit for purchasing building materials based on solidarity of a group with no collateral. This supply lending program is 100% privately funded by CEMEX, the third largest multinational cement manufacturing company in the world, operating out of Mexico. Launched in 1998 to reach the informal or self-construction segment, PH targets low-income workers, whose households earn approximately 50-150 pesos ($5-$15) per day.

In 2005, PH had 48 offices in 23 Mexican cities, with more than 75,000 participating families, who have built the equivalent of 33,000 additional 110 sq. ft. rooms. The repayment rate was 99.2%.

Program features:

- Provides $4 of materials for each $1 saved.
- Membership: 15 pesos/per member (“socio”)/per week,
- Fixed raw material prices for 70 week periods.
- CEMEX sells construction materials to participants at market prices.
- Technical advice for customized house growth project for each family provided on fee basis (one room at a time).
- Warehousing services to store materials according to their needs.

The first phase of the program lasts 10 weeks. Each member starts by paying PH 105 pesos (after taking 15 from a total of 120 pesos) for the first 5 weeks, totalling 525 pesos. At the end of the 5th week, PH delivers raw materials for construction worth 1,050 pesos, effectively providing the members with a credit worth 5 weeks payment. This phase helps to establish the credibility of PH in the community by delivering on the promises it made and also tests the commitments of the members.

The second phase of the program is 11 to 70 weeks, during which members receive raw materials worth ten weeks at the end of week two of the second phase, ie, materials advance of eight weeks if they remain committed beyond the first phase. Deliveries are made during weeks 12, 22, 32, 42, 52 and 62 if the members keep up their weekly payments and stay in the program.

- **Government also has a role:** Governments should adopt policies that can enhance competition in the housing micro finance sector as only heightened competition spurred by new entrants into the market is likely to lower the interest rates on a sustainable basis[7].

- **Diversify funding to capital markets:** on balance sheet corporate debt or corporate bonds are the most appropriate for housing micro finance providers because of the small amounts, relatively short term and diversity of housing micro loans[8].

What is the impact of financing on housing quality in slums?

Housing microfinance allows the poor people in slums to buy good quality construction materials. Without access to finance, slum dwellers often buy small quantities of construction materials often of low quality, which in turn will negatively impact their housing quality. Quality of housing in slums is an obvious advantage of housing microfinance.

Most housing microfinance providers want to ensure that their clients build good houses. This is in the interest of the housing microfinance provider, given that housing quality will have a direct effect on repayment rates, as well as on the provider’s image among slum dwellers. Hence, most housing microfinance providers recommend or even require beneficiaries to purchase materials from a reputed supplier. Housing microfinance staff are trained to ensure that the slum dwellers get better quality materials than they could buy independently. Some housing microfinance institutions have contracts with material providers through which the borrowers get discounts, while the supplier gets a constant stream of business. Whatever the relationship between the housing microfinance institution and the supplier, it has a positive effect on the housing quality.

As new entrants like construction material suppliers and even cement companies are coming to the market to provide housing micro finance, the quality of housing should continue to improve in slums. The CEMEX/Patrimonio Hoy case places considerable emphasis on enhancing the technical skill of its borrowers. They do so by providing an architect or advisor for the borrowers for a small fee. It is found that good construction practices actually decrease the housing costs, while improving the quality at the same time.

[7] Fergusson, 2003

[8] Fergusson, 2003

Is housing microfinance financially sustainable?

Housing microfinance lies at the intersection of formal housing finance and micro-enterprise finance[9]. It can be sustainable with the necessary scale, on an institutional basis. At scale, several successful housing microfinance providers can be a good tool for national governments in solving the shelter and settlement problems. For example, the Ministry of Housing in Morocco, currently undertaking a large slum upgrading program ("Villes Sans Bidonvilles" or "Cities Without Slums"), estimates that 80% of slum dweller's financing needs will be met by incremental housing microfinance loans as opposed to mortgage finance[10]. The involvement of mainstream financial institutions in housing microfinance is critical to leverage local capital necessary to scale up and make micro lending sustainable. This will help the housing finance institutions improve their market access by providing services to the low/moderate–income households, which constitutes the majority of the population of the developing world. Specifically, microfinance institutions require access to additional, commercial sources of financing, such as loans from commercial banks and bonds, which would provide liquidity, particularly in local currency, to the sector and thereby allow it to reach scale.

One of the major challenges for the sustainability of housing microfinance is the access to long term funds for the housing microfinance providers, who often experience a mismatch between the assets and liabilities. In developing countries, this mismatch is true even for mainstream financial organizations, due to institutional constraints on interest rates and access to capital markets.

There are many approaches to solve the problem of access to long term capital: international markets, warehouse lines of credit, secondary market approaches, etc. In the meantime, national governments can encourage the mainstream financial organizations to enter into partnerships with MFIs. However, in some countries, the regulatory environment is not conducive to such arrangements. A common circumstance is that central banks prohibit banks from lending to MFIs. Additionally, the collateral requirements imposed by central banks on national banks for lending to MFIs, where the ultimate sub-loans are not secured by traditional forms of collateral, effectively scuttles any possibility of accessing long term finance by housing MFIs.

The mainstream private sector financial institutions in housing microfinance often lack familiarity and tools to reach the target market. Commercial banks are learning the value of MFIs as a service linkage and are building bank capacity to develop policies that recognize irregular incomes of slum dwellers. Thus, credit policies should be adjusted to meet the needs of low income people. Indeed, a "one size fits all" set of guidelines and regulations for all segments of society will not encourage the mainstream financial institutions to reach out to low income populations.

Another critical aspect for sustainability of housing microfinance is profitability (linked to reaching scale). Profitability will eliminate the dependency on grants to sustain the operations. At present, the high administrative costs amounting to almost 20%[11], makes the interest rates very high. Even though these rates are low compared to the money lender rates, they deny access to many potential customers, and thus reduce the business for MFIs. Use of appropriate technologies can bring down the administrative costs to a certain level. There are instances where housing microfinance institutions have significantly increased the number of loans processed by one officer by improving the technology. These kinds of improvements will go a long way in making housing microfinance sustainable.

Cross selling other products can augment the coverage of these institutions, and hence subsequently increase the access to slum dwellers. Some examples of offerings include savings products, remittance services, and other types of credit by housing microfinance institutions. This kind of relationship banking with clients in slum dwellers can further contribute to sustainability for housing microfinance institutions. A diverse portfolio of products will increase the number of clients for the housing microfinance institution, as well as raise the repayment rates, contributing to the sustainability of operations.

What is needed to scale up slum dwellers' access to housing micro-finance?

Low income communities are inherently considered risky, involving high transaction costs and small margins. Private sector involvement, crucial for scaling up any initiative, is limited mainly because of this risk perception. Hence, the main challenge for regulators is to reduce the risks associated with private sector participation, in order to mobilize additional capital.

In addition, it is important to avoid premature and inappropriate regulations, especially interest rate caps. Regulators should not compare housing microfinance interest rates to the mortgage lenders. They should be compared to the rates of informal providers.

1. Governments should replace interest rate subsidies with direct demand subsidies, preferably in the form of portable homeownership or downpayment vouchers. These

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[9] Daphnis, 2004.

[10] From conversations between ShoreBank representatives and the Minister of Housing and other ministry representatives of the Kingdom of Marroco in November 2005.

[11] Ferguson, 2003.

subsidies can complement the housing micro finance for poor people and also will effectively avoid distorting the market.

2. Governments could further encourage select private financial institutions with a good track record in serving low income people with other products to demonstrate the feasibility and profitability of housing microfinance. This might require these institutions to develop specialized terms for underwriting, marketing, servicing and collateral guarantees. SBI is currently working with the Moroccan bank BMCE Bank, to pilot a lending for slum dwellers who are purchasing government-subsidized new homes. In this instance, SBI and the bank have created “Retail Platforms” to bring the bank directly to the slum dwellers. SBI worked with BMCE to adapt the lending methodology to account for informal and irregular incomes. Prior to launching the products with BMCE, SBI conducted demand surveys of income levels in the slums to segment the market and determined that many slum residents indeed qualified for these loans. BMCE is further leveraging a government-sponsored guarantee program, FOGARIM, which was created to encourage lending for low income housing needs among private commercial banks. While the pilot with BMCE is still in the early stages, BMCE has lent $23 million to the low income housing sector, including slum dwellers, since the pilot began in early 2006. In cases where long-term funding for on-lending to MFIs is limited, such funding could be mobilized through international equity investment or bond issues in the local capital markets.

3. Promote research and best practice dissemination in the field of housing microfinance to improve performance of individual institutions and encourage more entrants and competition in the field.

4. Housing microfinance providers can establish strategic business partnerships with a variety of building materials suppliers to market housing microfinance. This is the case of MiBanco in Peru, who established marketing arrangements with the largest cement producer in Peru, a roof manufacturer, an association of lumber suppliers and carpenters, and hardware stores. These alliances will probably evolve into financing partnerships, which will probably enhance the ability of MiBanco to reach a larger number of customers for its housing microfinance products.

5. Capital market developments such as secondary markets, bond issues, mortgage insurance, special purpose vehicles, and other such tools could expand housing microfinance.

6. Improvements in portfolio performance (credit underwriting and collections), efficiency, technology, and ultimately, profitability, will be the primary determinants of each institution’s success and of the viability of the model.

Conclusion

The basic finding is that housing microfinance has the potential to become one of the most effective ways for slum dwellers to improve their own housing and their livelihoods. Housing microfinance has the following critical characteristics:

- It overcomes two main obstacles preventing the poor from accessing traditional housing finance: incremental building and the requirement of collateral.

  On one side, the small and sequential loan products that characterize housing microfinance suit the progressive building methods of the poor and is also affordable. This model not only fits the construction practices of the poor, but also reduces the risk for credit providers as the loan amounts are small. Some of the important benefits for the borrowers are the small repayment increments and flexible repayment terms that suit poor people whose income fluctuates unpredictably over the long term.

  On the other side, the use of alternative collateral arrangements is very effective in reducing the risk to the credit providers and thereby enabling the poor to access housing finance. Successful housing finance providers have developed a variety of innovative collateral arrangements for their loans so that they are better suited to poor borrowers.

- It could achieve the required large scale and be done on financially sustainable basis. The phenomenal growth and expansion of microfinance has proven that the low income population certainly offers a business opportunity for the private sector. The provision of quality housing for the poor in slums will be enhanced by involving the private sector in government slum upgrading efforts. But it is also evident from the cases that the involvement of the private sector may not occur automatically and certain conditions may be necessary for encouraging the private sector to enter this market. The key is to create an enabling environment in which the private sector can operate. This may look different in different countries. An equally important factor is the adoption of innovative financial models by the private sector so that they can provide the flexibility needed when targeting the poor while keeping their risk at a manageable level.

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Promoting Housing Finance Market Development in Armenia

By Dr. Karapet Gevorgyan and Stefan W. Hirche, KfW Entwicklungsbank[1]

Introduction

In the following we outline the comprehensive approach that Armenia is taking to develop its housing finance market. In the introduction, we provide a background on the socioeconomic and financial sector reforms implemented in Armenia during its transition to a market economy as well as a snapshot of the banking market. Further on, the article describes the situation of the Armenian housing stock and of its housing finance market. Given that background, we explain the vision that the Armenian government and the Central Bank of Armenia (CBA) developed together with KfW Entwicklungsbank to support a vibrant housing finance market. Then, the paper continues with the outline of the joint CBA/KfW development program, which assists in the creation of a strong primary housing finance market and prepares the ground for secondary market development at a later stage. Concluding, we point out early impacts of our efforts so far, offer an outlook of future challenges as well as suggestions for the involvement of other actors in strengthening the housing finance sector in the country.

Starting in 1995, the Armenian government and the CBA launched a wide program of socioeconomic reforms, starting with a massive privatization of agricultural land, state-owned entities (at the early stages only micro, small and medium sized enterprises (MSME)) and residential property. These reforms also addressed the financial sector and in particular the banking sector. Since the Armenian government and CBA initiated these reforms, they submitted the banking sector to a significant restructuring. Programs and policies have been aimed at strengthening supervision (both on- and off-site), gradually increasing capitalization, consolidating of the banking system, integrating corporate governance and implementing anti-money laundering regulations.

The CBA continued down the reform path, broadening and deepening initial measures. In 2005, it integrated other components of the financial sector (insurance, capital market) into a unified supervision structure, and commenced to actively reform these segments. These reforms helped realize two of the essential preconditions for long-term funding and economic vitality: sound insurance and properly functioning securities markets.

The reform course resulted in macroeconomic stabilization and growth, as well as positive developments in the financial system since 2001. In the past four years, the Armenian economy has been growing at a double-digit rate, with stable inflation (under 3% pa). The forecast for the current year is similar, which has earned Armenia the label "Caucasian Tiger" in some recent economic publications.

In the past few years, financial intermediation of the banking system has been rising gradually from a low level, with the banking sector of 21 institutions broadening its customer base under moderately increasing competition. The trend is well reflected in the figures: in 2005, total assets of the banking system and domestic loans grew by 21.2% to EUR 828 million and an impressive 34 % to EUR 555 million respectively. Notwithstanding this positive trend, the level of financial intermediation in Armenia remains unsatisfactory. The ratios of banking system assets to GDP and loans to GDP stand at 19.8% and 8.3% respectively (rising 0.6 and 1.3 percentage points). The low level of financial intermediation is confirmed by relatively high interest rate spreads in Armenia. In 2005, these ranged between 13% and 16% pa[2]: high in comparison to those of more advanced markets, such as the average 5% pa of the Baltic and Central European countries.

Such high interest rate spreads are partially explained by the small size of Armenian banks. However, another important factor is the limited supply of funding at adequate maturities. The demand for long-term loans is growing but "long" savings in the economy are virtually non-existent. The mismatch in attracting and allocating

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[2] CBA (2006)

financial resources generates a need for additional coverage against expected losses from related risks (liquidity, interest rate, etc.).

The housing situation and housing finance market in Armenia

With the collapse of the Soviet Union and the interruption of financing from the central Soviet budget, all major construction of residential housing stopped. In most cases, the construction of 80-90% of the finished multi-floor buildings remains incomplete. Large blocks of concrete stand unfinished and uninhabited in younger quarters of the capital city Yerevan and other major towns. This implies that most of the available housing (except for privately driven construction of expensive villas and small stand-alone houses) dates back to the period from the late-1960s until the mid-1980s.

The current condition of this inherited housing stock is dire and is deteriorating further for three main reasons:[3]

- Armenia is located on an unstable tectonic plateau and the most recent large earthquake in 1988 caused major damage to housing in northern and central parts of the country, including Yerevan;

- no major repair and maintenance projects to prevent the gradual ruin of existing multi-apartment buildings have been financed and carried out since the early 1990s;

- even basic everyday maintenance has been extremely limited in the last two decades, as neither the private apartment owners nor the municipalities in charge of the buildings has had the necessary financial resources.

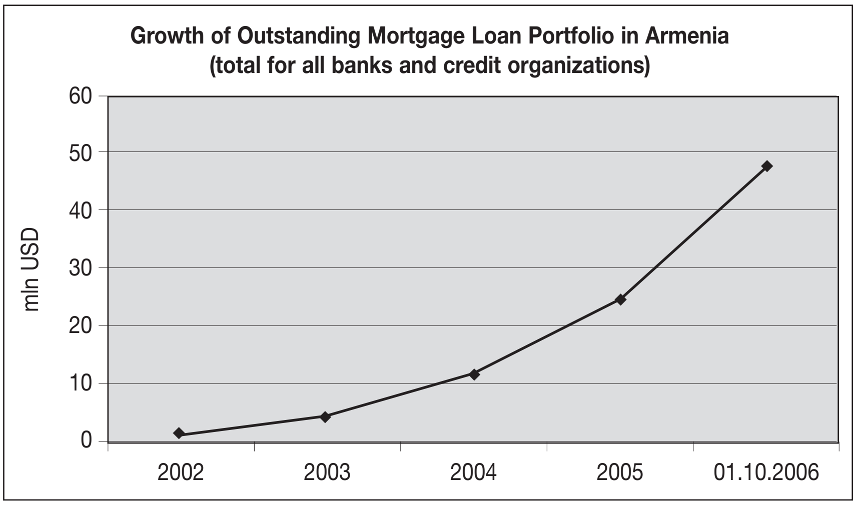
Although the last few years are characterized by a new and growing dynamism, the observed construction boom is mainly concentrated in Yerevan city center. The newly created, so-called “elite” apartment blocks are priced extremely high and are unaffordable even for the aspiring Armenian middle class.

To overcome or at least reduce the shortage of affordable, good-quality housing, it is important to make housing more accessible for large parts of society. As a key component of this objective, local financial institutions should be able to design and offer adequate financial products on a continuous basis. Through offering long-term mortgage loans with relatively moderate monthly installments, the housing finance industry will be one important part of the remedy.[4]

The provision of such services by Armenian banks and more recently by a few specialized credit organizations is a relatively new development in the Armenian economy, as the first housing loans were extended only in 2002. These initial housing loans were typically small loans averaging USD 5 to 10 thousand, provided mainly for incremental housing.[5] Beginning in 2003, financial institutions added “larger” loans, generally up to USD 30,000, for the purchase of apartments or construction of private homes to their product portfolios.

Since then, the mortgage finance market in Armenia has been growing fast, supported by favorable macroeconomic conditions and a continued strengthening of the banking sector. According to CBA statistics, the year-over-year volume of mortgage loans tripled in 2003, growing by 150% in 2004, doubling in 2005 and gaining an

Development of Main Indicators of Armenian Housing Finance Market (Chart 1)

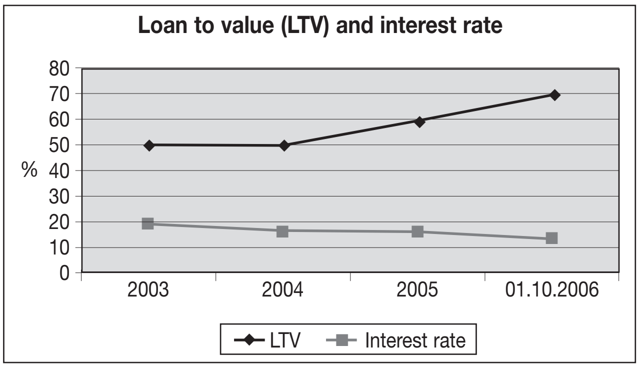


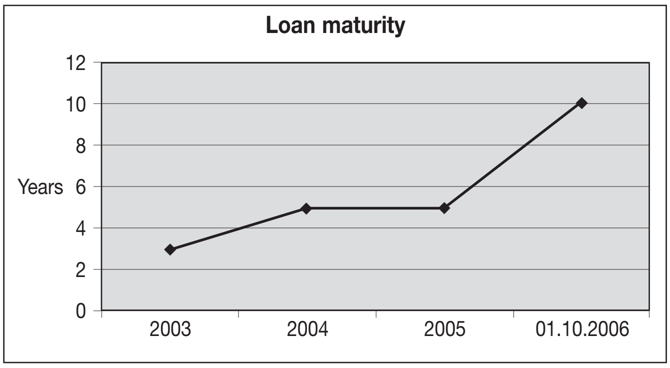
[3] United Nations Economic Commission for Europe (2004), p. 13-16, 18-20

[4] Ibid., chapter V

[5] Incremental improvements of housing are the refurbishment of a house or an apartment room by room, the replacement of parts of the roof or the addition of a new room.

Development of Main Indicators of Armenian Housing Finance Market (Charts 2 and 3)





additional 90% during the first nine months of the current year, resulting in a total outstanding portfolio of around USD 50 million as of 1 October, 2006 (see Chart 1).

This growth is mainly supported by improving terms and conditions on the supply side: as of early 2003, a typical housing loan had a maximum loan-to-value (LTV) ratio of 50%, an interest rate of 17-20% pa and a maturity of three years. As of mid-2004, the typical LTV and interest rates were similar, but the most common maximum term had become five years. Currently, an interest rate of 13-16% pa is common – with some banks offering a rate of 10-12% pa to customers with long and positive financial records; and the main mortgage lenders recently extended the maximum maturity to 7-10 years (see below Chart 2 and 3).

Even though the total mortgage loan portfolio of Armenian banks has been growing quickly, the supply of such loans is still limited to comparatively higher income groups of society. Therefore, the Government of Armenia and the CBA, supported by KfW Entwicklungsbank, have conceptualized a program, which shall have a two-tier impact: first setting conducive "rules of the game"; and second, increasing the supply of long-term funds for mortgage lending in the local financial sector. This approach will improve the supply of housing credit, decreasing the mismatch of the "demand-supply" relation. Most importantly, it will facilitate access to these loans for mid- to lower-income social groups, making housing credit "more affordable" for the general public.

Developing a Strategic Vision for the Housing Finance Market

Given the limited financial capacity of the Government of Armenia to cater to the growing housing needs of the Armenian population, the authorities have shown great interest in stimulating private sources of funding to serve these needs. This would allow concentrating the Government's scarce resources on the neediest part of the population. The main conduit for the mobilization of private resources would be the financial industry, offering long-term mortgage loans. However, many enabling factors for the development of a vibrant housing finance market have been missing. The CBA, together with the Ministry of Finance and Economy, took the lead in improving the situation. Both developed their visions of a strong housing finance market, emphasizing the need to first strengthen the legislative and regulatory framework, and thereafter the institutions of the financial sector. The goal set by the Armenian authorities was to support the quick development of both lending institutions (commercial banks and credit organizations[6]) and insurance companies to accommodate market development; to develop adequate mortgage and housing saving products; and to create a sound primary market, upon which a secondary market would be based.[7]

With these concepts the Armenian authorities turned to KfW Entwicklungsbank, a long-term partner in developing and strengthening the financial sector under the umbrella of bilateral German-Armenian Financial Cooperation (FC).[8] Together the partners commissioned a pre-feasibility and feasibility study to structure the overall approach to market development and KfW Entwicklungsbank's contribution. From the beginning, the assistance was designed to take a systemic

[6] Non-bank financial institutions are not entitled to accept deposits.

[7] Central Bank of the Republic of Armenia (2004) and Ministry of Finance and Economy of the Republic of Armenia (2004)

[8] KfW Entwicklungsbank conducts German FC on behalf of the German Federal Ministry for Economic Cooperation and Development. In financial sector development, the CBA and KfW Entwicklungsbank have so far successfully cooperated in introducing a viable deposit guarantee system, as well as a revolving refinancing scheme for MSMEs through local commercial banks ("downscaling") under the framework of the German-Armenian Fund. The Ministry of Finance and Economy and KfW Entwicklungsbank have set up the Credit Guarantee Fund, which provides partial 'AAA' guarantees to facilitate borrowing of Armenian commercial banks on the international capital markets. These guaranteed loans are used to finance medium-term loans for local small and medium enterprises.

approach, encompassing legal and regulatory advice, the establishment of minimum quality standards (MQS) for the market[9] and for products, provision of long-term financing to the development of a secondary market in the country as well as assistance in the coordination of all donor activities in this sector. The Government of Armenia entrusted KfW Entwicklungsbank with this wide “mandate” based on the successful prior cooperation.

During the preparation and design phase of the program, German FC financed consulting services to assist the Government of Armenia in creating a strong legal framework for housing finance in the country. The foundation of a strong legal framework provides a favorable environment for borrowers, financial institutions and other market participants. Although “the legal framework for the primary mortgage market [had already been] reasonably strong, particularly as compared to other transition countries in the region,”[10] the Armenian Government had decided that additional improvements to the legal and regulatory environment of the primary housing finance market would further enhance the growth potential of mortgage lending. The review and recommendations of the consultant on the current legal framework and new legislation under consideration were incorporated into the legislative process in two stages.[11] Thus, the Government of Armenia had already set conducive framework conditions for housing finance at the inception of the market.

As the legal and regulatory framework is but one of the success factors of a sound market environment, German FC also supported the Armenian market participants in the creation of adequate rules and unified practices in the form of MQS for mortgage lending. These voluntary standards will facilitate the creation of quality mortgage products, contribute to consumer protection, and improve originating, servicing and risk management. They will also help create a secondary market by attracting potential investors, which in turn will contribute to an increase in sustainable long-term sources for mortgage lending. The sound legal and regulatory framework and the MQS will allow borrowers to benefit from lower monthly installments, bringing better housing into the reach of lower-income households.

Upon these foundations, market participants will be able to build their mortgage portfolios. However, this will not be possible without a further prerequisite for affordable long-term housing finance products: the availability of refinancing with similar maturities – either from local capital markets, international financial investors, donors or international development finance institutions. The first option would be most desirable. It is the goal of the Government of Armenia and the CBA, as it would make funding available in local currency and would be less vulnerable to external shocks. However, a capital market that is both long-term and liquid does not yet exist in Armenia. At the same time, international financial investors are not yet prepared to invest long-term funds at a sufficient level in the country. Until the establishment of a viable local capital market or increased risk appetite by international financial investors, donors and development finance institutions, such as IFC, EBRD or KfW Entwicklungsbank, are the main sources of long-term funding for local financial institutions that matches their mortgage portfolios.

As the objective is to create a secondary market at a later stage, the feasibility study recommended structuring the refinancing facility under the German FC program as a liquidity facility, which refinances newly funded housing loans in local currency that meet certain conditions. In fact, the CBA and KfW Entwicklungsbank had already been running a similar local currency refinancing program for MSME lending, which will be used as a platform to develop an adequate housing finance program. Moreover, this set-up will facilitate the introduction of future secondary market operations.

Finally, making housing finance accessible to the previously unbanked and mainly lower-income groups is an important objective of the Government of Armenia. Although households may have sufficient income to repay a housing loan, this remains difficult for them to prove in many cases. As many Armenians do not yet use formal financial services and positive credit information from other sources is not available, banks and credit organizations have difficulties in determining new clients’ creditworthiness. In addition, the high level of income from informal sources and remittances of large segments in the Armenian population makes it very difficult for financial institutions to establish the payment capabilities of private persons to service a loan, be it short- or long-term.

Therefore, the feasibility study advocated the introduction of a ‘contractual saving scheme for housing’ (CSSH). A CSSH would allow customers to establish their creditworthiness with a lender by saving a regular amount for an agreed period.[12] As a result, the lender would be able to grant a housing loan, knowing that this customer has reliably paid in money over an extended period of time. On the other hand, the customer would benefit from a longer repayment term, thus lowering the actual redemption rate and raising overall affordability.[13]

Based on the recommendations of the feasibility study, the Government of Armenia and the CBA, together with KfW

[9] MQS include standards in underwriting, documentation, administration and data collection. They are aimed at establishing effective and efficient mortgage lending procedures and improving the risk management of mortgage loan portfolios.

[10] Rabenhorst and Butler (2005), p. 4

[11] For recommendations of the reports see Rabenhorst (2004) and Rabenhorst and Butler (2005).

[12] The proposal for an Armenian CSSH does not foresee a subsidy (“savings bonus”) to be part of such a product.

[13] Rabenhorst et al. (2005), p. 41-43.

Entwicklungsbank, developed their program to support housing finance market development.

Implementing the Vision

Toward the end of 2005, and coinciding with market expansion, market participants became more active and initiated an organization of the core players in the housing finance market. These included banks and credit organizations on one hand and insurers and real estate agents on the other. By March 2006, twelve organizations founded the Mortgage Market Participants' Association of Armenia (MMPAA). The MMPAA's main objectives are the development and continuous improvement of the MQS and representing members' joint interests in regard to the legal and regulatory environment in their dealings with the CBA and other authorities. The still very young MMPAA has already prooved itself capable of maintaining dialogue regarding MQS with the main policymakers and is successfully cooperating with foreign experts in charge of market development as well the institution, which provides staff training courses to the sector.

As a result of the feasibility study, the Armenian and German governments agreed to promote market development by focusing on a strong primary market before continuing with building a secondary market. German FC provides an initial FC Loan14 of EUR 6 million for long-term refinancing of mortgage loans as a new program under the German-Armenian Fund (GAF),15 which manages a kind of liquidity facility. An additional FC Loan of EUR 6 million for the same purpose is under consideration for the 2007 German-Armenian intergovernmental negotiations. This second tranche can be further increased by blending it with capital market funding to broaden the socioeconomic impact of the program. In addition, an agreement for an FC Grant of EUR 1.5 million has been signed for accompanying measures to the program, ie consulting services supporting the investment, strengthening the financial sector and assisting the coordination of donor activities.

In a local tender – a two-tier process with quantitative and qualitative parameters – the GAF has approved eight partner financial institutions (PFIs) out of 18 applicants – six banks and two credit organizations specialized in mortgage lending. Under the program, the GAF will provide the PFIs refinancing lines with maturities of up to eight years for their mortgage portfolios in local currency. The refinancing rate to the PFIs will be set based on the market environment and the anticipated demand by the PFIs. This will support two important policy goals set by the CBA: extending the maturities of (housing) credit and reducing the degree of dollarization in the economy.

To be eligible for refinancing, loans presented must adhere to the MQS, have a minimum maturity of ten years and an amount of less than AMD 12 million.[16] The refinancing window will operate from February 2007, allowing all PFIs to establish necessary internal structures and processes in advance and to have an adequate number of qualified staff available. As the refinancing will be provided on a continuous, revolving basis, with net revenues being retained for additional refinance, the GAF shall be able to sustainably support the development of the housing finance market in the long run.[17]

The consulting services under the program began in June 2006 to prepare the GAF refinancing window. The program consultant, Bankakademie International, started its assignment by the creation of a housing finance training program (HFTC) in cooperation with a local training institute. Based on the MQS, the training courses offered will provide necessary qualifications to loan and risk officers as well as managers of banks and credit organizations. The classes are open to other market participants (eg, insurance companies, appraisers, realtors) as well, in order to create a coherent understanding of the market's standards with a broad range of actors.

The purpose of the HFTC is to establish high quality standards in lending institutions to further strengthen the Armenian financial system as a whole and to improve overall service quality for borrowers. By now, only five months after kick-off, the curricula are established, local trainers have been selected and educated, and the first round of courses both for loan officers and managers has already taken place. The local training institution will offer the HFTC regularly to ensure an adequate supply of qualified professionals that will be required to sustain the rapid expansion of the housing finance market.

The work on the CSSH with the CBA and interested commercial banks will commence in 2007. The general design will likely include a long-term savings component at market rates in regular installments. The loan component may offer a lower interest rate on the loan, a higher loan amount than the savings amount (eg a multiplier of 2) or any combination of the two options. However, the bank will reserve the right to decline a loan offer in case the customer is not creditworthy. In this case, the bank will pay back the savings (including interest) to the customer. CSSH could be denominated either in USD or AMD.

[14] FC Loans are granted at the internationally agreed terms and conditions of 40 years maturity, 10 years grace period and an interest rate of 0.75% pa.

[15] The GAF is a revolving refinancing fund established back in 1998 under the umbrella of the CBA. Up to now, it has been providing local currency credit lines to five local banks for lending to MSMEs.

[16] AMD 12 million equal about EUR 24,700.

[17] The program would be able to refinance an outstanding portfolio of a minimum of at least 800 housing finance loans (estimated average loan size: EUR 15,000) at the same time. Given the option to leverage of the FC loans through capital market funds, the revolving nature of the refinancing window and the increase through interest earnings, the overall impact of the program's refinancing will be much higher.

In the framework of the program, the Government of Armenia has requested that KfW Entwicklungsbank take the lead within the international donor community in the housing finance sector. The purpose is to catalyze the cooperation between various projects in this field and to facilitate the coordination among the donor organizations and development finance institutions, which provide funding, technical, and institutional assistance to this segment of the Armenian financial sector. In addition to KfW Entwicklungsbank, the main international bilateral and multilateral organizations that have declared their strategic interest in developing the mortgage lending market and supporting the enabling legal-regulatory environment include USAID, EBRD, IFC, ADB and the World Bank.[18] For the sake of avoiding duplication and overlap of activities among different programs, thus maximizing the efficiency of the use of scarce financial resources available to this sector, KfW Entwicklungsbank has assigned a Local Coordinator for Housing Finance (LCHF) to the Government of Armenia and the CBA. The LCHF has commenced his assignment parallel to the program consultant team in July 2006.

In preparation for strong growth of the long-term mortgage finance market and accompanying demand for long-term refinancing, the Government of Armenia and the CBA also receive legal advice for the creation of adequate secondary market legislation, within the scope of above consulting services. Given that the direction of market development cannot be foreseen at this early stage of its development, it seems likely that the draft laws both on covered mortgage bonds as well as securitization and asset backed securities will be developed. Currently, the Government of Armenia and the CBA are elaborating these draft laws in cooperation with the consulting team. An early adoption of the laws would allow the market participants to prepare well for the first deals in the secondary housing finance market in a few years time.

Summary and Outlook

Despite being early in the process, the program's launch already seems to have contributed to increased competition and improved quality of mortgage products and services in the market. Armenian financial institutions have started to increase the longest maturity on offer to ten years, interest margins are tending downwards and the MQS have already been applied by several lenders. This indicates that the program is set to achieve its two-pronged overall objective (improvement of the housing situation of lower income households with a parallel development of the financial sector) over its life and beyond. Based on improving market conditions, the establishment of the housing finance refinancing facility under the GAF toward the end of this year, and the anticipated availability of other sources of long-term funding, growth in the volume of outstanding housing loans to approximately USD 100 million by the end of 2008 is highly feasible. In fact, as long as there is no economic downturn or political crisis, the housing finance market can be expected to be a major growth factor for the Armenian financial sector overall. The potential for growth becomes evident when comparing the ratio of mortgages to GDP of less than 1% in Armenia with the figures in the most developed markets such the EU and the USA with 45% and 78% respectively.[19]

However, the effort to sustainably develop the housing finance market encompasses and requires more than what is being done in the framework of the program supported by KfW Entwicklungsbank. First of all, the program's volume of long-term refinancing is too low to support the anticipated growth of the primary market alone. It would be highly desirable if other development finance institutions and investors contributed significant amounts of their own. Moreover, many other areas, closely linked to housing finance, need to be developed in parallel: pension funds, insurance, consumer education and real estate appraisal just to name a few.

In addition, construction/developer finance as well as housing microfinance finance should be introduced in the Armenian market. The former is an important instrument to allow the supply of housing to grow at a similar rate as the demand for new housing, which will be fueled by the increased availability of housing finance. Without developer finance, the supply of new units may be outpaced by demand, resulting in price inflation instead of improved housing availability for Armenian households.

In addition to CSSH, housing microfinance is an additional tool to assist lower-income groups with loans to incrementally improve their housing situation. As the credit technology required is very similar to micro lending for businesses, the development of housing microfinance products can build on the successful introduction of micro lending within the framework of the GAF. It will also benefit from the legal, regulatory and quality improvements made in connection with mortgage lending in general.

As we have illustrated, the Armenian housing finance market is growing rapidly in a fertile and sound environment. Even though the prospects are bright, much work still needs to be done to allow this market to reach full bloom and to improve the housing situation for low- and middle-income households. As there are many chances as well as challenges, we invite Armenian as well as international actors to seize the market opportunities and to develop solutions for continuous growth together.

[18] USAID plans to provide technical assistance for reforming the regulatory environment and staff training, without attaching funding to its program. In contrast, IFC and EBRD will inject additional funds into the market, by extending direct lines of credit to local financial institutions, whereas ADB and KfW do not work directly with private sector entities but have to coordinate their activities with the government.

[19] Porteous (2006)

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A Rising Star: The National Mortgage Insurance Corporation of Serbia – Nacionalna korporacija za osiguranje stambenih kredita (NKOSK)

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The purpose of the article is to provide a case study on NKOSK and how it was used as a catalyst to launch mortgage lending in Serbia.

Objectives of the Corporation

In 2002, after years of economic and political turmoil, the Government of Serbia and the National Bank of Serbia (NBS) were looking for mechanisms to stimulate economic reform and development. There was serious concern with the state of the underdeveloped and neglected housing and financial sectors.

At the time, conditions were not favourable to the development of a functional private mortgage market in Serbia. Existing taxation of housing and registration were significant impediments to the growth of that market that could deprive Serbia of the economic benefits that would arise from increased homebuilding activities. Likewise, legal practices surrounding the insufficient protection of lenders' rights were preventing the growth of the mortgage market. Before the enactment of the Mortgage Law, in 2006, the courts had exclusive jurisdiction over enforcement of the mortgages, which meant that the lender could not assess the amount of time needed for the enforcement in case of a default (there are reports that some of enforcement cases took more than 5 years).

In response, the Government decided to create the National Mortgage Insurance Corporation of Serbia (NKOSK):[1] a publicly-owned corporation mandated to develop the private mortgage market in Serbia by offering targeted financial products to address critical market needs. Through its financial activities, NKOSK was to promote improvements to the housing and financial sectors. Initially, NKOSK's products would be in the form of mortgage insurance and at later stages it would explore liquidity funding and possibly other intermediary services.

NKOSK was considered a catalyst with which the necessary economic, legal and regulatory reforms could be addressed. For developing markets such as Serbia, governments do not have the luxury of time to complete all the needed reforms before demonstrating tangible results for Serbian families.

The goals of this corporation were to:

- Encourage banks to lend mortgage funds to qualified borrowers;

[1] CMHC was originally retained by the Central Bank of Yugoslavia to develop the business concept and plan. CMHC continues to assist with the implementation of NKOSK through the generous contributions of the Canadian International Development Agency (CIDA) and the World University Services of Canada (WUSC)

Development of a Housing Finance Sector

I. Enabling Environment	II. Housing System Foundations	III. Active Housing and Mortgage Market
1. Macroecon. Environment	1. Building & Land Use Regulation	1. Supply of Affordable Housing for Sale
2. Political Environment	2. Financial Regulation of Potential Mortgage Lenders	2. Supply of Funds for Housing Finance & Experienced Mortgage Lenders
3. International Investment		
4. Govt. Priority for Housing		
5. Social Safety Net	3. Legal Infrastructure for Mortgage Lending	3. Information to Support Housing Finance Transactions
6. Consumer Demand & Confidence		

- Test the components of the housing finance system and promote improvements and standardization;
- Promote access to housing finance choices for consumers;
- Promote lower interest rates and other transactional costs;
- Pave the way for future mortgage funding instruments secured by high quality real estate assets.

State of the Market

Developing a housing finance sector requires an enabling environment created by government, appropriate legal and financial infrastructure and an active housing and mortgage market. The chart above summarizes the framework for the assessment that was undertaken to develop NKOSK. This article will focus on some of the key findings.

Consumer Demand and Confidence

The preferred time to introduce mortgage financing and mortgage insurance is at the beginning of a period of sustained economic growth. At the time of NKOSK's introduction, Serbia had achieved major gains in economic restructuring in a short period of time. Inflation had been reduced to an estimated 15% for 2002 from 40% in 2001 and NBS had restructured the banking system, removing many licenses and restoring integrity to the system. The Yugoslav Dinar YUD/€ exchange rate had been stable since year 2000. The rapid pace of reform was continuing with support from international financial institutions (IFIs). Unemployment remained close to 30%.

Challenges in Mortgage and Housing Environment

Shortage of Affordable Housing: Especially in larger urban centres, there was a shortage of housing due to:
- Lack of access and affordability for young adults
- Shortage of serviced land for development
- Poor reputation of the local construction industry

Housing Finance Challenges:
- Short-term deposits created funding mismatches for banks
- Bank capitalization was low
- Banks had limited consumer credit experience
- High fees and taxes (up to 8.5% of house price) were an impediment to mortgage lending

- 80% of population was outside of the banking system
- Dinar-denominated loans were relatively non-existent and most banking activities, including personal savings, were conducted in Euros and to a much lesser degree in Swiss francs
- Since many of the banks operating in Serbia were European, liquidity was not a significant issue
- There was limited credit information on borrowers
- Income and expense statistics were unreliable; wages were often in cash

Lender Attitudes to Mortgages:

In that environment, banks looked to the government for direction in developing the market. Banks wanted registered properties and assurance so that they could successfully repossess defaulted properties in a reasonable time frame. Banks saw mortgages as valuable assets for their balance sheets and as a cross-selling opportunity for other consumer products.

Consumer Attitudes to Mortgages:

Up to 2001, no functioning mortgage or real estate market existed in Serbia. Under the previous socialist system, people used to receive real estate as a gift from their employer (typically a state-owned company) after several years of employment or work experience. A mortgage or loan was treated as a gift because at that time inflation was very high. It was a challenge to change people's understanding of what a mortgage loan was.

As a result, it was very important to develop a public awareness of the need to create a functioning real estate and mortgage market, as well as to develop a public awareness of how to buy real estate under the new system. Real estate would no longer be provided for free.

A September 2002 survey of potential mortgage borrowers was conducted in Belgrade, Novi Sad and Nis. The dominant characteristics of respondents were:

- Young, well educated, married and working in management positions or as highly qualified intellectuals; average household incomes €600-800; positive views on economic growth.
- 40% lived with parents, 35% in apartments that did not meet needs; 22% were renting.
- 69% of respondents wanted a favorable loan so they could purchase an apartment; majority also wanted other loans or credit cards.
- Majority were looking for loans from €20,000 to €30,000 with monthly payments of €200-300 respectively.
- Respondents were willing to have employers act as guarantors of repayment or endorsers.
- Concern with high interest rates.

Legal System:

Two existing laws and current practices met, to some extent, legal conditions that are required for mortgage lending; namely, that housing purchasers are able to establish a valid property title, and that a lender can register a claim against a property for the provision of a loan and enforce their registered claim. However, legal challenges that remained were:

- Three different registry systems[2]; and incomplete registries, especially in the south
- Testing the new mortgage law when it came to enforcing creditors' registered claims against a property where a mortgage borrower had defaulted

Regulatory Issues:

- NBS' policy of tightening the banking sector; restricting the number of banking licences for a period of time
- Capital requirements were brought in line with Basel standards
- There were no specific regulations for mortgage lending in terms of provisions or recognition for mortgage insurance.

However, regulators accepted that specific regulations were required for mortgage lending and mortgage insurance to reflect international approaches and to ensure the safety and soundness of the system.

Recently, minimum reserve requirements for foreign borrowing were implemented to dampen overall lending growth. Higher than expected inflation in Serbia had been attributed to this growth in lending,

Strategy to Address Deficiencies in the Market

Stakeholders in the Serbian mortgage market realized that the needed reforms could not happen overnight; in fact it would likely take many years to overcome the decades of neglect. The political environment was not stable and the government needed to demonstrate a tangible result to Serbians. From a theoretical point of view, one would wait until all of the legal, regulatory and other preconditions were in place before starting to develop housing finance institutions.

But were there other options? Could the government wait years for the legal and regulatory reforms to take place? This would result in even greater housing deficiencies and still there would be no experience with mortgage lending.

[2] Depending on the part of the country, the title registrations are managed by three different bodies-land registry court, cadastar and courts of general jurisdiction. However, the process of uniting the land registry has been under way for several years now, and is expected to be completed in several. The cadastar is taking over the data and is working on the computer system of registration for the entire country.

Moreover, given the small market size for mortgages in Serbia, it was logical to rely on the existing banks, rather than create another lending institution such as a specialized mortgage bank. Mortgage insurance, which specialises in managing credit risk, was intended to contribute to a systemic approach to developing the banking and financial sectors. This represented a strategic opportunity to boost the housing sector and strengthen the balance sheet of the existing banks.

The decision was taken that Serbia could not wait until all the typical preconditions were in place before starting the development of a new institution. It was also clear that a private institution would not start any mortgage operations under such conditions and that the government would need to be the catalyst. The strategy called for a concurrent plan of launching a new company that would take on the credit risk while at the same time addressing the preconditions through a number of mechanisms including legal reforms and negotiated agreements with banks.

The new company would be the National Mortgage Insurance Corporation of Serbia (NKOSK). This corporation would be taking on not just mortgage credit risk, but also the uncertainty of launching mortgage lending in an uncertain market where there were many questions regarding title, enforcement, not to mention economic and political instability. The company structure and product design would play a big role in how these risks were managed and controlled.

The People

As with any successful business venture, the people and expertise behind the initiative were critical. For Serbia, this began with the current Minister of Finance, Minister Dinkiç. At the start of the project, he had been the governor of the Central Bank of Yugoslavia. Realizing the need for housing and housing finance after years of neglect, Governor Dinkiç created a team to look at possible strategies, models and options to initiate mortgage lending. The team included expatriate businessmen as well as local experts and analysts.

The team considered a number of European and North American mechanisms before retaining the services of the Canada Mortgage and Housing Corporation (CMHC). CMHC was selected for a number of reasons, including their success in Canada working with private lenders and their growing success internationally adapting mortgage insurance and liquidity financing instruments to new markets. CMHC assisted the Serbian team in developing the business concept and planning for NKOSK and they continue to assist with the implementation of the corporation.

The Serbian team's objectives were multiple:

- Leverage the resources of the growing number of foreign lenders entering the market
- Deliver tangible results to Serbians quickly
- Concurrently address the myriad legal, regulatory and infrastructure deficiencies
- Build a credible housing finance system that both business and consumers could have confidence in

To meet these objectives, the Serbian project team needed to work closely with banks and government agencies as well as draw on the technical and managerial expertise of CMHC. Notwithstanding these efforts, the active participation of the Minister of Finance was critical; first to ensure the political support needed for the legislative and regulatory changes.

Corporate Structure

The corporation was established to be a commercial shareholding company. It was initially founded with one shareholder, the government of Serbia. Ultimately, the private sector will be invited to participate. The decision to invite private sector investors remains the decision of the Government and may still be a few years away. Nonetheless, NKOSK is currently seeking strategic partners.

While its initial mandate was to promote the development of the mortgage market, its long term goal is to be a viable commercial company. It is this emphasis on commercial viability that is to keep NKOSK focused on commercial discipline. To emphasise this, the initial management team and staff were hired from the private sector.

NKOSK is regulated and established by a specific law on NKOSK. Insurance reserves and a 16:1 risk capital ratio are currently regulated by the law for NKOSK.

Product Design

The product was a key element of the strategy as NKOSK did not want to take on all of the risk itself. Since there appeared to good potential demand and lenders were eager to enter into mortgage lending in Serbia, NKOSK wanted to share the risk with banks in a fair and equitable manner. The question remained however: how much risk did NKOSK need to assume in order to encourage banks to enter the market and to offer borrowers access to affordable mortgage terms?. NKOSK also needed to deal with the lack of mortgage insurance regulations that would prevent adverse selection by banks.

Just after the formation of NKOSK, negotiations with respective banks operating in Serbia were begun. The product was presented to the banks and modified to include their feedback. The objective of all was to ensure the security of the banks' mortgage portfolio and ensure the viability of NKOSK's mortgage insurance fund.

A balance was struck: NKOSK covers 75% of the net loss that may be incurred as a result of default and ultimate foreclosure. The maximum loan to value ratio is set at 80%. Banks sign a contract with NKOSK stipulating that they will submit all mortgage loan applications that fall within a specific category to NKOSK for approval or rejection. If rejected, the bank has the option to issue the loan without NKOSK insurance. If approved, the loan will be insured.

Business Volumes
January 2005 – May 2006

Distribution of Insured Bank Lending by Loan Size			
Euros Number of (000s)	**Percentage Loans**	**Distribution**	**Average LTV**
0-25	1,322	49.9%	58%
25-50	891	33.6%	62%
50-75	271	10.2%	67%
75-100	94	3.5%	67%
100-125	36	1.4%	69%
125-150	16	0.6%	60%
150-175	5	0.2%	71%
175 +	15	0.6%	27%
Total	**2,650**	**100%**	**61%**

Source: NKOSK

Distribution of Insured Bank Lending by Loan To Value		
LTV	**Number of Loans**	**Percentage Distribution**
0-50%	690	26%
50-60%	357	14%
60-70%	868	33%
70-80%	735	28%
Total	**2,650**	**100%**

Source: NKOSK

NKOSK is promoting a standardized approach to mortgage origination. Standards such as those promoted by the EBRD serve as a model for NKOSK. However, because of the developing nature of the Serbian mortgage market, NKOSK must be more flexible in its approach to standardization. For example, NKOSK does not require borrowers to have life insurance because it is currently very expensive.

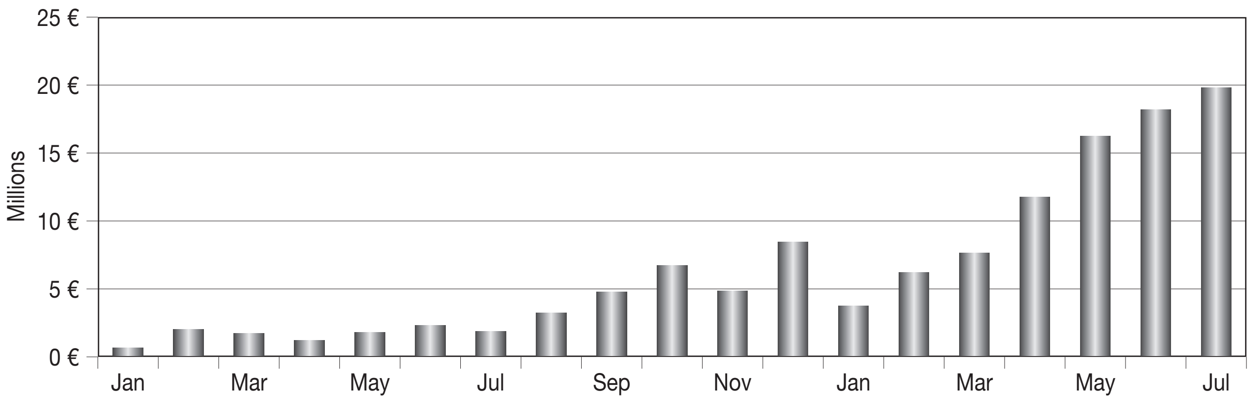
It should be noted that this product does not cover the first tier or layer of risk similar to American mortgage insurance. Rather, this product covers a portion of the net loss. There is still a strong incentive for banks to prevent or minimise losses since they are still exposed to 25% of the net loss. Banks are also responsible for pursuing default management and if necessary, foreclosure. The onus of ensuring that the foreclosure process works remains on the government. To a large degree, the risks faced by the Serbian government are similar to foreclosure risk in other countries. The Serbian government also faces the additional risks related to economic transition and the public sector employment transition. As one mitigation, unless the banks follow closely the foreclosure procedure prescribed by the Mortgage Law and the additional notifications prescribed by NKOSK, the banks risk loosing the insurance.

Other Incentives

The introduction of mortgage insurance offered an incentive to lenders in terms of reducing the credit risk. Like other markets, this risk reduction also contributes to the overall safety and soundness of the banking system. As such, banks enjoy additional regulatory privileges for using mortgage insurance. These include reduced capital and provisioning requirements for mortgage loans that are insured by NKOSK. The risk weight and the provision requirements for delinquent loans on insured mortgages are set at 0% to reflect the backing of the government-owned company.

The product and the initial regulatory incentives were successful at getting some banks to sign on. While this achieved some of NKOSK's objectives, in the first months of NKOSK's existence, the volumes and level of competition were lower than desired. The government then decided to introduce a co-lending program to be used

Value of Insured Mortgages per Month 2006-06



Source: NKOSK

in tandem with mortgage insurance. The program was designed by NKOSK and submitted for government approval.

Under the co-lending program, the borrower's down payment would be reduced to 10% and the government would provide a 20% loan. The bank would then provide a loan for the remaining 70%. For the first 20 years or until the bank's portion of the loan is paid off, no interest would accrue on the portion of the loan provided by the government. Interest of 0.1% would be paid to the government on the last 5 years of repayment. For lenders, one additional requirement was a maximum interest rate of 6.95% on bank loans which were combined with a government co-loan.

This product generated a significant increase in demand by reducing the down payment as well as the monthly instalments for borrowers. It also created the conditions where more and more lenders joined onto the mortgage insurance program as well as the co-lending program. Lenders actively competed for business – both for the co-lending program as well as for regular insured loans. While the co-lending program proved to be a strong stimulus to the market, it accounted for only less than 8% of total lending (the total of co-lending and insured lending) as not all borrowers used the program and subsidy would only be for up to 20% of the property value.

Results

So was this a fanciful experiment doomed to failure or did it achieve results? In October 2004, NKOSK was incorporated as a commercial company wholly owned by the government. It began operations in January 2005.

Impact on Market

As more and more banks signed onto the NKOSK program, competition increased and mortgage interest rates fell. When NKOSK began business, interest rates were around 12% on Euro-denominated loans. By the end of the first year, they had fallen to around 7%. The effective interest rates were lower still if bank loans were combined with a government co-loan program. While rising competition among banks contributed to lower interest rates, the greatest impact was seen after the implementation of the co-lending program.

By the end of the first year of NKOSK, over 1,500 loans had been approved for insurance with a lending value of over 40 million Euros. This rose to over 2,600 loans and over 75 million Euros by mid-May 2006 (after 16 months of operation). The average loan size and loan to value ratio have remained fairly low. The primary purpose of mortgages has been for the purchase of existing housing units. This will start to change soon as a new law permitting mortgages for the construction of new homes is implemented.

NKOSK has been successful at targeting modest housing. The vast majority, over 80%, of the lending has been for loans under €50,000. Additionally, the risk level has been relatively low as the averagee loan-to-value ratio has been around 60%.

NKOSK has experienced fairly steady growth, particularly since the start of 2006. January and February 2006 volumes were lower than the latter months of 2005, but this is related to seasonal factors including the Christmas season.

It is important to emphasise that a few months after the start of the mortgage insurance program, NKOSK successfully designed and implemented the co-lending program.

Lender Clients

The banks that use NKOSK's mortgage insurance reinforce the success of the story and speak of the confidence in the government's strategy. Key clients include institutions from Austria such as Raiffeisen Bank, HVB Bank, Hypo Bank and Erste Bank; and institutions from Greece such as EFG Bank. The list also includes Pro Credit Bank, an institution sponsored by the International Finance Corporation (IFC). At this time, there are thirteen banks in all who have signed on with NKOSK and with the exception of one they are all from EU countries.

New Law

In February 2006, the Government of Serbia approved a new mortgage law that achieved three key things:

- It established a clear administrative process for foreclosure with specific timeframes to be followed.
- It allowed for all property transactions to be registered at only one location, the cadastre, rather than several.
- It allowed for mortgages liens to be placed on homes under construction.

Other Market Improvements

In addition to the mortgage insurance company, Serbian stakeholders worked actively during this time to create a credit bureau. The National Bank of Serbia (NBS) and the Banker Association created a Credit Information Bureau which greatly improved the scope and reliability of credit information. The banks offered their support for this initiative. A new credit bureau was launched in 2004, and all 49 banks now operating in Serbia have signed contracts with this institution.

Conclusion

Starting a mortgage insurance company in any market is not without significant risks. What the NKOSK experience demonstrates is that in developing markets like Serbia, governments can develop pragmatic strategies that deliver results quickly while at the same time addressing the market risks and challenges. These strategies do require sober thought and require realistic tactics. It also requires governments to work closely with the private sector, to draw on international experience, and to stay focused on addressing legal and infrastructure deficiencies.

The story is not over and there remain a number of key challenges to address in Serbia. The new law is untested, further regulatory work is required, professional services such as property appraisers are under-developed, and the mortgage culture is still in nascent stages.

Still, a recent survey in Belgrade just emphasises the impact the government's strategy has had. In this survey of young Belgradians, they were asked what the best thing about living in Belgrade was. NKOSK was listed third – after beautiful women and night life. Who would have thought that mortgage lending could keep such company!

Update on Egyptian Mortgage Lending

By Raymond J. Struyk, Head, Egypt Financial Services Project[1]
and Melvin Brown, Senior Financial Adviser, Egypt Financial Services Project

The June, 2006 issue of *Housing Finance International* included an informative article by Stephen Everhart, Berta Heybey, and Patrick Carleton that introduced recent developments in the Egyptian housing sector.[2] Since the data for that article were gathered in early 2005, this brief article provides additional information on developments in mortgage lending with respect to loan volume, terms and conditions of mortgage loans, and the regulatory environment.

Regulatory Environment

The Real Estate Finance Law of 2001 is the key piece of legislation, regulating all mortgage lending regardless of the legal status of the lender or its supervisory agency. It contains a very strict definition of the loan instrument, which is specified to be a three-party agreement among the lender, the seller and purchaser of a dwelling. The stated intention of mandating this instrument was to provide greater security to the lender as well as the purchaser in Egypt's difficult mortgage lending environment. As noted in the earlier article, difficulties arise from two primary sources: (a) the long delays probable in registering a lien, and (b) a foreclosure process for mortgagors-in-default that is still viewed as uncertain despite comparatively recent legislative changes designed to speed the process and increase certainty. But the 3-party contract has draw-backs of its own that makes it unpopular with lenders.[3]

Currently the Mortgage Finance Authority (MFA), the regulatory body for non depository mortgage lenders and the organization charged with promoting the development of the mortgage market, is conservatively interpreting and enforcing the provisions of the 2001 law, including the mandated tri-partite loan contract.[4] The Central Bank of Egypt (CBE), on the other hand, despite its issuance of a circular implementing the terms of the 2001 law, has not attempted to enforce the exclusive use of the tri-partite loan agreement for mortgage credits and has de-facto granted the banks more latitude in their loan structuring. Several of the larger and more active commercial banks are employing a variation of the tri-partite agreement or a more standard 2-party loan contract in their mortgage loan transactions.

Mortgage Finance Companies (MFCs) are specialized non-depository lending institutions. As of early September 2006, two MFCs had been operating for about two years and a third had just been granted a license. They are subject to a fairly conservative leveraging ratio of 9:1 under the terms of the real estate law of 2001. The banking sector, on the other hand, is subject to CBE interpretations of the Basle II guidelines for credit at risk and continues to function under the more liberal leverage regulations of the CBE.

The principal restriction placed on the banks for mortgage lending continues to be the CBE ruling that limits real estate related credits to 5 percent of the total the loan portfolio. This restriction is not currently a limiting factor for the banks as CBE statistics indicate that the sector as aa whole could extend approximately LE15.5 billion in total real estate related credits at current asset levels versus a maximum of LE 650 million currently extended. (The current exchange rate is about LE 5.75 = $1.) The CBE has indicated that if this limitation becomes an impediment to loan growth, it could be adjusted. Consequently, as the volume of mortgage loans continues to grow, the imbalances in the regulatory framework cited above, considered in combination with the natural funding advantages enjoyed by the deposit-taking commercial banks, could prove a long-term disadvantage to the market effectiveness of the MFCs.

March 2005 witnessed an important development with respect to property registration requirements for mortgage lending. Only about 10 percent of urban

[1] The Egypt Financial Services Project is being conducted by Chemonics International under contract with the U.S. Agency for International Development. The authors wish to thank Aser F. Obeid for help in assembling data used in the article. The views expressed are those of the authors and not necessarily those of either organization. Correspondence to: rstruyk@egyptfs.com.

[2] S. Everhart, B. Heybey, and P, Carleton, "Egypt: Overview of the Housing Sector", *Housing Finance International*, June 2006, pp. 9-13.

[3] There is interest among banks to amend this law and much of the necessary drafting has been prepared by the EFS project and others. Political acceptance may be an issue.

[4] The earlier article indicated that MFCs were not issuing mortgages (p.12). This is not the case as these loans are in fact mortgage-based transactions but the relationship among the parties (seller, buyer and lender) is somewhat complex under this agreement.

Egyptian properties are registered, in part because it is a long, complex, and (until summer 2006) an expensive undertaking.[5] A requirement for using a property as collateral under a mortgage contract has been that the property be registered. Hence, few properties qualified for mortgages without first being registered. In 2005 the implementing regulations of the Real Estate Finance Law were amended, with one provision being that a mortgage could be issued for an unregistered property if the property were deemed to qualify for registration.[6] Lenders have used this provision after due diligence on the property. The Law requires that lenders initiate the process of registering the property and mortgage. This regulatory change obviously dramatically increased the number of properties qualifying for mortgage loans. An important contextual point is that the Government of Egypt is undertaking an ambitious program of reforming and modernizing the registration system for immovable property beginning in Cairo in nine districts plus one district where the upgrade is being implemented by the USAID Egypt Financial Services Project. Hence, the utility of the able-to-be-registered provision should decline steadily over time.

Volume of Mortgage Lending

The variation in the type of loan agreements being used by lenders creates confusion in the reporting of mortgage lending by financial institutions. The confusion arises as to whether *only* 3-party mortgages should be reported as a mortgage. The figures cited below are inclusive of all types of mortgage contracts.

The two MFCs report their lending to the MFA as mortgage loans. Both are building their portfolios by originating loans and by taking over installment loans originated by developers.[7] At the mid-September 2006, according to MFA data, the MFCs had a stock of 972 mortgage loans with a combined value at origination of LE 227 million. This compares with a June 2005 figure of about LE 16 million or $2.7 million.

Mortgage lending by commercial banks is reported to the CBE as a separate type of asset. However, there is some uncertainty as to whether 2-party home purchase mortgages are being reported as mortgages, but it appears to be the case. At the end of June 2006, commercial banks had an outstanding balance of LE 300 million of home purchase mortgages.[8] Conversations with commercial banks indicate that they are beginning to see home purchase mortgage lending as an interesting new type of consumer lending.

Using the figure just cited for commercial banks, the stock of outstanding home purchase mortgages in total was about LE 520 million in summer 2006 and the portfolio consisted of around 2,300 loans.[9] (Note that the LE 520 is for residential mortgages whereas the LE 650 ($133 million) cited earlier was for all real estate lending.)

The foregoing makes two points evident. First, this type of lending is growing very rapidly but from a very small base indeed. Two thousand loans in a country of around 13 million households is indeed a drop in the ocean. Second, loan amounts are large—an average of LE 232,000 or about $38,700 for loans made by MFCs. Obviously, in Egypt where average household income is about $6,875,[10] loans are going to very high income households.[11] If one assumes that loans finance 40 percent of the purchase price on average, then the ratio of the average house price *for these transactions* to average country-wide household income is 14.[12] Other analysts put the overall media price-median income ratio for Cairo at 6-7.

Loan Terms

As the competitive market for mortgage lending begins to develop in earnest, it is interesting to plot the data on loan terms and conditions being offered in the market. The market is now beginning to show greater elasticity in the structure of the mortgage-based credits being offered. Table 1 provides information on loan terms for the two MFCs and three of the main commercial banks with active mortgage lending programs.

Information in the table is based on official

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5 Egypt Financial Services Project, *Property and Registration Law in Egypt: Current Operation and Practice*, June 2005. Over the past few years registration fees have been gradually reduced. Finally in summer 2006, they were lowered to quite moderate amounts, with the fee, varying in four brackets depending on the size of the unit. The lowest fee is LE500 for a unit under 100 square meters, and the highest is LE2000 for units over 300 square meters.

6 Prime Minister's Decree No. 465 of the Year 2005 Amending Certain Provisions of the Executive Statutes of the Real Estate Finance Law, March 20, 2005.

7 In principle, these loans are recast as true mortgages; but the information on this point differs among sources.

8 Unpublished information provided by MFA.

9 Calculated by applying the average loan amount for MFCs to the commercial banks' loan volume.

10 Various World Bank web pages report the average per capita GDP in Egypt (Atlas method) in 2004 as $1,250 and an average household size of about 5.5.

11 According to World Bank data published on its web site, income inequality in Egypt is moderate. Using data for 2000, the Gini coefficient of 29 is reported. The richest 20 percent of the population received 39 percent of total income, and the poorest, 9.8 percent.

12 A ratio of median free market dwelling price to median household income for 1992 of 7 for Cairo is reported in Table 2 of S.N. Erbas and F.E. Nothaft, "Mortgage Markets in Middle East and North African Countries: Market Development, Poverty Reduction, and Growth," *Journal of Housing Economics*, vol. 14, 2005, pp. 212-41. S. Aziz, H. Kamal, M.S. Kamal, K. Selim, H. Serageldin, and D. Sims report a similar value for Cairo but are not clear as to the date for which this value applies; see *Housing Demand Study for the Arab Republic of Egypt* (Cairo: Report to USAID by the project Technical Assistance for Policy Reform II, 2006, p.36).

Table 1. Mortgage Loan Terms and Conditions for Selected Egyptian Lenders – Summer 2006

	Mortgage Finance Companies		Commercial Banks		
	Egypt Housing Finance Co.	Taamir	Egyptian Arab Land Bank[a]	Nat'l Societies General Bank	Commercial International Bank
Maximum LTV – %	75	80	75	80	70
Maximum PTI – %	35	40	40	30	40
Maximum loan term	10 yrs[b] 5 for Egyptians living abroad	20 yrs[b] 10 for Egyptians living abroad	10 and 20 yrs[c,d]	10[c]	15[c]
Interest rate – %	13	13	13.5 on 10 yr 14.0 on 20 yr	11.6	Fixed for 3 years at 13, then variable
Insurance required: – life – property	Yes Yes	Yes Yes	Yes Yes	Yes Yes	Yes Yes

Source: Egypt Financial Services project.

a. Government-owned bank
b. Actual term is around 7-8 years.
c. Actual loan period is not known
d. Longer loans are subject to more stringent underwriting

lender statements. Actual lending practices can differ from these general terms, often depending on the actual ability of the borrowers to meet the maximum payment to income criteria as set by regulations, management decisions concerning business intangibles and customer relationship factors. We know, for example, that in practice the average loan period offered through the MFCs is shorter than the maximums stated – actual averages are 7 and 8.5 years, respectively, for the Egypt Housing Finance Company (EHFC) and Taamir.[13] These loans are funded by a combination of equity and terms loans. The MFCs are looking to the recently created Egyptian Mortgage Refinance Company, a liquidity facility following the Malaysian Cagamas model, for liquidity in the future.

Loan periods for mortgages from the Egyptian-Arab Land Bank (operating cooperatively with the Housing Development Bank[14]) are 10-20 years. As established government-owned institutions reporting to the Ministry of Housing, they are heavily involved with the national program to provide low cost housing on loan terms that includes a subsidy (non-repayable) for a portion of the required down payment. The great majority of the mortgage credits extended by these banks are structured with borrower participation in the subsidy program administered by the Guarantee and Subsidy Fund (GSF).[15] The banks' government affiliation and mission apparently make them willing to accept greater interest rate risk than some other lenders. But, as the table shows, unadjusted for possible risk differences, their interest rates are the same as others in the market.

The Commercial International Bank (CIB), which has only recently expanded its mortgage lending programs beyond its own staff and favored corporate clients, may also be making 10-15 year loans. CIB is currently the only lender offering a loan repricing option – now set three years after loan issuance. The initial interest rate is not

[13] We do not have parallel information from the commercial bank statistics but anecdotal evidence indicates that the average loan term is still well below 10 years.

[14] There are plans to merge these banks within a year, which could lead to positive advancements in the overall development of the national housing finance program for Egypt.

[15] The GSF is an independent agency under the MOI but its programs fall under the supervision of the MFA. MFA management is also on the Board of the GSF.

indexed; rather the new rate will be whatever the bank's interest rate for this product is at the time of repricing.

In addition to the loan terms and conditions presented above, all lenders currently require borrowers to carry both life and property insurance during the life of their loan. Private sector lenders also require significant up-front fees for loan origination. Pre-payment penalties, typically 2 percent of the prepaid amount, are common.

Interest rates are high but not at such punishing levels as in some developing nations. The typical rate is 13 percent. Rates have, however, edged downward in the past year. Based on various indicators, it appears that spreads are relatively modest. Among banks, 90 percent of deposits are time deposits; in 2006, the 3-month deposit interest rate was 6.2 percent and certificates of deposit paid 9.5 percent.[16] Inflation at the same time is running about 5 percent. The World Bank reported for 2004 a 5.7 percentage point interest rate spread and only a 3.5 percentage point risk premium on lending in Egypt (defined as the difference between the lending rate to the private sector and the "risk free" treasury bill rate).[17] Together these facts suggest that interest rates may be difficult to bring down very much in the near term. Possibilities for reducing mortgage interest rates are further complicated by the fact that lenders are not rigorously calculating (or simulating) the price of the various risks they face; when they do, they may discover that they have been implicitly under pricing them.

Prospects

In many ways the situation in Egypt exhibits the potential for creating the type of dynamic housing finance market as that experienced by a number of countries in Eastern Europe and the Commonwealth of Independent States in the past 15 years: once the basic conditions to control credit and other risks were either in place or were being put in place, prices were stable and economic growth sustained, then mortgage loan volume grew sharply and eventually stabilized at the higher levels in response to the strong latent demand for better housing. While several of these countries employed deep subsidies to ignite their mortgage markets into periods of sustained growth (eg, Hungary), others did not – including Poland and Armenia.

The Egyptian mortgage market now appears poised for rapid and sustained growth, assuming the macroeconomic environment remains positive and that the Government of Prime Minister Ahmed Nazif continues on its strong reform path. The gains to date were based on continued progress in strengthening the legal basis for mortgage lending, substantial improvements in the regulatory environment, and, most importantly, the increased public awareness in the benefits of mortgage-based homeownership.

Based on the experience of other countries, the growing interest of commercial banks in this form of consumer lending, and the expected continued forward movement on the part of the Egyptian authorities in learning from others, sharp growth in mortgage lending can be expected in the years immediately ahead.

[16] Central Bank of Egypt 2004-2005 Annual Report and the Ministry of Finance, The Financial Monthly, vol .1, no .9, July 2006.

[17] World Development Indicators, 2006, Table 5.5.