Hungary's changing housing finance system

By David Parry

HUNGARY is in a state of political and financial flux. Areas particularly impacted by the change include the housing markets and the mortgage finance system. The current events in Hungarian housing finance should be closely observed as they can provide a model for other totalitarian socialist economies moving towards democracy and economic freedom, for example the USSR, Poland, Yugoslavia and even Czechoslovakia. The success or failure of restructuring of the Hungarian housing market and mortgage finance system may determine whether political reforms may be implemented in the nation and is crucial to the further integration of Hungary and all of central and eastern Europe into the world economy.

Geography and demographics

Hungary has a land area of approximately 36,000 square miles (93,000 square kilometres) and is about the size of Ireland or the US state of Indiana. Population, reduced by an exodus of young adults due to the 1956 revolution, increased slowly during the 1960s, reaching nearly 10.5 million in 1970.

There was a further population increase in the 1970s, to 10.7 million, but the 1980s have seen an absolute decline in population due, in part, to the consumer orientation of the economy and the concern of households to increase their possessions and income per household member. As shown in Table 1, it is estimated, some feel optimistically, that the population has stabilised during the 1980s at approximately 10.6 million and will now increase gradually through the 1990s.

With a population density of 296 persons per square mile, Hungary ranks 12th among the 27 European nations. This density will not change substantially, but urbanisation trends are strong and the nation will continue to become more urban. Without a solution to the current housing crisis this may create future political and economic problems.

The population is presently considered to be 56% urban with slightly more than 30% of the population residing in the nine cities with populations of 100,000 or more, while two-thirds of that (19% of the total) is in the capital city of Budapest.

Despite government policies that, at least nominally, encourage suburban and exurban locations, the trend is for population movement to the major cities. In 1960 only 39.3% of the population lived in the cities and towns while in 1989 nearly 60% do. Urban population has increased by over 2% during the 1980s while total population declined. One recent aspect of the urbanisation pattern is the development of close-in suburban areas consisting largely of single family homes and low-rise condominium flats, as contrasted with the development during the 1960s and 1970s of mid- to high-rise congested apartment buildings that have a propensity to turn into tenement slums. Complementing this is an increase in suburban industrial locations.

Table 1. Population Trends Hungary 1960-2000

Year	*Population (000)*	*Annual Rate of Change (%)*
1960	10,021	
1970	10,347	0.32
1975	10,397	0.10
1980	10,710	0.59
1982	10,711	0.00
1984	10,679	−0.15
1985	10,657	−0.21
1986	10,640	−0.16
1987	10,621	−0.18
1988	10,604	−0.16
1989	10,590	−0.13
Forecast		
2000	10,714	0.10

Source: Hungarian Statistical Office and Europa Yearbook.

There are less than 2.5 persons per household, but there is more than one household in some dwelling units, and the size of dwelling units is still small by Western standards. Overall in Hungary, there are 2.7 persons per dwelling, but 1.2 persons per room, excluding bathrooms.

The Hungarian economy

The change in the Hungarian economy is dominated by the increasing growth of the private sector. This is occurring because of three interrelated trends. The first is the creation of private business establishments, primarily in the agricultural, retail, service and building construction sectors. The second trend is the establishment of joint venture operations with Western individuals and business firms. Too often the joint ventures are in agri-business or personal services with existing Hungarian collectives or Tanacsok. Some are in financial services or tourism which help the domestic economy and balance of trade, but what Hungary needs most are joint ventures in the manufacturing and processing industries where the foreign partner can supply investment capital and technology and use Hungarian labour, land and resources.

The third trend is the privatisation of state- or Tanacs-owned industry. This has begun with the commercial banks which issue stock shares of ownership and is likely to occur in many of the national or Tanacs-owned enterprises when the next government, which should not be controlled by the MSZMP, takes power in 1990. Even the co-operatives are currently complaining about the amount of control the national government exercises over their production, pricing and financial affairs. When the next government assumes office there will be pressure to allow the collectives to privatise.

The collectives, primarily in the agricultural, transportation, manufacturing and construction industries, argue that the only control the national government should exercise is through taxation. In that regard Hungary implemented an income tax in 1988 for both business enterprises and individuals. The rate is highly progressive and private businesses feel that it is somewhat discriminatory in favour of public sector employees.

At this time there is no real estate transfer tax. If a taxpayer sells his dwelling and does not buy another he pays a capital gains tax; if he buys another then the tax does not have to be paid. A value added tax is levied on new dwellings at the time of purchase, but there is no property tax for the first 20 years of a property's life. There is presently no deduction of mortgage interest payments in the income tax structure, although this is being considered.

As privatisation continues it is likely that there will be more inflation, dislocation and inequities. In housing, for instance, the retired population, like all tenants in the Tanacs-owned housing, pay rents below market. The low rent reflects their previous below market wages. How can they be treated equitably if and when rents are allowed to go to market rates, which they will? Pensions have been increased during the past decade, but the government is facing something of a financial crisis at this time, however, because of inflation.

Table 2. Gross Domestic Product 1982-1988

Year	Gross Domestic Product (HUF billions)	Percent Annual Change	Consumer Price Index	Real Gross Domestic Product (HUF billions)	Percent Annual Change
1980	718.5	−0.5	100.0	718.5	
1981	736.5	2.5	104.6	704.1	−2.0
1982	847.9	15.1	111.1	763.9	8.5
1983	896.3	5.7	120.0	746.9	−2.2
1984	978.5	9.2	130.0	752.0	6.8
1985	1,033.7	5.6	139.1	743.3	−1.2
1986	1,088.8	5.3	146.5	743.2	−0.0
1987	1,226.4	12.6	159.1	770.8	3.7
1988	1,406.0	11.5	184.1	764.0	−0.9

Source: Hungarian Statistical Office.

Increasing pensions would be inflationary, and with the early retirement age there is currently one retired person receiving a pension for every two persons employed. This load, along with the other welfare programmes, makes privatisation difficult and puts upward pressure on prices and taxes and downward pressure on wages, while limiting funds available for investment.

Privatisation will put both inflationary and deflationary pressures upon the economy, resulting in sectoral inequities necessary because of the past inequities inherent in the previous non-market pricing, production and allocation systems. If the nation can weather the economic trauma without the state interfering in sectors such as housing, this may determine the interest of Western investors. Hungary must improve productivity if inflation is to be avoided or at least kept low. Improving the structure of the building industry and the real estate and finance sectors will be one way to generate improved productivity.

Residential real estate markets

The real estate market in Hungary as a free market institution is still evolving. With privatisation, new institutions are being created for both the marketing and financing functions. The real estate industry even has its own weekly publication, *Ingatlan Piac* (Real Estate Market). Until January 1989 the market was controlled monopolistically by the Hungarian Savings Bank (OTP), the Tanacsok and the State. This is still the situation in other Eastern bloc nations with the exception of Poland.

Despite the fact that more than 75% of Hungarian households now own their dwellings, the market has not been free. Ownership has been restricted to one home per adult over 16. It was also necessary to get the permission of the local Tanacs to rent a dwelling. Ownership of rental housing was predominantly the responsibility of the Tanacs, the State and some employers. As of July 1989, these restrictions were lifted, but the market still is dominated by State-owned institutions.

Until 1987, OTP not only was the primary mortgage lending institution, but also set home prices and was the only agency making a market for real estate. The only competitors until 1989 were other state-owned banks, state-controlled co-ops or the Tanacsok. It was illegal for individuals or other institutions to receive income from assisting or acting as an agent in the transfer of real property, and supplemental

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mortgage financing was under the control of OTP and the other state institutions.

If an owner wanted to sell a home or flat he would contact OTP (or, possibly, one of the other banks). The OTP branch officer would establish the price (value) of the property and OTP would buy the property at that price. The seller could appeal to a board if he disagreed with the price, but an increase in the price was unlikely. The only alternative to the seller was not to sell the property or to attempt to find another property owner willing to trade.

After OTP purchased the property, it would be advertised for two weeks and then offers would be accepted. Since all potential buyers were required to make offers at the same OTP predetermined price a non-price mechanism was necessary to allocate the homes among the buyers. The allocation was made by a board appointed by the local Tanacs. The criteria were based upon household income, the number of people in the family, their current housing (if they were vacating a unit within the Tanacs they had a higher priority), the down-payment and if it was in hard currency and, unofficially, the buyer's position in the Tanacs, the Party or the importance of his job.

To buy a dwelling, the prospective purchaser would first contact his employer or the local Tanacs to see if they had anything available. (A significant portion of Hungarian housing was and is owned or made available from the employers, especially the co-operatives.) If they did, he would rent it or make an offer, securing financing through OTP or through funds made available by the employer or co-operative. If, as was usually the case, they did not, he would contact OTP to determine what was in stock. By making an offer, he became one of the queue being evaluated by the Tanacs committee.

If he was single or married without children and in Budapest or a major city, had no hard currency, was working in an unimportant job and had no influential contacts, his probability of securing housing approached zero. There are horror stories of individuals or young families waiting for as long as seven years to secure a small dilapidated flat to buy or rent in Budapest.

While vacancy data are not reported, it is known that there is a surplus of housing in the rural areas and villages and a shortage in Budapest. The larger the size of the town or city the greater the queue applying for housing. The Budapest Tanacsok recently advertised 60 small, older flats (lakas) in poor condition and had 6,000 applicants. Hungary has an urban housing shortage and especially a shortage of habitable and quality housing. But as the Nobel laureate economist Milton Friedman is often quoted as saying, there is no such thing as a shortage, only a failure in the pricing system. With a good that is a necessity, like housing, this observation becomes somewhat cruel, especially in a market and economic system where in the past supply and price had been severely controlled.

Table 3 reports residential units built in Hungary from 1961 to 1989. Construction activity was low in the 1960s, reached a peak in the late 1970s and has been declining since. While Budapest and the towns did not receive their fair share of housing prior to the 1980s, they have since. During the 1980s new residential units constructed in the cities have increased at a more rapid rate than their share of population.

While the volume of housing constructed has declined, the quality and size of the dwelling units have improved. The majority of units built in the 1950s and 1960s were one-room flats, many with incomplete plumbing, the multi-storey grey buildings so common to Communist cities and the low-rise courts in the villages. The design quality of housing improved somewhat through the late 1960s and into the 1970s. This improvement has accelerated in the 1980s. To some degree this phenomenon can be observed in Table 4, which reports the average number of rooms and the size of units built.

The last column of Table 4 is construction costs per square metre. While construction costs have increased, they have not increased more rapidly than inflation, which would have been expected in an economy moving towards a free market. The reason for this is two-fold. First, government continues to control wages, especially in certain enterprises. Second, there is an

Table 3. Dwelling Units Built 1960-1989

Year/period	*Budapest*	*Other Towns*	*Villages*	*Total*	*Units/Year/ 1,000 Population*
		(Annual Average Units Built)			
1961-1965	10,164	18,616	27,691	56,471	5.6
1966-1970	11,788	23,500	30,198	65,486	6.5
1971-1975	15,467	36,502	35,659	87,628	8.4
1976-1980	17,118	40,298	33,127	90,543	8.5
1981-1985	14,882	31,955	27,100	73,937	6.9
		(Number of Units Annually)			
1986	9,956	33,254	26,218	69,428	6.5
1987	10,311	25,913	20,976	57,200	5.4
1988	8,519	22,442	19,605	50,566	4.8
First Half 1989	1,079 (preliminary)	n/a	n/a	n/a	

Source: Hungarian Statistical Office.

increasing share of private construction (see Table 5) and the private sector tends to be more efficient. Note also that the private builders tend to work as much as seven days a week and often employ workers in the second economy. Construction costs have shown substantial increase in the last two years, however, and would have increased even more if government had not put a cap on construction industry incomes.

Home prices have been rising at about the rate of inflation, slightly above this in Budapest and below it in the remote villages. With OTP controlling prices by making a market, however, price increases were limited and price differentials in underdemanded/oversupplied remote markets are not substantially below those in the cities. The result was that homes in the smaller cities and villages would often remain on the market, ie in the OTP inventory, for months or years, while dwellings in the major cities sold immediately, especially "affordable" housing. Still OTP did not increase home prices in Budapest as housing was viewed as a right. Unfortunately, it was an often unattainable right.

In the 1980s the Tanacsok and the State found that being a landlord of subsidised rental housing was an onerous burden, especially when they were the institutions doing the subsidisation. Some Tanacs housing was made available for purchase. Most of this was the small inferior flats described above. The more run-down and the fewer the amenities in the units, the slower they sold, but even inferior well-located units sold rapidly in Budapest. Occupants of the rental housing were given the option of purchasing the rental unit they occupied, often at as little as 50% of "market" value (as determined by OTP). When 50% of the tenants elected to buy, the building would be converted to ownership tenure. If a resident elected not to purchase his flat, then the Tanacs could sell the unit to OTP or to a non-resident given they had other Tanacs-owned housing available for the current occupant.

This did little to resolve the housing shortage, but did result in the reported home ownership rate increase. Home ownership had always been high in the villages, but in the major cities it had been as low as 33% because most of the housing developed and converted during the 1950s and 1960s were Tanacs-owned rental flats.

In January 1989 the housing market apparatus changed. Private real estate brokers were allowed to augment the brokerages housed in OTP and the other banks, in co-ops and Tanacsok. In mid-1989 there were 55 private brokerage companies licensed, 30 in Budapest and 25 in the other cities and towns.

Home sellers now have an option. If they do not feel the price OTP or the other banks offer is sufficient, they can list their home with a private broker. In fact, OTP, MHB and the other banks prefer to take a listing and act as a broker rather than purchase and inventory the home.

The typical brokerage contract is a 60-day Exclusive Right to Sell Listing, similar to those common in the UK and US. There is no multiple listing agency and signage is not used except in the store fronts of the broker's office if he has that type of location. A potential buyer will contact the many banks and brokers handling property listings.

The commission rate is not universal, varying between 1% and 7%, with 2% to 3% the norm. If a broker represents the seller he will collect his commission from the seller; if he represents the buyer from the buyer, and if he represents both, a slightly reduced shared commission from both. For example, if a homeowner signed a listing agreement at 3% for a flat priced at HUF2 million, the broker would receive a commission of HUF60,000 when the property sold. If he represented a seller who purchased the flat with a similar agency agreement he would receive the same, but if he represented them

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Table 5. Dwelling Units Built by Type of Contractor 1976-1988

Type of Contractor	*1976-80*	*1981-85*	*1986*	*1987*	*1988*
		(Percent of Homes Built)			
State	46.4	43.0	33.7	37.3	30.6
Co-operatives	5.9	3.9	2.5	2.4	2.5
Small Builders	—	0.1	0.3	0.2	0.6
Non-Construction Organisations	3.5	3.4	3.1	2.6	2.1
Private Builders	44.3	49.6	60.4	57.5	64.2

Source: Hungarian Statistical Office.

Table 4. Size of Dwelling Units Built 1976-1989

Year/Period	*Average Number of Rooms*	*Square Metres*	*Construction Costs/ Square Metre (HUF)*
1976-1980	2.3	66	7,265
1981-1985	2.4	74	9,797
1986	2.6	83	12,914
1987	2.5	81	14,282 (preliminary)
1988	2.6	85	16,500 (estimate)
1989 Estimate	3.0	90	19,500

Source: Hungarian Statistical Office and interviews.

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both he might lower his commission to both by a third, receiving HUF80,000 or 4% of the purchase price.

Competition in the brokerage market has seen a 15% to 20% increase in home prices. A change in the banking laws and the mortgage system, however, has somewhat dampened demand and kept prices from increasing even further. It is now more difficult to qualify for a loan.

The Hungarian banking system

Hungary reformed and restructured the banking system in 1986. The reform allowed private ownership and operation of commercial banks. Many of the functions of the existing state-owned National Bank of Hungary (the Hungarian Central Bank) and the National Savings Bank (OTP) were transferred to the new commercial banks, most of which still have substantial shares of government agency ownership. Some of the new commercial banks are beginning to provide mortgage loan financing to the private sector, but OTP is still the largest mortgage lender.

Hungarian financial institutions, their age, capitalisation, ownership and functions, are summarised in Table 6. The institutions most concerned with real estate are OTP and MHB, although other banks such as EIB, BHB and K&H are also marginally involved in residential mortgage financing and are likely to become more so.

OTP, with deposits of HUF280 billion and capital of HUF1.3 billion, is the largest financial institution in Hungary, other than the Central Bank. The bank carries out a broad range of functions in addition to the typical savings bank functions of collecting deposits and making mortgage loans, which include consumer lending for household goods, automobiles, etc; lending to co-operative and private retail stores; lending to manufacturing, distribution and production co-ops and private companies; foreign currency operations; operating a travel and touring service in a joint venture with a private Austrian firm; running the football pool and national lottery; leasing and factoring; and real estate related functions, eg building tenement housing; financing state, Tanacs and private housing, commercial and industrial buildings; constructing, refurbishing, buying and re-selling flats and homes; acting as an estate agent; and managing residential and other property.

The bank has 600 branch offices throughout the country to serve the eight million individual, partnership, co-operative and Tanacs depositors and has additional deposit collection branches in 3,300 post offices and 5,000 co-operative mutual assistance societies. Some of the new Hungarian political parties feel many of the functions performed by OTP should be private. Changes in this institution are likely next year.

The largest of the new commercial banks is the Hungarian Credit Bank Ltd (MTB). Founded in 1987, the bank has nearly HUF14 million in registered capital. While the Hungarian government still participates in ownership, the majority of the stock is owned by the 900 non-governmental shareholders which includes Tanacsok. The ownership includes foreign companies, co-operatives and middle and small size enterprises. This year individuals are also acquiring stock.

MHB has performed so well in the real estate sectors that they are splitting off the real estate operations' arm and forming a separate company. Bonds and stocks are to be issued and, while MHB will retain some ownership, the new entity, to be known as the Real Estate Bank Ltd, will not be a subsidiary. The new bank will operate a real estate brokerage, provide residential mortgage financing, manage real estate investment partnership funds and develop commercial and industrial properties. The REB arm of the MHB currently claims to have 20% of the real estate brokerage and mortgage finance market, equivalent to OTP, and is a significant competitor to the state agency.

Other institutions may also be planned which will create additional competition and improve the real estate marketing and finance functions. The Bank for Innovation for the Construction Industry (EIB), for instance, has a brokerage operation but is currently limiting lending activities to commercial and industrial properties for Hungarian citizens. BHB has a brokerage, but is not particularly active in residential real estate. Banks in Hungary not listed in Table 6 include Citibank of New York and the Central European Bank, referred to in Hungary as an "offshore" bank.

At present the Hungarian banking system could still be considered somewhat primitive. Except for limited consumer, auto and mortgage loans, the banks primarily serve the state co-operatives, Tanacsok and some small enterprises with short- and long-term credit. There are only 50,000 households with cheque book accounts and bank credit cards, and automatic teller cards are just being issued and nearly all companies pay their wages in cash. If and when Hungary begins to increase the number of personal cheque book accounts and credit cards, the money supply impact may be inflationary without significant credit limitation policies.

The mortgage finance system

The residential mortgage interest rate until 1989 was 3% for a fixed rate 10- to 25-year loan with a 30% down-payment. This rate held even when inflation moved to double digits. The low interest rates relative to inflation further stimulated housing demand and exacerbated the shortage. They also encouraged borrowing, as interest rates paid on savings accounts were more than three times the mortgage rate.

Higher interest rates were some-

Table 6 Financial Institutions in Hungary

English Name	*Magyar Acronym*	*Year Founded*	*Capitalisation (million HUF)*	*Ownership*	*Chief Functions*
National Bank of Hungary	MNB	1924	1,500	SO	Central Bank, Monetary Auth Supervise CBs & Set Int Rate
AGROBANK	A	1984	1,500	JS 458 Co-op SH	Ag & Food Processing Finance & Co-op & Private
Budapest Bank Ltd	BHB	1986	6,400	JS State-61% 394 SH	Small & medium sized Co-op & Private Business Financing
Commercial & Credit Bank Ltd	K&H	1987	10,600	JS State-50% + 400 Ag Ind & Trd SH	Joint Venture Financing
Hungarian Credit Bank	MHB	1987	14,000	900 SH Co-op/Int/Ind	Short Term Crdt. Some Cons & Mortgage Finance (See Text)
Hungarian Foreign Trade Bank Ltd	MKB	1950	6,000	Primarily SO	Foreign Trade & Currency
Innovation Bank for Construction Industry	EIB	1983	1,200	JS 61 Const/Coml/ Ins & Bank SH	Commercial/Ind RE Cons/ Mortgage/Prop Mgt
INTERBANK for Foreign Trade Ltd	I	1980 (pvt 1988)	2,200	JS SH Foreign Trd & Co-op	Develop Financing Import/Export
General Banking & Trust Co Ltd		(original1922) 1952 (pvt1986)	1,500	JS	
General Bank for Venture Financing Ltd		1985	2,200		
MEZOBANK National Banking Inst of Agri Co-ops Co Ltd	MB	1986	2,000	JS Ag & Co-op	Ag Co-op Financing
National Savings Bank	OTP	1949	1,300 (deposits 280,000)	SO	Res RE Constr, Mktg/Fin PLUS (See Text)
Post Bank	PB	1988	2,200	SO	Collection of Deposits & Loans to other banks
Savings Co-operatives	T	1957	10,000	SO	Analogous to Credit Unions
Real Estate Bank Ltd		Being Formed 1989		JS	Formerly Subsidiary of MHB for RE Brokrg/Devel/Lending

Source: National Bank of Hungary
SO – State Owned; JS – Joint Stock (private); SH – Shareholders; Ag – Agricultural; Co-op – Co-operatives; Ind – Industrial; Trd – Trade; Cons – Construction; Int – International Firms

times charged for larger or more expensive housing, as measured by square metres or rooms per household member, but the higher interest was easily avoided by simply listing additional family members at the new address. Privatisation of the construction industry and the general financial reforms encouraged the construction of larger homes. OTP also made a conscious effort to build and make loans on higher quality housing.

Often this resulted in an upward transfer of income as it was the more affluent homebuyer who could afford the new, more expensive homes. The 3% mortgage rate was available to all buyers and was subsidised by the state through OTP, which was a state agency. At this time the other banks making mortgage loans were also state owned, fully or partly.

As for the real estate broker system, the mortgage system also changed in 1989. Government, which had directly given subsidy through the state-owned banks at a 3% mortgage rate, allowed or caused interest rates to rise to 18.5%. They also permitted a loan fee, which is currently one point. Clearly, an increase from 3% to effectively 19.5%, an increase in interest of 617%, was a shock to the economy and the housing markets.

The new mortgage instrument was for 25 years and the rate was no longer fixed, but was variable with the current rate being set by the central bank. As of this writing, it has not been possible to determine the index or mechanism used to adjust the rate. Hungary does not yet have a truth in lending law.

Wages have not kept pace with inflation. The 1988 household income was estimated to be HUF220,000. With the average price of a dwelling at more than HUF2 million, the income-to-home price ratio was nearly 10. With a 70% 25-year loan the monthly mortgage payment on an 18.5% mortgage loan would be 117% of reported average household income. With the 3%, 25-year loan the monthly payment was only 52% of income. Even the 3% ratio was high, but the 18.5% ratio, which is more than 100% of income,

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is intolerable and unworkable in an economy that encourages home ownership and especially in an economy that is moving away from subsidies and toward privatisation.

Government anticipated this situation and has established mortgage subsidy programmes. A programme known as a Socio-Political Subsidy provides assistance for the down-payment to keep the mortgage amount low and affordable. There are several mortgage payment subsidy programmes which are described below. Essentially all the programmes codify the earlier allocation schema, but were intended to eliminate some of the previous inequities and discrimination by position, association, wealth and income and make home ownership available to a broader spectrum of the population. The conditions for qualification for the subsidy programmes include:

- The household does not own a dwelling or;
- If a home is owned it must be sold and all proceeds of the sale be used for the new subsidised purchase; and
- The dwelling meets a reasonable need criterion based upon rooms per person.

Several programmes could be considered forms of social engineering, in that they encourage families to have two or more children. This may be in response to the declining birthrate and population of the country.

Unlike the 3% subsidy programme, where the state-owned banks, especially OTP, absorbed the loss from the below market interest rates, under the new programmes funds are given directly to the home buyers or the banks by the state. Most of the programmes have size of dwelling unit or price restrictions associated with them so there will not be as much upward income transfer to more affluent households buying more expensive homes.

The socio-political or down-payment subsidy programme is available to all households meeting the criteria listed above for use in purchasing an existing dwelling, constructing a new dwelling or purchasing and remodelling state or Tanacs-owned flats or homes. The subsidy is available to all qualified home buyers whether they are financing their home or not as a function of the number of children or dependants in the family, but has limitations as to the number of rooms per person, excluding kitchens and bathrooms based on a previous government criterion for allocating the Tanacs lakas. If a qualifying household had sufficient funds to purchase a home without borrowing they could conceivably receive the down-payment subsidy in cash. If they sold a home, however, they could only receive a subsidy up to the difference in the price of the new dwelling and the cash received from the previous sale.

In addition to the socio-political down-payment subsidy, an additional HUF30,000 for each dependant is available to households earning less than HUF3,500 per month (HUF42,000 per year). The total subsidy is available up to a limit of 55% of the home price or value.

More than children qualify as dependants. Dependants include all natural and adopted children up to the age of 16 and all students up to the age of 25. Others included are family members with a 67% or higher disability and parents or grandparents with incomes of less than HUF3,500 per month. Future children can also be included in that a couple under age 35 can receive the subsidy by contracting for future children (one within three years or two within six years) and receive the down-payment assistance now. If they do not meet their contract on time they must pay back the advance with 18.5% interest, but if the wife is pregnant when the due date arrives then the contract will be extended.

The Mortgage Interest or monthly payment subsidies fall into three categories. The first, the General Subsidy, is available to the entire population regardless of family size and is limited only by the general criteria listed above and the size and price of the dwelling. Qualifying buyers receive a mortgage payment reduction of 30% of the monthly mortgage payment, after all other subsidies, for the first five years of the mortgage and 15% of the payments for the next 10 years. It is also available for buyers qualifying for other subsidies, but takes a subordinate position.

The Dependant Subsidy is a function of the number of children or dependants in the household and is limited to buyers qualifying for the Socio-Political Subsidy. Payments

Table 7. The Hungarian Socio-Political Housing Subsidy Programme

Number in Household	*Down-payment Subsidy HUF*	*Cumulative Subsidy HUF*	*Rooms Allowed Under Reasonable Need**
2	—	—	1 to 2
3	50,000	50,000	1½ to 2½
4	150,000	200,000	2 to 3
5	400,000	600,000	2½ to 3½
6	100,000	700,000	3 to 4
7	100,000	800,000	3½ to 4½
8	100,000	900,000+	4 to 5+

Source: OTP and *Ingatlan Piac.*

*Dwelling Unit can exceed the Reasonable Housing Need Criteria by one room and still receive the subsidies which increases the right hand side of the column by one room. Rooms do not include the kitchen or bathrooms.

Modern housing in Budapest.

from this programme are summarised in Table 8. It is available for up to 15 years on a declining scale and may be augmented if dependants are added during the subsidy period. A family of three would receive a subsidy on the amortised payment of 40% of the first HUF300,000 of their mortgage; a family of four, husband, wife and two children, a subsidy of 70% of the first HUF400,000.

The General and Dependant Mortgage Subsidy programmes can work in tandem for qualifying households. Table 9 demonstrates how the tandem plan would work for a childless couple and a couple with one, two or three dependants. The childless couple would get no Dependant Subsidy so would have relief on 30% of their mortgage payment, HUF10,952 per month during the first five years and 15%, HUF5,296 (not shown), from years six to 15. A family of four would receive a 70% subsidy on the first HUF400,000 in amortised payments and a 30% subsidy on the remaining 70% of the full mortgage payment. Their total subsidy would be HUF16,696 or 36.6% during the first five years and be reduced to 33% from years six to 10 and 31% from years 11 to 15 (not shown). All subsidies cease after the 15th year or when a property changes hands. Changes in dependants must be reported and will result in adjustment of the subsidy schedules.

Banks licensed by the state to receive the subsidy payments, eg OTP and MHB, determine the qualification of the mortgagor when he makes an application for the mortgage loan. They use an income to mortgage payment after subsidy ratio of three to determine if they will grant the loan. The subsidised loan is not assumable by other parties and the total subsidy cannot exceed the full monthly mortgage payment.

The third Mortgage Payment Subsidy programme is related to a savings account. Prospective borrowers establish a savings account with one of the licensed banks designated as pre-mortgage savings. After five years they are eligible to borrow up

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Table 8. The Hungarian Dependant Mortgage Payment Subsidy

Number in Household	*Percentage of Monthly Payment* 1-5 years	6-10 years	11-15 years	*Amortised Amount Subsidised Limit HUF*
2	0	0	0	
3	40	15	15	300,000
4	70	35	15	400,000
5	80	40	15	500,000

Source: OTP and Ingatlan Piac

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to 200% if they qualify for the Socio-Political Subsidy and 100% if they do not. The total amount of loan that can be subsidised under this programme is HUF300,000. The subsidy can be up to 70% of the amortised mortgage payment during the first five years, 40% during the second five years and 15% to year 15. The account can remain in the bank during the loan period earning interest. There is no limitation as to the price or size of the home and the subsidy can be used with the General or Tandem Subsidies.

Other subsidy programmes are still available in the form of interest-free loans from the Tanacsok and employers often give mortgage payment subsidies to present or new highly valued employees. The employer gets a 50% rebate on the subsidy from the state.

The government and the National Bank officials are worried about the potential expense of the subsidy programmes. Were there a way to do it, they would be phased out tomorrow. The programmes may provide a smooth transition to a privatised housing finance market. The question is at what cost in terms of inflation, taxation and capital consumption.

Conclusions

It is still too early to see if the various subsidy programmes will be effective or how much they will cost. It is clear that the major problem for Hungarian housing is supply, both of quality habitable dwelling units and mortgage funding. If the subsidy programmes make the development of housing profitable to the emerging private sector, then it may assist in alleviating the current problems.

Directing resources to housing may, however, prevent the rapid expansion of the economy necessary if the market economy, privatisation and integration into the international economic community are to be successful. Hungary is capital short, especially in hard currencies. Housing is not the only type of real estate development that is sorely needed and agriculture, industry and the public infrastructure all require investment funding. The construction technology lags behind the West, and if Western methods were employed they would use up capital for equipment and international currency for materials.

A potential partial solution, so far as housing finance is concerned, is the development of secondary mortgage markets. Currently none exist. Even those, if they captured domestic capital, may drain resources from other necessary investments. Foreign investors would be reluctant to invest in Hungarian secondary mortgage markets because of the tenuous convertibility of the forint. If the capital investment in the country promised by the Western community of nations is realised, then the value of the forint may solidify and become as convertible as the Austrian schilling.

What exists are chicken and egg conundrums. Housing, and other consumer goods, are necessary to provide incentives for the population to accept the hardships that will be experienced during privatisation. Privatisation is necessary to provide the incomes and products, both from imports and domestic production the population demands. Capital investment is necessary to provide employment for the presently underemployed labour force. It is also needed for the investment in housing and to provide housing finance.

The inflation rate during the first half of 1989 is down slightly from the 1988 rate. Some of this may be due to postponed demand, both because of the new high mortgage and consumer interest rates and the uncertainty and expectations of the public concerning the policy changes after the upcoming elections. In any case, if the inflationary pressures lessen it may be possible to lower the 18.5% mortgage interest rate, and phasing out of the subsidy programmes will be less painful. ■

Table 9. Tandem General & Dependant Mortgage Payment Subsidies

Persons in Household:	*2 HUF*	*3 HUF*	*4 HUF*	*5+ HUF*
Maximum Purchase Price with Subsidy:	3,400,000	3,850,000	4,280,000	4,650,000
Loan Amount (70%):	2,380,000	2,695,000	2,975,000	3,255,000
Full Monthly Mortgage Payment @18.5%, 25 years:	36,505	41,337	45,632	49,926
Dependant Subsidy:	0	1,804 (40% of 300,000)	4,295 (70% of 400,000)	6,135 (80% of 500,000)
General Subsidy:	10,952 (30% of 36,505)	11,860 (30% of 49,533)	12,401 (30% of 41,337)	13,137 (30% of 43,791)
TOTAL Monthly Subsidy:	10,952	13,664	16,696	19,272
Adjusted Monthly Mortgage Payment (first 5 years):	25,553	27,673	28,936	30,654
Subsidy as a % of full Monthly Mortgage Payment:	30.0%	33.1%	36.6%	38.6%

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Major changes in US secondary markets

By Robert Van Order

UNTIL recently, American mortgage markets were fairly easy to understand. They were dominated by depository institutions (mainly savings and loan associations) which by both regulation and tax incentive were induced to hold most (about 80%) of their assets in mortgages. These mortgages were financed with low-cost, government-insured deposits. There were at one time about 4,000 savings and loans and about 14,000 commercial banks. Currently, there are fewer than 3,000 savings and loans, and the number will be under 2,000, perhaps 1,000, in the next few years.

Mortgage markets were characterised by both regulation and by the savings and loans providing all the major aspects of mortgage lending. That is, they originated loans, serviced them (ie, collected the payments and managed defaults) and were the ultimate investors. The mortgages were mainly 30-year fixed-rate mortgages which were financed with short-term deposits. The maturity mismatch generated by borrowing short term and lending long term became quite risky, and in the early 1980s, when interest rose rapidly, many institutions had large losses.

The major change in mortgage markets has been the unbundling of the three aspects of mortgage lending — origination, servicing and investing. This is most evident on the investment side. Pools of mortgages now trade in national and international markets, almost as efficiently as Treasury securities. An effect of this has been to allow savings and loans to avoid interest rate risk. They can originate fixed rate loans and sell them, but make money from servicing them. Mortgage rates are now determined by capital markets in general and are largely independent of the ups and downs of the savings and loan industry.

It is also true that originating and servicing have become unbundled. Servicing contracts are valuable assets and trade in fairly active markets. A contract to service a pool of loans may sell for 0.5% to 1% of the value of the pool. Many institutions now make quite separate decisions about originating, servicing and investing. For better or worse, decisions about all aspects of mortgage markets are now made in ruthlessly competitive markets.

History and overview

The primary (ie, origination) mortgage market in the United States is dominated by depository institutions (especially savings and loans, but also commercial banks and credit unions) and mortgage bankers, who act as dealers and servicers in mortgages. After origination, mortgages are either held in portfolio (eg by a "traditional" savings and loan) or sold into the secondary market. While there has always been a secondary market in the United States, until recently it was informal and *ad hoc.*

The rise in the secondary markets in the 1970s and especially in the 1980s came about largely because of standardisation of pools of mortgages brought on by three government agencies: The Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and the Government National Mortgage Association (Ginnie Mae). Sales into the secondary market have risen from $69 billion in 1980 to $281 billion in 1988. Almost 40% of the outstanding stock of mortgages is now in pools that trade with the secondary markets.

Fannie Mae, the oldest of the agencies, was established in the 1930s. For most of its history it operated like a national savings and loan, gathering funds by issuing its own debt and buying mortgages which were held in portfolio. This was a particularly useful function during credit crunches when deposit rate ceilings limited the ability of savings and loans to raise money. Fannie Mae was a useful countercyclical tool because it was the only "deregulated" savings and loan.

In 1968, Fannie was moved off budget and set up as a private, government-sponsored corporation. It receives no government funding and its operations are separate from the "on-budget" parts of the government. Ginnie Mae was created in 1968 to handle Fannie Mae's policy-related tasks. It is on the federal budget and is a part of the Department of Housing and Urban Development.

Ginnie Mae was responsible for the major innovation in secondary markets, the mortgage-backed security (MBS). An MBS is a "pass-through" security. The issuer passes through all of the payments from a pool of mortgages (both principal and interest and net of its fee) to the ultimate investors who receive *pro rata* shares of principal and interest payments. The issuer also guarantees the payment of interest and principal even if the borrower defaults. Ginnie Mae deals only in federally-insured mortgages. Its guarantee is on top of the federal insurance, and mainly amounts to a guarantee of timely payment.

Freddie Mac was created in 1970. Like Fannie Mae, it is a private, government-sponsored corporation, and it is off budget. About 95% of its business is MBS pools (like Ginnie Mae pools) of conventional (ie, not federally insured) mortgages. Fannie Mae now deals almost entirely in conventional loans and has, since the early 1980s, moved heavily in the direction of MBS pools, largely as a result of the trouble it, like the savings and loans, got into in the early 1980s when interest rates went up and the maturity mismatch in its portfolio brought about big losses. MBS pools have the major advantage of eliminating almost all interest rate risk for the issuer of the pool.

Because Ginnie Mae is "on budget" it has a "full faith and credit" federal guarantee. And because Freddie Mac and Fannie Mae are separate corporations, they both have a nebulous, implicit guarantee and are (or soon will be) regulated by the Department of Housing and Urban Development. Fannie Mae and Freddie Mac are now, except for details, quite similar and compete quite intensely; the relative market shares of the two fluctuate almost randomly.

The major vehicle for all three agencies is the MBS. Currently, there are almost $800 billion in agency MBS pools outstanding, and about $70 billion in private, non-agency pools. Trading volume in these securities in 1988 was about $2.4 trillion. This indicates an extremely liquid and competitive market. All three agencies guarantee their MBSs against default losses. Because, unlike Ginnie Mae, Freddie Mac and Fannie Mae deal primarily with conventional mortgages, their risk exposure is larger than Ginnie Mae's. However, they have some protection from private mortgage insurance, large down-payments (20% or more) for uninsured loans, and from regional diversification.

More recently, secondary markets have developed beyond the "plain vanilla" mortgage-backed security and have attracted funds through additional means. This is because a *pro rata* share in a pool of 30-year fixed-rate mortgages is not what all investors want. While MBSs have no credit risk they have two types of interest rate risk: the usual risk that any long-term security that has value will fall when rates rise, and second, a risk that is similar to that of callable bonds, because borrowers have the option to refinance (ie, call the bond) and they tend to do this when rates fall. Hence, upside gains are limited.

Beginning in 1983 with the first collateralised mortgage obligation (CMO), issuers have created "derivative securities", which take pools of mortgages and pass through payments in non-*pro rata* ways. The first CMOs established groups or "tranches" that received principal payments in sequence; the first tranches receiving interest plus the first $X in principal payments, the second tranches receiving the next $Y in principal payments, etc. In this way a complicated 30-year callable security was broken into a sequence of short-, medium- and long-term bonds which could be sold to different types of investors. This carving up of the mortgages does not eliminate their interest rate risk, but it does allow the risk to be allocated more efficiently.

Complications in tax law limited the use of CMOs. Tax reform in 1986 created the "real estate mortgage investment conduit" (REMIC) which solved most of the remaining tax problems. REMICs are much the same as CMOs (the names are often used interchangeably), but they and CMOs have become much more exotic, carving up the cash flows from a pool of mortgages in very complicated ways. They can now be tailored to quite specific needs, but because of their complicated nature, REMIC tranches are often difficult to evaluate; no two tranches are exactly alike, so that they are much less liquid than straightforward pass-throughs. In 1988 REMIC and CMO volume was about a third of the $240 billion in mortgages that were issued during the year.

Creating pools and derivative securities

Mortgage-backed securities are created in two ways. One version (called "Cash") involves selling mortgages (eg, conventional mortgages made by a savings and loan or a mortgage banker) to either Fannie Mae or Freddie Mac in return for cash. The agencies then form pools out of these loans (sizes vary, some pools are over $100 million) and sell shares in the loans to dealers, who in turn sell them to investors.

The second way (called "Guarantor" or "Swap") involves less work by the agencies. With Guarantor a lender exchanges (swaps) a pool of mortgages for a security made up of those mortgages. Functionally this amounts to renting the agency's guarantee. The lender can then hold the pool or sell it.

The charge for renting the guarantee varies, but for a standard pool of fixed-rate mortgages the fee charged by Fannie Mae and Freddie Mac is around 15 to 20 basis points (0.15% to 0.20%). This fee includes a charge for credit risk and processing, administrating and other costs, net of some "float" income received by the issuer. Ginnie Mae charges a smaller fee, largely because it faces less credit risk, because its loans are federally insured to begin with. All of Ginnie Mae's and most of Fannie Mae's and Freddie Mac's business is now done through guarantor-type programmes.

Because they are more or less standardised, most pools consist of fixed-rate (usually 30-year) mortgages. However, an increasing share of adjustable-rate mortgages is

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being pooled. In the first half of 1989 34% of Freddie Mac's pools were adjustable rates, versus 18% in 1988 and 7% in 1987.

Pools trade like bonds. As mentioned above, trading volume is heavy, almost $2.5 trillion last year. The average MBS turns over about three or four times a year. This is lower than in previous years largely because of the increased use of derivative securities, which because of their idiosyncratic nature are difficult to trade.

Derivative securities are generally created out of already existing MBS pools. A typical derivative security might be made out of Ginnie Maes which are bought by a Wall Street dealer. The dealer will then create, say, a REMIC after deciding on what types of tranches to create. Frequently, REMICs are created because a particular group of investors wants a particular type of bond, say one with a maturity of close to five years. A dealer will set up a REMIC with a five-year tranche as well as other tranches.

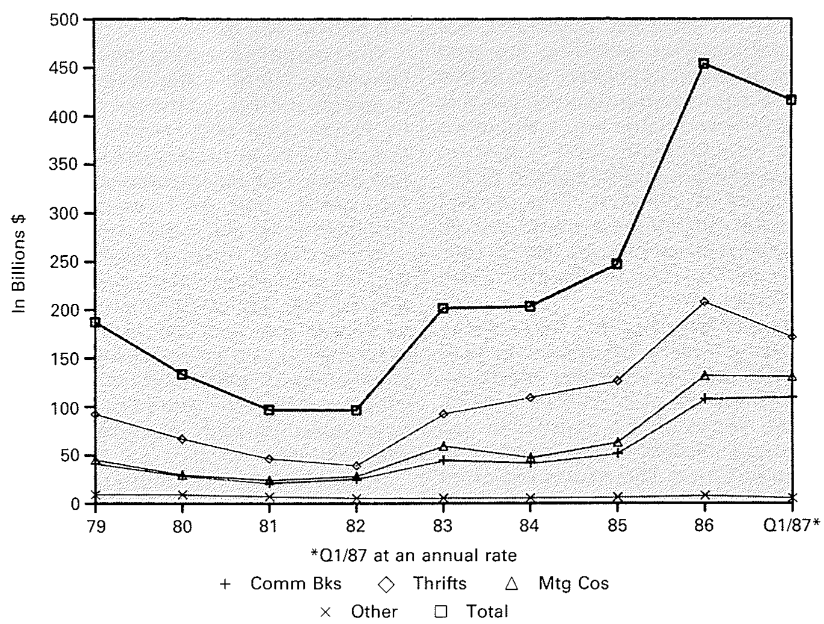
Because all of the payments made into the pool have to be passed out and the investors have to be assured that there will always be enough in the pool to pay them off, REMICs, and all derivative securities, have a "residual" class which balances the books. Residual classes can be very complicated and very volatile. The success of a dealer in doing a REMIC deal (ie, the extent to which he sells the tranches for more than he paid for the MBS pool) quite often depends on finding buyers for residuals.

A major source of REMICs has recently been through Fannie Mae and Freddie Mac. The REMICs are still formed by dealers who buy the pools, set up the tranches, and sell them to investors, but the agencies add their guarantee to the tranches. (This is somewhat redundant because they have typically already guaranteed the pools, but there is always some — small — risk that something will go wrong with deals that are set up privately. In any event, investors seem to be willing to pay for this extra comfort.) Since it was given authority to do REMICs in early 1988, Freddie Mac has done about $28 billion in REMICs through mid-1989. Fannie Mae, which got authority in 1987, has done about $23 billion.

Chart 1

1-4 Family Mortgage Originations

By Lender Type



The Extent and Role of Secondary Markets

The overall mortgage market

Chart 1 depicts annual originations of 1-4 family mortgages by major lenders. As can be seen from the chart, the volume of business in the mortgage market is quite volatile. This occurs primarily for two reasons: (1) housing demand (both for new houses and resales) is very volatile — housing is among the most interest-sensitive sectors of the economy — and (2) refinancing of existing loans is also very interest-sensitive. These two effects reinforce one another, so that mortgage originations tend to move inversely with interest rates.

Hence, in 1981 and 1982 when interest rates rose abruptly, housing production dipped sharply. Furthermore, existing homeowners moved less, had old, low-rate mortgages assumed more often*, and generally refinanced less in an effort to keep old, low-rate mortgages alive. Originations fell precipitously, By the beginning of 1986, housing production had stepped up as interest rates fell. When the rate decline accelerated during 1986, refinancings rose rapidly, and accounted for about

*Currently, most conventional mortgages cannot be assumed by a new owner, but government-insured mortgages generally can. In the 1980s many state laws allowed assumption of previously unassumable conventional loans and assumptions were a major factor. These state laws were generally overturned in 1982 by Congress.

$200 billion of the record $454 billion in single-family mortgage originations. Volume has declined since then, but, at about $370 billion, it is still well above the levels of 1983 through 1985.

Table 1 gives a breakdown of major lenders' share of 1-4 family originations. Table 2 gives the share of new mortgage investment (including MBSs) of various lenders over time. Together the two point to an important recent development. While the role of savings and loans as originators has not changed much over time, their role as ultimate investors in mortgages has diminished. This is in large part a result of secondary markets bringing in new investors, and of deregulation allowing savings and loans to invest in a wider range of assets.

Types of mortgages

Chart 2 shows the relative amounts of fixed-rate mortgages (FRMs) and adjustable-rate mortgages (ARMs) originated in the past few years. During early 1981, federal regulations authorised federally chartered depository institutions to originate ARMs. The ARM share of originations rose rapidly, but then fell in 1985 and 1986. It increased in 1987 and 1988, and was over half of conventional loan closings until recently.

The main factor in explaining the fluctuations in ARM share is the spread between FRM and ARM rates,

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Chart 2

FRM/ARM Spread & ARM Share

on Conventional Loans Closed

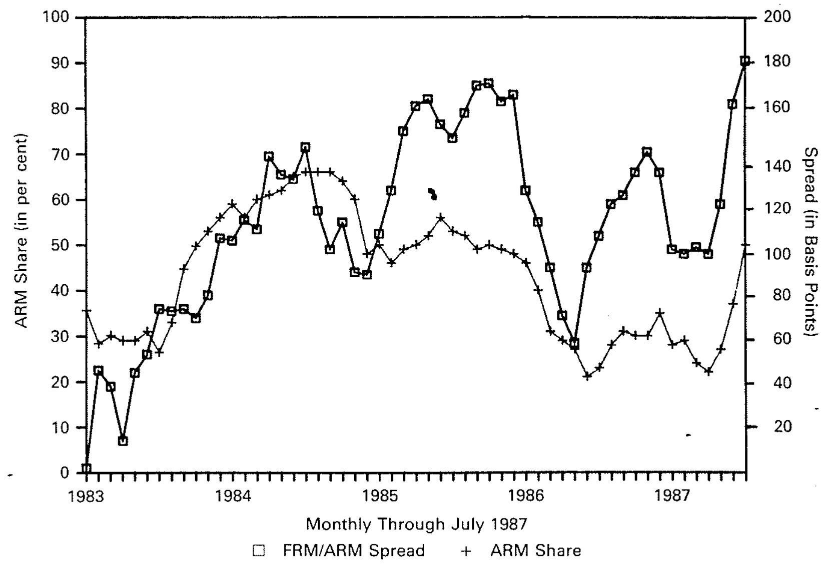


Table 1. Lender Share of Residential Mortgage Originations, 1950-1988

Decade	*FSLIC-insured Thrifts*	*FDIC-insured Savings Banks*	*Commercial Banks*	*Federal Credit Agencies*	*Mortgage Companies*	*Other*
1950-1959	43.5%	10.0%	20.3%	0.7%	17.8%	7·7%
1960-1969	45.7	7.1	20.3	1.5	20.5	4.9
1970-1979	47.2	6.3	21.0	3.8	17.9	3.8
1980-1988	41.4	6.1	23.4	2.0	24.0	3.1

Source: US Department of Housing and Urban Development.

Table 2. Investor Distribution of Net Growth in Residential Mortgage Debt Outstanding, 1949-1988 (based on year-end data)

Decade	*FSLIC-insured Thrifts*	*FDIC-insured Savings Banks*	*Commercial Banks*	*Federal and Related Agencies*	*Life Insurance Companies*	*Private and Public Pension Funds*	*Mutual Funds*	*Other*	*Memo: Multiclass Securities*
1949-1959	38.6%	16.4%	11.3%	5.8%	18.3%	1.5%	0.0%	8.1%	0.0%
1959-1969	42.2	14.1	13.1	6.8	8.0	3.3	0.0	12.5	0.0
1969-1979	47.9	6.7	19.0	6.9	0.1	4.3	0.0	15.1	0.0
1979-1988	28.6	4.1	19.2	6.2	5.0	2.7	3.7	30.5	13.0

Note: The percentage figures represent the ratio of the change in holdings of whole residential mortgage loans and single-class pass-through securities from the end of one decade to the end of the next decade to the change in the amount of total residential (1-4 family and multi-family) mortgage debt outstanding during that time period. Memo item on multiclass securities reflects agency and conventional CMOs and REMICs.

Sources: Federal Reserve Board, Office of Thrift Supervision, Department of Housing and Urban Development, Investment Company Institute, Mutual Fund Sourcebook.

Public pension funds' holding of pass-through securities are Freddie Mac estimates.

Chart 3

Agency Purchases – Per cent Share

of 1-4 Family Mortgage Originations

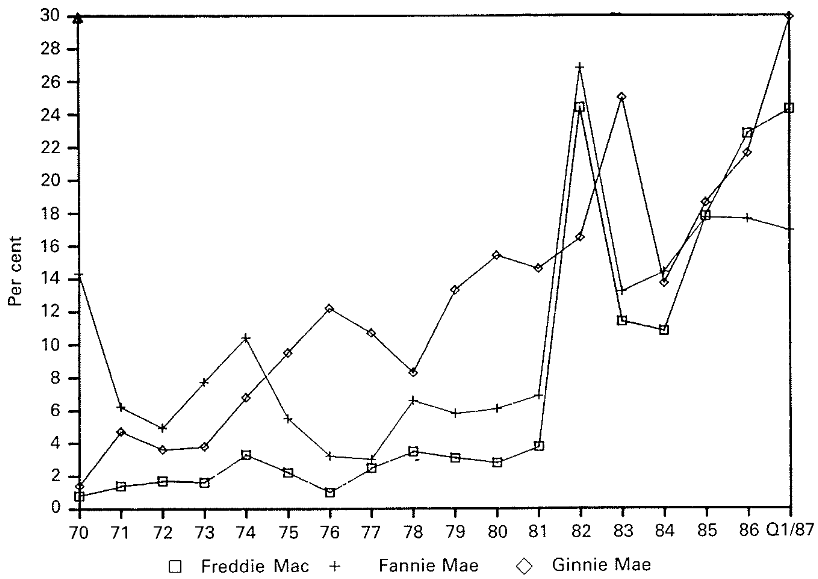
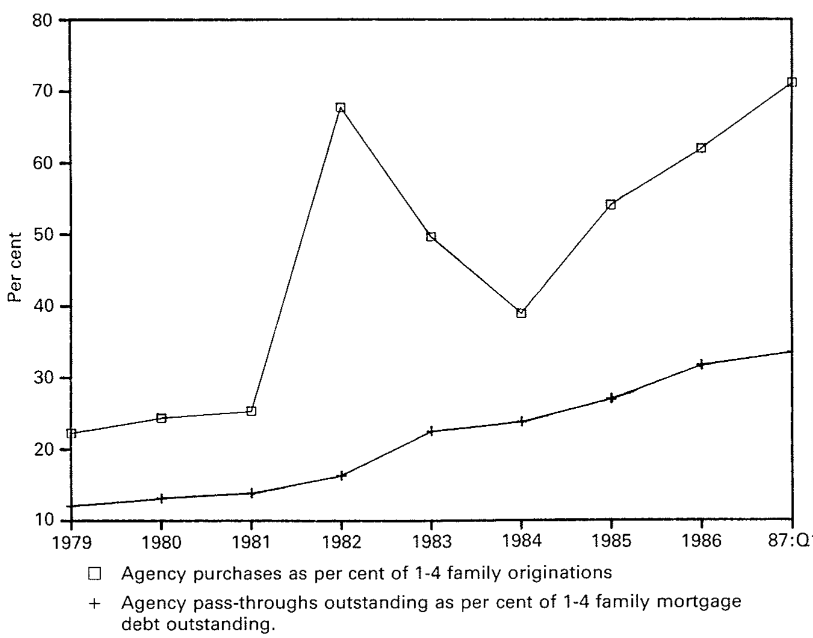


Chart 4

Agency Acquisition of Home Mortgage Debt



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also depicted in Chart 2. The rise of ARMs came at a time when FRM rates were well above ARM rate; the share declined with this spread, rose as the spread had again widened in 1987 and 1988, and fell again this year when the spread narrowed again.

ARMs come in many forms and are much less homogeneous than FRMs. This makes them more difficult to assemble into pools, which is a factor in their relative unimportance in secondary markets. Most ARMs have caps that limit changes in rates and payments. These caps also make ARMs difficult to evaluate. Most ARMs are halfway between a fixed-rate and a true floating-rate instrument, and as a result they do have some interest rate risk (as much as half the interest sensitivity of FRMs).

ARMs and FRMs account for almost all mortgages. Recently, there has been some discussion of price level adjusted mortgages (PLAMs), which will be indexed to the inflation. There is currently a proposal for government-insured PLAMs.

Extent of the secondary market

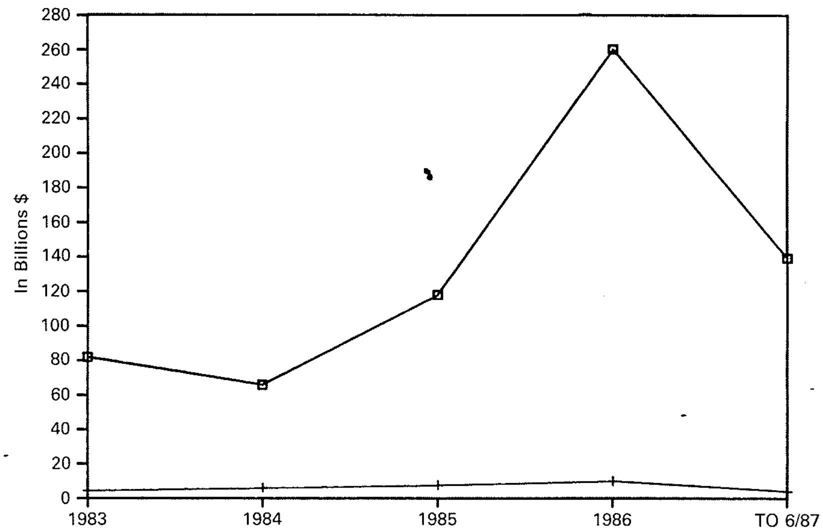
Chart 3 shows that the activity of the major players in the secondary markets can vary substantially from year to year. The ratio of secondary market purchases to originations also fluctuates (Chart 4). Historically, this was because of the secondary market's role as a residual lender that had increases in business activity (eg in 1970, 1974 and 1981) when shortages of deposits cut into thrifts' ability to make mortgage loans. During the early 1980s — especially after the introduction of mortgage/security "swap" programmes by Freddie Mac and Fannie Mae after 1981 — portfolio lenders relied on the secondary market to convert seasoned loans into pass-through securities, which were far more liquid and could be more effectively used to collateralise borrowings. More recently, the secondary market has become a more permanent source of funds for the primary market and originators of fixed-rate mortgages have sharply increased their reliance on it.

Chart 5 shows the volume of FRM and ARM purchases in secondary mortgage markets. The FRM volume has overwhelmed the rather small amount of ARMs. While this is partly due to the heterogeneity of ARM contracts, the primary reason for the small trading volume of ARMs is that thrifts have tended to want to hold ARMs in portfolio and have been increasingly interested in selling FRMs in secondary markets, avoiding interest rate risk and earning income from servicing. Hence, the secondary markets are allowing thrifts to diversify out of FRMs (and out of mortgages if they want), yet assuring a supply of FRM credit to homeowners. More recently, ARM activity has picked up and new pooling techniques have made it easier to pool them. Overall, they are still a small part of the secondary market.

Chart 5

All Agency Single-Family Purchases

Fixed-Rate vs ARMs



ARM purchase data before 1986 excludes FNMA ARM MBS swaps

□ FRM + ARMs

The Federal role

The rise in secondary markets has not come without controversy. While secondary markets do support many thrift institutions by buying mortgages from them, they also compete with them because they provide an alternative source of funds (from capital markets rather than deposit markets). This has lowered mortgage rates on some (particularly on FRMs, for which secondary markets have probably lowered rates by about one-quarter of one per cent), which has lowered the profit margins of traditional savings and loans.

Not surprisingly, this has raised a protest from some savings and loans. The underlying issue is part of the broader policy discussion of the use of federal guarantees. Clearly, the "savings and loan problem" and the enormous costs of deposit insurance are the major impetus, but there has for some time been increasing concern about the safety of all beneficiaries of federal guarantees, and about their role in resource allocation.

The federal government, through implicit and explicit guarantees, plays a large role in mortgage markets. Inevitably, this role involves some sort of subsidy. Whether mortgage markets, and ultimately housing, should be subsidised is an important issue, one which has to be solved in Congress. My focus here is on the narrow issue of the way that federal guarantees affect mortgage markets and the efficiency of different types of guarantees.

There are two major types of federal guarantees in mortgage markets: securities guaranteed by the federally-sponsored agencies and deposit insurance of banks and savings and loans. Both work in much the same way; they attract funds into mortgage markets at lower costs than would be required otherwise. As of May 1987, FSLIC-insured institutions had $1.141 trillion in liabilities, of which over 80% (mainly insured deposits up to $100,000) was explicitly covered by an implicit or explicit federal guarantee. Implicitly, an even greater amount of the liabilities (and some of the equity) of these institutions is covered because most of the time a failed institution has been merged with another savings and loan, and its liabilities (and sometimes some of its stock) kept whole. Similarly, the total liability of the secondary market agencies (MBSs plus debt) was $647 billion at the end of 1986.

At the end of 1986 there were $1,667 billion in 1-4 family mortgages outstanding. Of these, $814 billion were held as whole loans by federally-insured institutions, $127 billion by federal agencies, and $518 billion were in federally-sponsored pools. These three groups add up to $1,459 billion. That is, 88% of the 1-4 family loans in the United States benefited from some sort of federal guarantee. The remaining 11% were

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held by other institutional investors (eg life insurance companies or pension funds), were securitised by private conduits, or represented mortgage credit extended by individuals (mostly home sellers).

This share has changed very little. In 1980, 85% took advantage of a federal guarantee. The difference between 1980 and 1986 is in the form of the guarantee. The share of the agencies (rather than deposit insurance) rose from 19% in 1980 to 39% in 1986. Because many agency-guaranteed pools are held by banks and savings and loans and financed with deposits, there is a good deal of overlap in the two guarantees. The above figures are adjusted for the overlap.

It is difficult to estimate how much the advantages involved in these guarantees have affected mortgage rates, but we can make some ball park estimates of how they have affected the borrowing rates of the institutions involved. We might define the advantage to an institution of either agency status or deposit insurance as the difference between the rate it would have to pay to raise funds if it were a fully private institution (with its current portfolio) and the rate it actually pays (with the guarantee).

One way of looking at the value of the federal guarantee is to compare agency MBS yields with those of comparable, private MBSs. While we do not have reliable public data on private yields, there is a consensus that they are about one-quarter of one per cent above those of agency securities. This is consistent with recent estimates that fixed-rate mortgages eligible for agency purchases ($187,600 for Fannie Mae and Freddie Mac) have rates about 0.25 to 0.3 percentage points below ineligible loans (virtually all of the private MBS pools are made up of ineligible loans).

Hence, the agencies have probably lowered rates on fixed-rate mortgages by about one-quarter of a percentage point. Because agencies have not been nearly as heavily involved in adjustable-rate mortgages, the effect on ARMs has probably been smaller.

Some of this one-quarter point difference is due to the implicit federal guarantee, and some of it is due to the benefits of liquidity that come from the enormous size and trading volume of the agency MBS market. It is hard to separate the two effects. Whatever the source of the decrease it is clear that at least on the fixed-rate side the agencies have squeezed the savings and loans' profit margins.

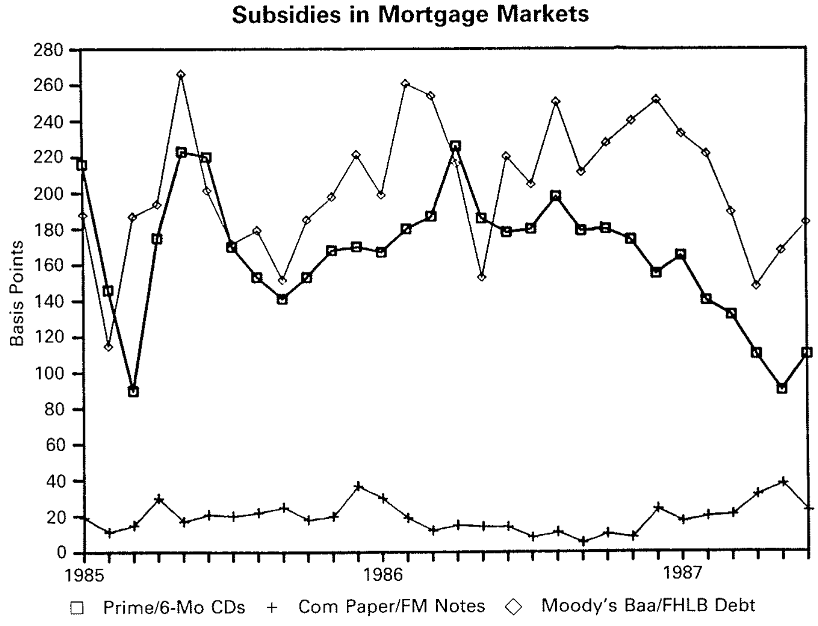
However, as recent events have clearly indicated, there is also a significant subsidy to savings and loans from deposit insurance. It is more difficult to estimate the advantage for federally-insured institutions because it is hard to estimate the rate at which they would borrow (and this would vary across institutions) in the absence of deposit insurance. We can consider two conservative proxies for this: one in the short-term part of the market and one in the long-term part.

Looking at short-term borrowing, it is almost certainly the case that thrifts, without deposit insurance, would borrow at no less than the prime rate, and recent experience suggests a lot more. One estimate of thrifts' advantage is calculated as the spread between the prime rate (a short rate) and six-month certificate of deposit (CD) rates. This is in Chart 6.

In the longer end of the market, thrifts would have to borrow at rates of comparable private corporations. We do not know for sure what rate class that would be; we think that Baa would be a good approximation. Hence, we look at Moody's index of Baa bonds, minus a comparable thrift borrowing rate. Since thrifts do not issue many long-term deposits, we use as a proxy the 10-year rate paid by Federal Home Loan Banks (who lend to the savings and loans). Chart 6 also depicts the spread between the Baa rate and the FHLB

Chart 6

Subsidies in Mortgage Markets



10-year rate. As can be seen from the chart, the estimated thrift advantage is larger than Freddie Mac's, around 100 basis points for either of our measures. This is offset somewhat by the 20% fee paid by savings and loans for deposit insurance.

The bottom line in the chart depicts a similar calculation for Freddie Mac, which issues short-term notes. The comparison is between Freddie Mac one-month notes and one-month rates on commercial paper issued by AA-rated corporations.

Private conduits

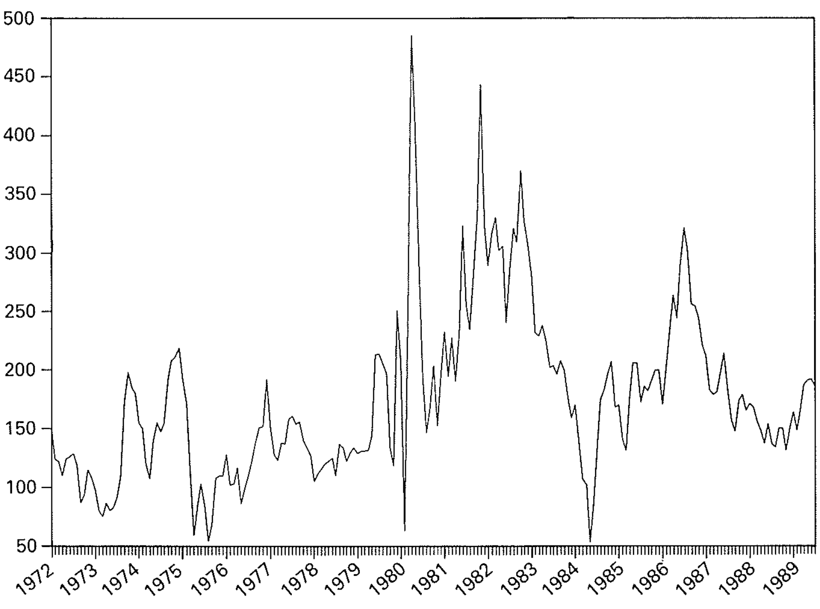
A key limitation on the agencies in secondary markets is the above-mentioned limit on loan size. We estimate that in 1988 roughly $65 billion in ineligible or "jumbo" loans were originated (ie, loans with a balance greater than Fannie Mae and Freddie Mac limits, $168,700 in 1988). This was about 20% of the conventional single-family market ($329 billion in conventional single-family originations).

The large amount of refinancings in 1986 of older, smaller loans made the jumbo share lower than the 25% that it had been in previous years. While the agencies are statutorily excluded from this market, thrifts may hold jumbo loans in portfolio (funding these investments with insured deposits), thus limiting the size of the secondary market in jumbo loans. Estimates of the size of the private conduit business run between $8 and $16 billion, the range representing difficulties in estimating private placements. In any event, a fairly small percentage of jumbo originations were securitised through private conduits. Apparently, the thrifts were formidable competitors, and they competed by emphasising ARMs. ARMs have generally held a larger share of the jumbo market than of the market as a whole.

Chart 7

FIXED-RATE MTG — 10YR TREASURY SPREAD

(In Basis Points)



Monthly Avgs: Jan 1972-July 1989

Benefits and costs of the secondary markets

The main benefit of secondary markets is to increase the efficiency of mortgage markets by increasing the number of investors that buy mortgages. This promotes a more dependable supply of funds so that disruptions or bottlenecks from one type of investor can be corrected by tapping a different investor. Two important effects of this are:

Secondary markets increase the liquidity of mortgages.

This allows funds to flow to high-cost areas, evening out regional rate differentials; it allows savings and loans to borrow against mortgages without incurring the costs of buying and selling securities; and promotes competition in all capital markets by making it easier for funds to flow to where they are valued most.

Secondary markets allow more efficient risk allocation.

A major issue has been risk-taking by savings and loans and the effect of that on federal insurers, especially by institutions holding fixed-rate mortgages financed with short-term deposits. Adjustable-rate mortgages are a good way of limiting this risk, but it is important to borrowers that FRMs be available at market rates.

'Promoting competition'

Secondary markets assure this. Hence, they allow the savings and loans to control risk via ARMs, yet assure the availability of FRMs (eg by selling them to portfolio lenders with longer-term liabilities). Also, they allow savings and loans to hold other, non-mortgage assets (to diversify), yet

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have mortgage money still available.

Without secondary markets many smaller savings and loans would run the risk by having too many of their loans concentrated in a single area. By selling loans into secondary markets, they can buy into the agencies' national diversification and still concentrate on originating loans locally.

A major result of secondary markets is that mortgage markets are much less sensitive to the success or failure of the savings and loan industry than they were in the past. This has been a benefit of late. Despite the catastrophe happening to the savings and loans, the mortgage market has prospered with minimal disruption. Chart 7 depicts spreads between yields on mortgages and 10-year treasuries. While spreads have gone up this year, they are well within historical experience despite a lot of turmoil.

While the secondary market, particularly the agency part of it, has (because it has lowered mortgage rates and cut into spreads) not been a boon to a lot of savings and loans, it has, for the same reasons, been a benefit to home buyers. Whether this is a net social benefit is a source of controversy. One argument is that the lower mortgage rates come from a government subsidy which distorts resource allocation, taking resources away from other investments and largely benefiting the middle class. An alternative story is that mortgage-backed securities (because of efficiencies and scale economies) are a more efficient way of raising funds than are traditional deposit sources. This lowers real resources used in producing mortgages and leads to more efficient capital allocation by integrating mortgage markets with other markets.

There is, of course, some truth in both views. Firm evidence is scarce, largely because effects of secondary markets on mortgage rates are almost certainly small (one-quarter of a point or so) and are hard to sort out and separate from other more important causes of mortgage rate changes. Hence, we do not know much in detail about how much secondary markets have stimulated housing demand, and how much of this stimulus is due to subsidy and how much to lower resource costs.

Finally, in the wake of the savings and loan problem, there has been increased awareness of the risks involved in federal guarantees and concern about whether there will be new disasters from other programmes. The recently passed Savings and Loan Bill calls for several studies of government-sponsored agencies (including those in mortgage markets as well as other such agencies) with an eye on their capitalisation and their risk-taking.

Even the most ardent supporters of the agencies acknowledge the need for studying their riskiness. They (including the author) are inclined to point out that the savings and loans that got into the worst trouble did not get into trouble with mortgages. Rather they made risky commercial loans and took equity positions and other risks that by law the agencies cannot take. This, plus the benefits of national diversification will almost certainly lead to the conclusion that the agencies are not about to be another scandal. Whether they should be controlled more than they are or required to be more heavily capitalised is, however, a separate question, which is the topic of a somewhat different paper. In any event, analysis of federal credit agencies will have to be done in detail, one at a time. Answers will vary from one institution to another, because different institutions take different amounts of risk. The key issue in the coming months is whether policy will be based on good economics or rules of thumb.

'The competitive balance'

Forecast

The recently passed Savings and Loan Bill (and other recent regulatory changes) will, on balance, increase secondary market activity. This is largely for two reasons: (1) The new rules will have stronger capital requirements for savings and loans, but the requirements will be smaller for agency-backed MBSs, and (2) tighter capital requirements will keep many savings and loans from growing, and in some cases institutions will have to shrink. This will mean a bigger need for outside investors, who will come in through the secondary market.

There are some offsets. For instance, savings and loans will have to hold a larger percentage of their portfolio in mortgages, but this will have a fairly small effect, and will to some extent be done through MBSs (again, because of the lower capital requirement for MBSs).

An important question is the "competitive balance" between the savings and loans and the secondary markets. Again, both actors use a similar sort of federal guarantee to raise funds. In the past, the savings and loans had a bigger subsidy (clearly reflected in the costs of the "bail-out"), but they also had an inefficient instrument (deposits markets have been less efficient than securities markets).

The subsidy content of deposit insurance has clearly been cut a lot, and in the short run this does not bode well for the savings and loans. In the longer run, as deposit markets become more efficient and the more efficent savings and loans survive, their role relative to the secondary markets is a much more open question. ■

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Progress in housing finance development

AT THE meeting of the Housing Finance Development Committee of the International Union of Housing Finance Institutions, held in Washington DC on 16 September 1989, the chairman of the committee, Luiz Eduardo Pinto Lima of Brazil, gave a report on international development in housing finance. An edited version of the report is set out below.

As we approach the last decade of this century, it is clear that the world is undergoing a remarkable period of change and transition. Even in the past year there have been astounding political developments as well as much restructuring of national economies and consequent impacts on systems for housing finance. Overall, financial globalisation trends accelerate as the world economy becomes ever more integrated. But there are marked differences between the regions. Probably the major success stories in housing finance development efforts are in countries of Asia and the Pacific, such as Korea, India and Thailand.

In this region, however, there is no standardised institutional pattern for the housing finance systems that have developed. In the Caribbean the more traditonal forms of building societies and housing finance institutions are generally doing very well, and in the Central American countries there has been a strong revival of housing finance activity. In the countries of Latin America there are major differences in their economic achievements and perspectives.

I understand that in some countries of Africa housing finance activity through building societies and other entities is becoming more substantial. As for developments on the European scene, there are many.

Generally speaking, in some countries specialised institutions for mobilising savings and providing finance for housing continue to do well, and in developing countries there is no doubt that they meet a real need. In the industrialised countries there are more questions about the value and necessity of a specialised housing finance system.

The traditional institutions have sought to expand their powers and expand their range of financial services, and many have opted to become banks. In several places, they have proved vulnerable to competition and a variety of forces, and there have been bankruptcies, takeovers and mergers, voluntary or otherwise.

Such is the sad and surprising story of the thrift industry in the United States. The problems of the industry became so serious that their resolution became the Government's highest priority. In response, legislation has now been enacted, known as the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) or, more commonly, the "Thrift Bailout Plan". The legislation will cost an estimated $166 billion through to 1999 to close or merge failing institutions.

Over 30 years, including interest, the cost is estimated at nearly $300 billion, with taxpayers paying about $225 billion and the healthy portion of the industry paying the rest. Already 223 savings and loans have been closed, and it is estimated that 600 institutions will be dealt with by the new Resolution Trust Corporation (RTC).

The RTC may also wind up with up to $400 to $500 billion in real estate and other assets owned by bankrupt savings and loans. A new Office of Thrift Supervision in the Treasury Department replaces the Federal Home Loan Bank as regulator of the thrift system. The office recently reported that 2,934 institutions had total losses of $3.7 billion in the second quarter of 1989, and that losses of this magnitude were likely to continue in the near future. The losses, of course, are not spread evenly; most of them have occurred in a handful of States, including Texas. At least one third or more of the industry continues to do well, with satisfactory profits.

It will take some time for the effects of the FIRREA to be determined on the many pressing problems to be resolved, including asset disposition as well as new enforcement and regulatory measures.

United Nations

Turning to the international scene, the United Nations has adopted a Global Strategy for Shelter to the Year 2000. This is a follow-up to the International Year of Shelter for the Homeless (1987). This year has come and gone with little improvement for the millions more added to the ranks of the homeless and displaced.

The 12th session of the UN Commission of Human Settlements met in Cartagena, Colombia, with the participation of 350 delegates from 82 countries, from April 24 to May 3, 1989. The Commission adopted 24 modest resolutions, for final action by the UN General Assembly, but spent most of its time on questions of implementation and monitoring of the new Global Strategy.

However, little effective support was demonstrated for the Strategy, and it is evident that the international donor community is reluctant to step up its contributions for this purpose.

In Cartagena, only $1.5 million was pledged for the Strategy exercise, to the UN Habitat and Human Settlements Foundation.

The main features of the Strategy draw upon the Vienna Recommendation of the Second International Shelter Conference held in Vienna in 1986, at the time of the International Union's Triennial Congress. Governments are expected to serve as enablers of action by the private sector, including interaction with non-governmental and community-based organisations. Governments are urged to put into place national finance systems for addressing shelter development on a sustainable basis and at the required scale. National coalitions for shelter are to be encouraged.

The Commission meeting itself, which cost millions of dollars to convoke from both national and international resources, demonstrated the realities and the difficulties which remain. Apart from a few interested governments, the Commission's constituency for a major international shelter programme is virtually non-existent, especially from those with a real stake in the "building business". There were no representatives present from the construction industry, labour unions, co-operatives, credit unions, architects, urban planners, engineers, church organisations or other housing and professional groupings.

The International Union was represented by its senior consultant, who submitted a statement to the session which, *inter alia,* endorsed study and action regarding debt-equity conversions and other arrangements to facilitate capital flows to developing countries through the housing, building and construction sector. The statement suggested that a special task force or working party be established, and that there should now be a review of the need for a new financial services entity to assist countries in mobilising resources and financing for shelter and housing development. There were several favourable comments on the statement, but no formal response to the proposal.

The International Union continues as a member of the Habitat International Coalition (HIC), a federation of over 200 organisations now based in Mexico City, which presented statements to the Commission regarding the necessary involvement of NGOs and Community Based Organisations (CBOs) as partners in housing and shelter development. The HIC is promoting an international convention on housing rights, is taking actions against forced evictions in various countries, and working towards greater recognition of the role of women in housing development and management.

But serious questions remain about the effectiveness of the United Nations in dealing with problems of housing, shelter, the homeless and displaced peoples generally. The sector has low priority, and receives only about 2% of aid assistance across the board. Though it continues to carry on technical co-operation activities financed by the UN Development Programme, the UN Center for Human Settlements (Habitat) is handicapped by the financial and budgetary constraints affecting the UN system as a whole.

The International Union continues to support and co-sponsor the International Shelter Conference project, the third of which is convoked for Washington, DC, from April 25 to May 1, 1990. The conference will be held on an invitational basis for 300 participants from both public and private sectors selected on a worldwide basis. The conference will devote special attention to a number of specially commissioned case studies from different countries, focusing on the policies and techniques for public/private sector co-operation for action for housing and shelter. The International Union is represented on the Advisory Committee for the Conference through Mark Boléat and Eric Carlson.

As I have indicated that the United Nations efforts to develop a Global Strategy and Action for Shelter seem becalmed, if not adrift, it is evident that there must be a concerted effort, through considerable networking, for greater achievement in this field. The Third International Shelter Conference is a major step in this direction. There will also be a need for direct prodding and lobbying of governments lagging in financing for this sector. Investment groups as well as NGOs and CBOs must become involved.

World Habitat Day, the first Monday in October, is suggested as a time for reporting on progress with housing and shelter programmes. The next meeting of the UN Commission on Human Settlements will be held in Harare, Zimbabwe, in 1991.

The World Bank

The World Bank is the leading actor among the multilateral agencies concerned with housing and urban sector improvement in the developing countries. The October 1988 Annual Urban Sector Review prepared by the Infrastructure and Urban Development Department of the Bank contradicted the fear that with its reorganisation the Bank would diminish its lending for the urban lending. Fiscal year 1988 was characterised by a continual increase in urban lending.

Nineteen loans and credits were approved, amounting to $2,016 million or 10.3% of Bank lending. The average loan size per project went up to $106 million. There were 11 IBRD loans for a total of $1,408 million and eight IDA credits for $60 million. One billion dollars of this lending was for housing and $680 million of that amount was in housing finance projects. Although it is only six years since the Bank's first housing finance loan, this activity now accounts for 34% of total urban lending, or about $1.5 billion in total over that time span.

The expansion of the Bank's activities in the urban sector has been

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accompanied by a shift in focus, the emergence of new lending instruments, and an increasing reliance on financial intermediaries. The Bank is moving away from its former sporadic interventions, such as promotion of sites and services schemes. The trends of Bank lending in this field now give special attention to: urban administration and municipal finance through the devolution of resource mobilisation and investment planning to local authorities; land management and regulatory environments to stimulate private initiatives and investment especially in housing, land developments and urban transport; and housing, not only as a basic human need but also as a potential contributor to domestic resource mobilisation and financial development.

United States Agency for International Development

The United States Agency for International Development (AID) Office of Housing and Urban Programmes continues as the major bi-lateral source of funding and technical assistance for housing finance programmes. In the past 25 years, through its Housing Guaranty loans and related grants and through its technical support, the Office has worked in over 50 countries, and provided guaranties for over 200 loans totalling $2 billion. Although the Office is based in Washington DC, it operates largely through seven decentralised regional offices, located in Ecuador, Honduras, Jamaica, Ivory Coast, Kenya, Tunisia and Thailand.

In November 1988 the Office convoked an important Washington Policy Conference on Shelter and Urban Development, which brought together at ministerial and executive level some 65 prominent leaders, mainly from developing countries. The Conference focused on the requirements for meeting the challenges of shelter and urbanisation in the coming decades.

In 1988 the Office authorised Housing Guaranty Loan programmes totalling $125 million for the following countries: Ecuador, India, Indonesia, Jamaica, Jordan and Sri Lanka, and for the Central American Bank for Economic Integration (CABEI). For Fiscal Year 1989 the Office has authorised three sectoral programmes, for Jamaica, Indonesia and Jordan, amounting to $200 million for the life of the project.

In the past the AID programme provided support for the development of savings and loan systems and institutions, many of them in Latin America. Although some have disappeared, in 1988 there were active systems in seven countries, serving an estimated 77 million investors, with total savings deposits of $32 billion. Some 2.5 million homes were financed by these institutions over the past 25 years.

The Office now supports a variety of initiatives to help solve urban problems, including training on financial and technical management skills for municipal staffs; urban neighbourhood infrastructure; municipal facilities; and sites and services and core housing.

Regional development banks

In the chairman's report for the committee's meeting in Cannes, optimism was expressed that the regional development banks were beginning to show more interest in the basic aspects of housing finance, savings mobilisation, and support for the housing sector generally. To date, this optimism has not been warranted, as evidenced in the low priority for shelter programmes of the Asian Development Bank, the African Development Bank and the Inter-American Development Bank.

The Asian Development Bank includes "urban development and housing" as part of its social infrastructure sector, which also includes water supply and sanitation, education, and health and population. The ADB 1988 Annual Report shows that lending for this sector rose to $445 million from $135 million in 1987.

However, a look at the projects approved shows that just three loans accounted for the bulk of lending: the Second Medan Urban Development project in Indonesia for $220 million, the Second Health and Population project for $49 million also in Indonesia, and the Fifth Sewerage Treatment project in Korea, for £133 million. Total loan approvals by the Bank in 1988 for all sectors amounted to $6 billion.

Three other countries did benefit from pre-project preparatory or technical assistance grants: Bhutan, for Low Income Housing Finance, ($96,000); Fiji, for the Housing Authority, ($96,000); and Pakistan, for Low Income Housing ($100,000), and for the House Building Finance Corporation ($318,000). The total grant-financed technical assistance programme of the Bank for 1988 amounted to $50 million.

The Inter-American Development Bank expects to increase its overall lending activities as a result of the increase of $26.5 million in the Bank's authorised capital resources to help meet Latin America's needs during 1990-93. In 1989 the Bank, under new President Enrique V. Iglesias, was undergoing staff reorganisation and reduction, and it was not certain to what extent lending for urban development would be expanded beyond the typical level of 4% average in the past.

In 1987 the Bank made four loans for urban development, two to Jamaica for Township Services, and one each for Sites and Services programmes in Guatemala and Ecuador. There is a shift towards a more integrated approach of lending for municipal improvement and management of resources, and Colombia has benefited from the Bank's emerging activity in this field. However, in 1988 the Bank made only one urban sector loan as such, for $12.6 million to carry out urban development projects in 86 medium-sized cities in Honduras, ranging in size from approximately 10,000 to

80,000 inhabitants.

Although present interest and action is meagre, it is useful to recall the prior cumulative lending of the Bank in this field. In all, the Bank has made 96 loans amounting to $1,596 million to finance urban development projects whose total cost is $3,179 million. These loans have helped to build 408,416 housing units along with urban and community facilities. In addition, 36,544 sites and services in 139 communities have been provided for home construction.

As for the smaller, sub-regional development banks, the Caribbean Development Bank has done little recently in this field, with the exception of a loan for housing finance to St Vincent. The Central American Bank for Economic Integration (CABEI) is doing more, but largely with funding from AID.

The Inter-American Bank for savings and Loans (BIAPE) is endeavouring to provide credit and services to its member institutions, especially for reform and restructuring. In addition to its headquarters office in Caracas, it now has also established an office at Rockefeller Center, New York City, to facilitate relationships with the financial institutions and capital markets in that area. Shelter Afrique, the Company for Housing in Africa, with headquarters in Nairobi, has helped to activate with modest investments a number of small scale projects in various countries for community upgrading, sites and services, and low cost housing.

Regional associations

UNIAPRAVI, the Inter-American Housing Union, based in Lima, is especially active. It has established a new Inter-American Center for Housing Statistics, taken part in the formation of a Latin-American shelter network, and is endeavouring to devise new policies to confront the severe problems of debt and inflation in countries of the region. The 27th Inter-American Housing Conference in May 1989 in Guatemala City was a resounding success. The International Union provided two plenary session speakers, Norman Strunk, who spoke on the US savings and loan crisis, and Eric Carlson, who presented a report on Housing Development Trends in Asia and the Pacific. Alvaro Barreto of Sao Paulo, who was elected President, is committed to helping to develop new policies for financing of housing and shelter.

Within the region, there are tremendous differences. While Central American countries are enjoying a significant renewal of housing finance activity, economic difficulties impede progress in countries like Argentina, Brazil and Peru. Bolivia, however, is in the lead in following up the Vienna recommendations for housing sector reform, privatisation and coalition building. Chile, Colombia and Ecuador continue with strong programmes.

The Caribbean Association of Building Societies and Housing Finance Institutions (CABSHFI) approaches its fifth anniversary with 50 members from most of the island states and a notable record in the areas of training and professional advancement. The housing finance institutions are mostly doing very well. A major reconstruction effort after the hurricane in Jamaica has been successfully completed; the Dominican Republic has been engaged in a boom of building and urban renewal activity; and interesting housing finance reforms have been implemented in St Lucia. The high quality of CABSHFI's discussions is evident in the report of the Housing Finance Seminar held in Port of Spain, Trinidad, in November 1988, on Financing Low Income Housing in Small Economies.

In the Asia-Pacific region there are also momentous developments. India, Thailand and Korea are in the vanguard of the housing finance development scene, with major innovative programmes. China is also intent on developing its internal housing finance system, and is now represented in the International Union through the China Bank for Industry and Commerce. Japan's actual and potential role as a provider of finance for housing, warrants special attention with the release of new information that the 12 largest banks in the world, ranked by deposits on December 31, 1988, are now all Japanese. Japan is now also the largest provider of international aid.

Conclusion

The Union still has considerable work before it, as well as opportunities for constructive world service, even in the light of the budgetary constraints under which it operates. Priority should continue to be given to attracting new memberships. As the regional groupings are the foundation stones for the International Union's programme and services, perhaps the Union has opportunities to expand its scope, particularly in two directions.

One is to develop new linkages with housing finance institutions in the USSR and other countries of Eastern Europe, especially as some are already undertaking to open up their economies to increase privatisation. The International Union should promote information and initiate discussions regarding proposed new memberships from the socialist countries. Similarly, there may be possibilities for membership and a potential new regional grouping centred around the Arab States. These should be encouraged through direct action and dialogue by the Union. With the addition of both China and Japan to membership in the Union a new universality is becoming possible. This, in turn, should facilitate more interest from other organisations concerned with housing guidance, such as mortgage banks, commercial banks and institutional investors.

Only with an increased and growing membership will the Union be able to derive adequate resources for financing a core programme of service and action. ■

The effect of global financial developments on building societies

By John G. Heimann

THE structure of the financial services industry is changing dramatically. Deregulation — the opening up of domestic financial markets to international competition and the abolition of exchange controls and other restrictions — is sweeping around the globe. Free market principles are being embraced by countries as different in outlook and development as France and Chile, Canada and the Soviet Union, bringing in their wake a spate of liberalisation measures. A new phase of market capitalism — global, rather than national — has been irreversibly established.

Wherever we look, we can see the powerful effect of the globalisation of capital on the world's economy. The pace of growth in international money flows is nothing short of astonishing. Last year a staggering US$10 trillion of securitised funds moved across national frontiers. Global financial transactions currently amount to a historically high multiple of the volume of world trade. Foreign exchange transactions alone are in excess of US$500 billion a day. It is clearly the movement of capital — not trade — that is driving the economic and financial world.

More specifically, we can point to the extent to which the vast accumulation of savings in Japan is channelled through institutions and intermediaries into overseas investments. We can also see the growing proportion of foreign trading in equities and foreign bonds fuelled by the expanding appetite of institutional investors

in the United States and Europe for non-domestic securities. 'Thrifts' and building societies have already begun to tap non-domestic sources of capital in meeting their financing requirements.

What does all this portend for financial institutions — and in particular the world's building societies and savings institutions? My paper concentrates on four broad interrelated themes or issues –

(a) Globalisation and its impact on the structure of building societies and the services they provide.
(b) Deregulation and the increasing competitive pressures that have resulted.
(c) The capital base of the industry and the need to ensure that it is adequate to meet the pressures and opportunities that are facing individual institutions.
(d) The need for effective supervision and regulation in this sector of the financial services industry.

Globalisation

In order to foresee the role of savings and home loan institutions in a global capital market system, the first step is to identify the probable dimensions of the financial intermediary system as it is currently developing. What is becoming abundantly clear is that we will have a two-tiered capital market: a global market for the securities of well-known, highly rated issuers; and local markets which will meet the financing needs of non-global issuers. These markets will be intermediated by global financial institutions, in the first instance, and by local intermediaries in the second.

It should be stressed that local does not mean small. It does mean an institution which has chosen to concentrate its activities in its home country. Therefore, it may be very large, even dominant, at home. Its financing needs will be denominated in local currency and its issues will best be received in a market in which it is well-known and respected.

It is true to say that the sweeping changes that have already transformed the wholesale capital markets have only begun to leave their mark on most of the retail sectors of the financial services industry. I would include here the building societies and savings institutions. The housing finance industry with its heavy dependence on branch networks has tightly restrictive barriers to entry as the clearing banks, insurance companies and specialist mortgage lenders have discovered in the United Kingdom, for example.

There, the building societies' share of mortgages outstanding is still above 70% and has actually risen in recent years despite the widespread entry of other lenders and the proliferation of competition. Other local practices — particularly statutory obstacles — have also effectively compartmentalised the industry within national boundaries. With the onset of securitisation of mortgages in the UK and France we may soon be seeing the emergence of an increasingly international marketplace for housing finance.

Within the European Community, the 1992 proposals for a single market will arguably have their greatest impact on the retail sector of the financial services industry. We are beginning to see an increasing number of financial institutions respond to these changes — through mergers, joint ventures and other forms of working relationships. What is abundantly clear is that there are serious imperfections in the market which represent enormous business opportunities for financial institutions from other countries, either within the Community or elsewhere. In the mortgage market within the EC, there are vast differences from country to country in the cost of home loans.

In Spain, I understand that the annual cost of a home loan (measured in terms of the excess of mortgage rates above money market rates) is more than double the cost in the UK. While many sectors of the wholesale financial markets can be said to have been arbitraged to perfection, the opportunities for cross-border competition in the retail markets are self-evident. The 1992 European market, with the single passport concept, will clearly facilitate this process. Financial intermediaries within the European Community will be capable of conducting their business in any country of the EC as long as they are authorised in their home country within the Community.

Deregulation and competititon

For the world's building societies and savings associations, deregulation is an increasingly predominant theme. Historically, in many countries in Europe, in Australia and to a lesser extent in the USA, mutual savings institutions — established on the co-operative principle of one member/one vote — have operated in a highly regulated and restricted environment. There have been distinct areas of demarcation between the products and services offered by the building societies, and those provided by the commercial banks. More and more these distinctions are being eroded and the building societies and savings institutions are competing head-on with their commercial banking rivals in the housing, savings and retail banking markets.

In the UK, building societies, as elsewhere, are governed and regulated in their activities by statute. The Building Societies Act 1986, the central legislative framework, substantially liberalised societies by allowing them to expand their operations in the housing field and to provide ancillary financial services to their customers. Those of the top ten societies that have decided to pursue a retail banking strategy now offer current accounts, cheque cards, credit cards and ATM services to their clients.

More importantly, perhaps, the 1986 Act established the basis on which members could vote to convert their society into a public limited company with full banking status, a process that has been under way for some time in the United States. It will also be possible in the future for members to vote to accept a takeover by a non-society, provided that the successor entity receives authorised banking status. The voting requirements of members in favour of an acquisition, as laid down in the Act, are more rigorous than for a conversion. Notwithstanding this, the outcome of the Abbey National vote on conversion suggests that — at the right price — members may be prepared to vote in sufficient numbers to approve the special resolutions in respect of an acquisition of a society by, for example, a bank or an insurance company.

The acquisition of a building society provides immediate access to UK retail banking — in its broadest sense. There are a number of financial institutions that have publicly declared their interest in concluding negotiations with a willing seller, and there is currently much speculation about the feasibilty or otherwise of acquiring a building society on a "hostile basis".

In the United States, savings and loans institutions have for some years enjoyed the freedom to convert from mutual status to joint stock companies. Since 1982, Merrill Lynch has advised on more than 90 thrift conversions. As is generally known, the thrift industry in the United States has been plagued with a number of problems recently. In some cases, the management of thrifts have unwisely applied the capital raised on conversion to support highly speculative investments. In addition, the structural mismatch between making long-term fixed rate loans and taking short-term variable rate deposits has led to dramatic losses on mortgage portfolios during periods of interest rate volatility.

The problems of the US S&L associations are well known, chronicled, as they have been in minute detail, through Congressional hearings. And, of course, Congress has taken action to safeguard the depositors in thrifts and effectively restructure the S&L industry. This is not the forum for a rehash of what went wrong, why, and who was a fault. Nor would it be appropriate to discuss the strengths and potential weaknesses

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in the recently enacted Financial Institutions Recovery, Reform and Enforcement Act. Rather, it would be helpful to see what lessons can be learnt from the enormous past mistakes so that we will not repeat them in the future.

First and foremost, the users of financial services will not be served by, nor will they tolerate, less than fully competitive products and prices. In a private system, competition is the driving force, and innovation is a primary tool. Those institutions which cannot meet competitive standards, for whatever reasons, will fall by the wayside. No longer do depository institutions enjoy special protective treatment. Therefore, they must compete in order to survive and to do this successfully they must offer that which their customers demand since those customers have the sophistication and capacity to choose. Secondly, the institutions which offer expanded service must have the capability to manage diversification effectively.

In Germany, as the population is simultaneously declining, ageing and becoming more prosperous so the retail banking market is becoming more attractive. This is generating greater competition — not as yet from foreign institutions — but more from the large Frankfurt banks as they pursue the concept of "Allfinanz". All three big banks, Deutsche, Commerzbank and Dresdner, have recently undertaken restructuring of their mortgage finance business and have followed this with plans to improve their profile in life assurance. As prosperity increases, we have seen a growth in the volume and sophistication of savings. Thus the proportion of German personal sector savings going into insurance policies has risen in the last ten years from under 20% to 30%. The "Allfinanz" concept — the provision of a wider range of services beyond the traditional loan/deposit relationship — is becoming the predominant retail banking strategy.

The purchase of one's own home is the single largest and most important financial transaction that an individual will undertake. As such, the provision of the mortgage is perhaps the pivotal financial relationship. From the point of view of the providers of this loan, the mortgage business has the dual attraction not only of involving generally low-risk/high quality assets but also of presenting opportunities for cross selling other financial services.

In their home markets building societies and savings institutions almost universally have a strong foothold; and there are substantial barriers to entry for non-domestic institutions. The housing finance and mortgage systems in Europe are far from homogeneous and the legal system for transfer of ownership of residential property varies from country to country. Creating a distribution network from scratch and securing a funding base, whether retail or wholesale, is a particularly expensive exercise. Competition, therefore, in these increasingly deregulated markets is likely to come more from within than from foreign institutions and we can expect to see much consolidation amongst societies and savings institutions.

Capital

Growth and competition will be affected as much as anything by having access to sufficient capital. The central banks of the G-10 countries, under the auspices of the Cooke Committee, have reached agreement on establishing common minimum standards for the capital adequacy of their commercial banks. These new risk-based capital guidelines have been causing commercial banks to restructure their capital bases. This has given rise to a plethora of new financial innovations — such as Variable Rate Notes and Direct Issued Preferred Stock, both of which Merrill Lynch has pioneered.

Since the beginning of 1988 — when it became clear which types of instruments would count as Tier I and Tier II capital for regulatory purposes — Merrill Lynch has raised more than US$9.0 billion in capital for US and European financial institutions in the form of equity, preference shares and subordinated debt issues.

Currently, the Basle Committee's paper on international convergence of capital standards does not directly effect many of the world's major savings institutions and building societies. In the United Kingdom, for example, the Building Societies Commission has a separate calculus for determining the capital adequacy of the institutions under its supervision. Nevertheless, in its 1989 Annual Report the Commission points out that — measured by the Basle Committee's rules — the solvency ratios of the largest 46 societies all exceeded the proposed minimum requirement of 8% by at least 1%, and the weighted average was over 11%. In fact, all the UK building societies would already meet the minimum requirements of the Basle Agreement if it were to be enforced now, and the majority would do so by a comfortable margin.

As societies position themselves to meet the challenges of the next decade, the question of capital allocation will become increasingly important. Without a Tier I equity instrument, mutual institutions must consider carefully the extent to which they wish to diversify, particularly where this is more capital intensive than their traditional business. Moves are afoot, in the UK as elsewhere, to create — for mutual organisations — shares with some of the characteristics of equity or ordinary shares in a company.

In Australia, at least one society has issued permanent shares which count as Tier I capital without compromising its mutual status. For many institutions there are technical and wider conceptual issues to be wrestled with before a real equity instrument comes into being. Capital, in the form of accumulated reserves, term subordinated debt, and perpetual subordinated debt — which is likely to come into being in the UK in early 1990 — remain the only viable sources of capital for the time being.

The absence of equity and preference shares, as a means of raising Tier I capital for societies, make the idea of a "level playing field" a nonsense. Societies will be severely constrained in their ability to compete with their commercial banking rivals as long as they are prohibited from raising Tier I capital. The competitive advantage of those with access to these markets is dramatic, as evidenced by the recent US$ preference share issues by UK and Irish clearing banks which have enabled them to raise substantial amounts of Tier I capital at a fixed cost below 10%. Although societies are sufficiently capitalised at present, it should not be the case that they are forced to forego mutual status in the form of conversion, or acquisition by a third party, in order to plan with certainty for growth and diversification. For the major societies, which compete — in reality — not with other smaller societies, but with the large commercial banks, these issues are particularly vexing.

For smaller — regional — organisations a plan for growth built around niche marketing will continue to be a winning formula. These organisations will prosper doing what they have been successful at for many years — taking deposits and making home loans.

In the United States, a strategy that embraces strong regional concentration has served many thrifts — and commercial banks as well. For example, the strategy of acquiring small regional banks that can be moulded into a substantial and profitable regional banking organisation has proved very successful for Ohio's Banc One Corporation. The question of capital adequacy for many smaller organisations pursuing a strategy of limited diversification may not — for the moment — represent a problem. For those major societies that have already embarked on a "high street" confrontation with the retail banks, the issue is more pressing.

The changes in the housing finance markets that I have attempted to summarise are unquestionably bringing major benefits to the consumer. Greater competition is providing a wider choice of lenders and mortgage products, and at a lower cost than ever before. But while the emerging marketplace is full of new opportunities, prudence dictates that we pay attention to the problems and the risks.

Supervision and regulation

I have already alluded to one of the main areas of risk opened up by the deregulation of savings institutions — the mismatch between deposits and loans which has resulted in the well-publicised problems affecting the industry in the United States. There are clearly other areas and categories of risks. Securitisation of mortgage assets, for example, removes the direct relationship between lender and borrower and therefore one might assume diminishes the extent to which lenders can oversee their mortgage loans. As competition intensifies, there is likely to be an increasing tendency for savings institutions to break out of their traditional territories and pursue lending opportunities with which they are less familiar and which in some cases may involve significantly higher risks.

I have referred to the substantial progress of the G-10 central banks in establishing common minimum standards for the capital adequacy of their commercial banks. Outside commercial banking, one can see substantially less progress towards international harmonisation and common standards setting. The agenda is a long one, covering a vast range of issues from taxation and accounting standards to capital adequacy and conduct of business rules. A significant part of the problem is that there is no mechanism, similar to the Cooke Committee of the Bank for International Settlements, to review the regulation of non-banking institutions on an international basis. Efforts to broaden the scope of regulatory review beyond commercial banking are clearly needed.

I have described in this paper the increasing challenges that are represented by the twin processes of globalisation and deregulation. As never before, the housing finance industry is faced with a bewildering array of strategic issues and opportunities. In their domestic markets, the indigenous savings institutions tend to have a strong foothold. Carefully planned diversification into new markets, new product areas, and possibly other countries will undoubtedly pay dividends for those institutions with the capital to support them and with clearly considered and effectively implemented strategies.

Regional or local concentration on niche markets will serve many other smaller organisations — without the capital or ambition to take on the 'financial supermarkets'. There will be many who choose to join with others to face the challenges of the 1990s, and some who will formalise their existing links with insurance companies and other providers of financial services to form powerful multi-product organisations. The boundaries between the housing finance market and other sectors of the retail financial services industry are likely to become increasingly blurred.

In conclusion, perhaps I may end by offering a note of caution, Ambrose Bierce's definition of an acquaintance: "A person whom we know well enough to borrow from, but not well enough to lend to". ■

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The World Bank's housing role

By Per Ljung

THE World Bank initiated its urban operations in 1972 with a small technical assistance loan to Turkey and a sites and services project in Senegal. Total lending in that year was $US10 million. From this modest start, Bank lending grew steadily and reached $US500 million in 1981, but it remained essentially flat through the first half of the 1980s. Indeed, when the full impact of the second oil shock was felt by the developing countries, it looked as if World Bank support for urban development might come to an end. The Bank's urban lending was questioned by many of its own macro-economists and by some economic planners in developing countries. They saw housing and urban infrastructure as "social" rather than "productive" investments. Given the shortage of public funds and the need to increase exports, the emphasis was put on industrial and agricultural investments.

This forced a reassessment of the role of shelter and municipal infrastructure in the macro-economy and of the World Bank's approach to urban development. New types of lending emerged; for example, the Bank's first loan supporting a housing finance institution — CIH in Morocco — was approved in 1983. As a result, World Bank lending for urban development has expanded extremely rapidly during the last five years and the nature of sector work and the composition of lending operations have undergone a dramatic change. Since 1986, lending has averaged $US1.5 billion, or over 8% of total World Bank lending. The expansion of the Bank's activities in

the urban sector has been accompanied by a shift in focus, the emergence of new lending instruments, and an increased reliance on financial intermediaries. Most noticeable has been the expansion of the Bank's support for housing finance institutions which now accounts for over one-third of urban lending — or a total of over $US1.2 billion over the last two years alone.

This transformation of the World Bank's urban activities represents a timely and appropriate response to the long-term challenges of unabated urbanisation — aggravated by the economic difficulties of the 1980s — and to the lessons learned from earlier basic needs-orientated urban projects.

I will now briefly review some of the key urban trends and lessons we have learned during the past two decades. I will follow this with a brief assessment of the experience from our traditional shelter projects — ie, sites and services. Finally, I will focus on the agenda that is being pursued in our housing finance operations.

Urban trends and lessons

Continued Demographic Pressure. The urban population in developing countries increased from less than 300 million in 1950 to about 1.3 billion today and a projected 1.9 billion by the year 2000. The average annual growth rate, 4%, is not unprecedented, but the resulting absolute numbers go far beyond what has ever been experienced in the industrialised world. Just the annual increase in the developing world's urban population is of the order of 45-50 million (compared with 7-8 million in developed countries). The rapid growth in urban population — and the relative decline in rural population — will inevitably shift the locus of poverty from the countryside towards the cities. Up to the end of the century, the number of urban poor will increase by 30% to about 430 million — or one-third of all the people in the Third World who live in absolute poverty.

Harsher Economic Environment. Since the late 1970s, increased inflation, slower growth, more debt and financial collapse define the major dimensions of the economic environment of many developing countries. These macro-economic conditions and resulting adjustment processes have had a major impact on shelter and urban infrastructure investments. Housing investments — as percentage of GNP — fell by about one-seventh between the mid-1970s and mid-1980s. All indications are that urban infrastructure investments also fell in real terms. A recent Bank review of a number of adjustment programmes found, for example, that infrastructure expenditures were cut more frequently and more deeply than any other major category of public expenditures.

Although less easily documented, the economic turbulence of the 1980s has also had major implications for urban poverty. Real wages have declined in many urban areas — often by 20-40% — and unemployment has increased. There is also clear evidence that an increasing share of the urban labour forces in Latin America and Sub-Saharan Africa has moved into informal sector activities.

The World Bank expects the 1990s to be a little friendlier to the developing countries than the 1980s. However, it is unlikely that the glorious 1960s will return. Thus, we can expect the next decade to be characterised by modest growth and tight budgetary situations.

It is also worth mentioning here that we have learned that inappropriate government policies related to housing and urban development have contributed significantly to macro-economic instability and hardship for the urban poor: in Argentina, an inappropriate regulatory framework for housing imposed a deadweight cost on the economy equivalent to 6-7% of GNP; in Malaysia, housing prices have been pushed up by 50% (equivalent to 3% of GNP); in Poland, infrastructure bottlenecks and housing shortages have reduced labour mobility and increased nominal wages — but reduced real wages; in Bolivia, inappropriate housing finance policies have increased inflation by a quarter; in Nigeria, manufacturing firms have to spend 20% of their capital investments just to overcome infrastructure deficiencies.

Changing Roles for Cities. Recent research has confirmed what intuition has already told us: cities play a key role in the development process. Some 60% of GDP of the developing countries currently originates in cities, and 80% of GDP growth will take place in the cities. If growth is to occur, the cities must therefore "function". But evidence is that they function poorly. As I mentioned earlier, one reason is the policy environment which governs urban development. But the other is the totally insufficient or dilapidated infrastructure of cities. Telecommunications, which is becoming a crucial dimension of international trade, is hopelessly underdeveloped. Power systems often operate at such a low level of reliability that many industries have to have their own generator. Water supply, which is needed by the industrial sector to the tune of three times the level of human consumption, is equally unreliable and industry must often sink their own wells to supplement public supply. Urban transport is a nightmare which, coupled with the inadequacy of telecommunication, can paralyse commodity and information exchanges. Our understanding of the importance and role of productive urban infrastructure is increasing and, as it does, pointing to the conclusion that its improvement has to be an essential part of any urban strategy.

Governments Can't Do Everything. Unfortunately, cities often fail to achieve their productive potential, and they appear to act more as brakes on economic development than as sources of energy. Rapidly expanding slums and squatter settlements, increasing congestion, air and water pollution, and deteriorating infrastructure are hardly consistent with the optimistic yet abstract notion of cities as engines of economic growth. Too often, rapid urbanisation — which requires annual investments in shelter and infrastructure of $US100-150 billion — has outstripped many (if not most) governments' abilities to cope with the demand for even the most basic services. They simply do not have the financial and human resources to do the job.

The urban development model that emerged during the post-war period relied heavily on central government finance and public sector agencies for the implementation of fragmented projects. It also assumed that regulations could effectively — and costlessly — be used to achieve a desirable urban structure at both the national and individual city level. Indeed, this approach to urban development represented the ultimate extension of the state interventionist central planning model. It is now clear that this model puts too much faith in governments' ability to manage the details of the economic development process. Even though many countries are moving ahead with the liberalisation of their economies and expansion of the role of the private sector, few reforms have taken place in the field of urban management. Thus, for developing countries to cope with the challenges of rapid urbanisation, it is essential that the structure of governments, and the roles they play in the urbanisation process, be changed. This will require, most fundamentally, that governments change from a posture of directly trying to solve urban problems to one of acting in an *enabling* role as facilitators of solutions.

Worsening Urban Environment. As most of us can attest, the urban environment is deteriorating in most countries. Two-thirds of urban dwellers are not connected with sewage systems, and less than one-quarter of the collected sewage is treated before being released into rivers, lakes and seas. Municipalities do not have the capacity to collect more than about half the solid waste that is being generated and only a small fraction of what is collected is properly disposed of in sanitary landfills, composting plants or incinerators. Emissions of air pollutants from cars and factories in cities are growing by 5-10% a year. Even though it is difficult to establish strict causality, it appears that the eco-

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nomic and especially human costs can be heavy. For example, in Manila's Tondo slum, an area with poor sanitation, infant mortality is two-and-a-half times higher than the national average, and typhoid and tuberculosis rates are respectively four and nine times higher than in the middle- and upper-income areas of the city. Indeed, if measured in terms of the impact on health and mortality, inadequate sanitation in cities stands out as one of the major environmental problems in developing countries. Not only money but also major technological, institutional and regulatory innovations are needed if environmental conditions are to be significantly improved.

Growing Urban Poverty. As stated earlier, at the turn of the century the number of urban poor is likely to exceed 400 million. However, the fears that urban migrants would create an exploding mass of unemployed or under-employed people have generally turned out to be unfounded. The migrants tend to find jobs relatively quickly and, when adjusted for skill levels, they earn about as much as the long-term city dwellers. This means that enhancing the productivity of urban jobs is more important than employment creation *per se.* Small and medium-sized enterprises are the most important employment sources for the urban poor. However, it is these smaller — often informal — enterprises that suffer the most from inadequate infrastructure and costly government regulations. This means that if we can improve the efficiency of cities, we will also enhance the living standards of the urban poor. Furthermore, we have learned during the last decade that it is government induced distortions on the land and housing markets that have prevented the urban poor having access to adequate shelter at affordable prices.

Lessons from traditional shelter projects

The sites and services projects made up the bulk of the World Bank's early shelter interventions. These were complemented by projects that were aimed at extending basic infrastructure facilities to existing settlements. Thus, while the upgrading project helped to improve the living environment for millions of urban dwellers — many of whom were poor — these projects cannot really be classified as "housing". Thus, I will limit myself to give some lessons from our sites and services projects.

The sites and services projects were designed to capitalise on the untapped resources of the poor through self-help construction. Typically, the projects involved:

(i) provision of land tenure;
(ii) selected trunk infrastructure to connect new areas with existing networks;
(iii) on-site infrastructure (water sanitation, roads, drainage and electricity) often based on communal solutions;
(iv) core houses ranging from a simple wall with utility hook-ups to completed buildings;
(v) social facilities such as schools, health clinics, community centres; and
(vi) financing for the plots, core houses and for self-help building materials.

There is little doubt that these projects represented major improvements over existing approaches to publicly sponsored housing in developing countries. They were universally cheaper than publicly built apartment complexes. They were economically viable. However, the beneficiaries tended to belong to the middle class rather than the poor. Although subsidies in nominal terms were limited, there tended to be large hidden subsidies: interest rates tended to be below market rates and below the prevailing rates of inflation; land was sold at prices far below its replacement costs, etc. There were large implicit subsidies through mortgage loans because of slack recovery performance by the lending institutions. This is not really surprising since mortgage loans were usually provided by construction orientated project agencies rather than by financial institutions. Furthermore, the sites and services projects tended to become foreign supported enclaves. Few governments adopted them on a large scale.

More important, however, was the fact that the low-cost, affordable model for urban development — as represented by the sites and services approach — had little impact on local zoning and building codes. There is now mounting evidence that it is government regulations — rather than speculation or disinterest by formal sector housing developers — that prevent the urban poor from obtaining land and adequate shelter. In Malaysia, for example, more than 50 permits are required for the development of a housing area — a process that takes four to seven years. In Jordan, the minimum legal plot size is four times larger than what low-income families can afford. Similarly, in the Indian state of Tamil Nadu it is illegal for the private sector to duplicate the successful sites-and-services schemes financed by the World Bank. In Bombay, the urban land ceiling legislation has stopped virtually all official and most unofficial land transactions, pushing up land and property prices to incredible levels; a simple shack in a typical slum area is now selling for $US20,000-30,000. In Karachi, most newly serviced plots are bought by middle-class "land speculators" — to serve as a safe savings instrument with a positive return after inflation — and, as a result, remain vacant for a decade or more.

In these kinds of situations the urban poor have little choice but to go "underground" and live in informal or illegal settlements. However, we have seen in countries that have a rather straightforward and simple system of building regulations and sound macro-economic policies that the organised private sector can respond to the shelter needs of low-income people. This is happening on a massive scale in Thailand today and the same move "down-scale" can be seen among private home builders in Indonesia.

Other constraints to a well-functioning housing market that the sites and services projects did not tackle straight on were related to weak housing finance institutions and outdated land information systems.

The new urban agenda

The broad-based approach to urban problems that is emerging from the trends and lessons that I have described can best be summarised as follows:

Decentralise government decision making and strengthen local governments to make them stronger partners in the urban development process.

Encourage the private sector to play a greater role in the financing, construction and operation of urban infrastructure — especially in the areas of housing, urban transport and solid waste collection where there are few, if any, economies of scale.

Enhance the productivity of urban enterprises through better provision of basic infrastructure and through regulatory reforms.

Improve the functioning of land and housing markets through better macro-economic policies, reform of zoning and building regulations, strengthening of land registration systems and housing finance institutions.

Reduce and rationalise subsidies so that they better reach those who are truly needy.

Adopt a more systematic approach to deal with urban environmental problems and give special emphasis to safe water and basic sanitation.

Address urban poverty through broader-based policy interventions that help to improve the productivity of urban jobs and regulatory and policy reforms to remove obstacles that prevent the poor from gaining access to affordable shelter.

The housing finance agenda

The reform of housing finance policies and strengthening of housing finance institutions constitute important elements in this longer-term urban development strategy. However, they have come to the forefront in the World Bank's urban development lending also for other reasons.

Housing is a major economic sector in all developing countries. Housing investments typically amount to 3-8% of GNP. It is therefore clear that the manner in which resources are mobilised for housing, how well they are invested and how efficiently they are utilised have a major impact on the prospects for economic adjustment and resumed growth.

However, housing is not only an economic good, it is also a basic human need. Thus, housing plays a central role in the social policies of virtually all governments.

Finally, housing is also a long-lived and costly asset which is heavily dependent on people's ability to borrow. During the last decade, higher and more volatile inflation and real interest rates have increased the risk of making long-term loans. This has also reduced the ability of financial systems to mobilise the resources needed to finance long-term assets such as housing. We have also found that when governments try to intervene in the housing finance system through mandatory lending targets, interest subsidies, etc, the ultimate effect has been to further destabilise the economy. Thus, the rapid expansion of World Bank lending for housing finance is largely a reflection of a desire to create a greater symbiosis between not only social and financial sector concerns, but also with urban development and fiscal concerns. Indeed, housing finance lending has become a major component of the Bank's strategy to support structural adjustment and financial sector reform.

Although my housing finance colleagues in the Bank could give a mile-long agenda for the Bank's housing finance operations, I want to limit myself to three points:

(i) The projects must encourage domestic savings and this requires that interest rates are positive in real terms and in line with general market conditions;

(ii) The burden on the government budget should be minimised;

(iii) Subsidies — if any — should be up-front, targeted to the poorest segments of the population and designed in such a way that they do not create macro-economic distortions or jeopardise the financial system.

Although much is needed to achieve all these three objectives, there is one item that stands out in most countries that have experienced macro-economic instability, ie, high inflation, etc. This is a well-designed mortgage instrument which contains some form of indexation to even out the repayment burden over time and thus makes the mortgages more affordable without subsidies. However, it should also provide for an equitable risk sharing between borrower and lender. We have seen such innovations in a number of Latin American countries, but many more need to follow suit. ■

PER LJUNG is chief of the Urban Development Division of the World Bank. This paper was given to the 18th World Congress of the International Union in Washington on 20 September 1989. The views and interpretations expressed are those of the author and should not be attributed to the World Bank, to its affiliated organisations, or to any individual acting on their behalf.

Debate continues over land registration

LAND information systems — whether in the developed or developing world — are seen by many as vital to economic growth.

For the most part, however, efficient systems are rare in Third World cities. Instead, they tend to be incomplete and greatly outdated; frequently, urban maps are 20 or 30 years old, lacking any description of entire sections of cities, particularly of the burgeoning peri-urban areas.

Few publicly question their merit; most agree that current systems should be improved or new ones introduced. In fact, because most urban areas are battered by the twin problems of exploding populations and dwindling resources, proponents say the systems assume a critical role; in theory, they can produce badly needed revenues.

Debate exists, however, on the level of sophistication needed in any given system, since the greater the precision and amount of information collected on each piece of land, the more expensive is the process. The deciding factor, say critics, should be the use for which the systems are intended; moreover, they insist that extremely complex (and therefore extremely costly) systems are probably unnecessary in any case.

While they come in various forms, land information systems involve recording some or all the facts about a parcel of land: what are its boundaries; who has tenure; what rights are associated with a property — for example, who can mine it, cut down the trees on it, subdivide it, rent it, or sell it; who owns the rights; who leases or occupies the property; and which financial institution has a mortgage on it?

The more comprehensive systems involve legal registering of land and issuing titles; and those who promote such systems for urban areas insist that legal records benefit both cities and residents.

According to Lynn Holstein, a land information specialist at the World Bank, land that is registered is easier to transfer and therefore more saleable. It can also be an important source of revenues for debt-ridden governments and municipalities.

He maintains that if the land market is to work properly, land and transactions should be registered. Once facts are recorded and individuals are given titles or documents, land will be bought and sold with fewer obstacles, and this helps the pace of development. Further, land registers, besides being associated with property tax systems, can also bring in substantial transaction fees. Moreover, they are potentially invaluable to agencies responsible for infrastructure and services, as information gathered for the registry becomes the basis for maps.

In Thailand, Mr Holstein notes, the government spent roughly $20 for each parcel of land it registered in nine provinces (in a World Bank-supported land-titling project). It charged property owners only a small fee (about $US4) at the time of the action, thus heavily subsidising the effort. But authorities correctly saw that the government could gain a great deal later, by charging transfer fees at the time of subsequent land transactions, as a percentage of the sale price.

"On average, 10% of urban properties in Thailand are sold every year," Mr Holstein notes. Because of this high turnover, the Thai government brought in $200 million in 1988 alone — the bulk from transfer fees amounting to about 10% of the sale price on each transaction — against an agency overhead of $24 million.

He adds that, "if they didn't have a good registration system, there wouldn't have been as many sales, which in turn would have meant less in transfer fees. But with the system set up to issue documents quickly and efficiently, and with the housing finance system operating, more people got access to credit than ever before, as they could produce the documents they needed for collateral. These and other elements were in place to have a land boom, and that's exactly what happened."

Land developers favour an efficient land registration system because it reduces their transaction costs. They do best when they can buy and develop the land quickly, and they have less difficulty getting subdivisions titled and loans approved.

In a broader sense, an efficient system helps establish order. "In small rural communities everyone knows who owns what, and if disputes arise they can be readily resolved. But in urban environments, where there's less of a sense of community, it's important to have some system to confirm rights. Without it, there can be chaos — corruption, forgery, family feuds, even killings — over who owns what. And feuds are not uncommon. Sometimes they reach the courts. But in many developing countries, where there are backlogs of hundreds of thousands of court cases, it can take a generation before they are settled," Mr Holstein says.

For individuals, he continues, land registration is both a type of protection and means to obtain credit. While it would seem to benefit mainly the middle and upper classes, it helps the poor as well.

"Titles are particularly important for the poor because if they have no way to prove their rights, as is usually the case in the informal land market, they can't show they bought a piece of property or land, are very vulnerable to those with false or competing claims, and can be evicted. Once people can prove legal title, however, it becomes more difficult for others more powerful, even governments, to deprive them of their rights or get rid of them. They also have a better chance of getting a fair price for their land if the government needs it for public works.

"Further, because individuals feel secure in their rights, they invest in their properties, adding rooms and making other improvements. These improvements have a multiplier effect, increasing values and the supply of rental housing — which again means more housing for the poor," he says.

He adds that individuals are more likely to get bank loans approved if they have proof of their rights. Banks are more apt to lend to those who want to build homes, for example, and to give credit, say, to open a business, if a title can be produced as collateral — something the bank can claim if the lender does not repay a loan.

Not everyone stands to gain, however. Mr Holstein says that, while no one openly opposes the idea of introducing land registration, various groups have a vested interest in maintaining the status quo.

Lawyers, for example, benefit from the confusion when no system of titling exists. "In the absence of an efficient registry, people purchasing properties must hire lawyers to figure out who has the most concrete rights," he explains.

Opposition also comes from the various institutions and agencies that play a part in any registry system. Often they view collaboration as a loss of status, resources and control.

In addition, large landowners — who may often be high government officials — oppose any scheme that makes the land market more visible and easier to deal in. "They don't want the public to see the extent and location of their land holdings," Mr Holstein says.

The land registration process

Occasionally, complexities arise in the steps associated with registering land. The first stage has two parts: one involves identifying the location and boundaries of the land parcel and describing it — usually with a diagram. The other part attempts to document the legal rights associated with the land — who has the rights, and whether they are freehold or leasehold. Problems surface, says Mr Holstein, although this process seems straightforward. "It could be that the data for the two different parts are collected by two different agencies, say, the department of justice and the department of lands. And it could also be that they don't work well together. If a conflict arises, the project will be stalled."

'Maintaining the status quo'

Once this stage is accomplished, the document containing the information is entered into the record, legally registered, and the owner is presented with a title. Here again, difficulties appear. Frequently, owners do not pick up titles because regulations may require that before the documents can be presented, people must pay a fee, transfer taxes, or any back taxes that are owed. Further, registry offices may be located far from where the poor live, which could translate into loss of a half or full day's work.

According to Mr Holstein, the operation can hit other snags as well, because all the actors — lawyers, government officials, and surveyors — argue about which type of land registration system is best. In a number of countries, the issue is whether to improve the existing deeds registration or to introduce a new system based on the registration of titles; and the debate continues after 100 years of experience.

He emphasises that land registration is a continuing process, not an event that, once accomplished, is completed.

"After the land register is created, all subsequent sales must be recorded or the whole effort will be wasted. Over the years, it will become outdated and the documents that are registered won't reflect reality, since 10% of property in urban areas changes ownership each year." He points to Belo Horizonte, Brazil, where the government issued 3,000 documents of ownership (as part of an upgrading project) in 1986-1987. Since then, not one of these owners has applied for permission to sell or list a new owner on the registry.

"If we assume that Belo Horizonte is no exception to the 10% annual turnover average, then many properties have been sold informally and the register is now well out of date," Mr Holstein says.

He stresses that if people are to be encouraged to register and become part of the formal system, they must be convinced such actions are in their interest. "Somehow, a balance must be maintained between what a government hopes to gain and individual property owners' benefits, because if the charges are too high, these will act as deterrents. So authorities should have a clear idea of what people are prepared to pay in return for what they perceive as benefits," he notes.

Office vs. field approach

Once authorities agree to create a systematically compiled legal land register, they must decide which approach they will use to accomplish it. According to Mr Holstein, the task can be performed in the office or on

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site. In the former (as is done in the Philippines), the agency responsible publicises it will accept claims; and individuals who want to register their land and obtain titles must send in various forms. The office then processes these claims, checking to see if they are complete and if conflicting claims exist.

In the field approach (as is done in Brazil and Thailand), notices are placed in local newspapers that an inventory of land parcels will be made and property rights (freehold or leasehold) will be determined. For the benefit of absentee owners, some of whom live abroad, notices are also placed in newspapers in expatriate communities. Meetings are held in neighbourhoods to explain the procedures and documents that must be produced, and the evidence people will need to prove their rights.

Next, adjudication teams set up temporary offices in neighbourhoods for a month or so, and go door to door with community leaders. First, they identify a property (walking around the boundaries, marking them on a map) and meet with owners of adjacent properties to reach an agreement that the boundaries are acceptable. Markers are then placed on the ground and numbers are assigned to each plot. The staff write a claim, on the spot, and the property holder signs — agreeing that these are indeed the boundaries.

"It becomes a community phenomenon. If a dispute arises between neighbours, it's usually resolved quickly, because the community leaders are watching," says Mr Holstein.

After this is accomplished, prop-

Malawi's land registration moves forward

BEFORE the 1970s, land transactions in Malawi were handled in the traditional way: deeds were exchanged at the time of sales, confirming that land or a building had been transferred. These deeds, however, did not stipulate to whom the land belonged; rather they stated only that a deal had occurred.

The problem with such a system, says R. C. Makono, Malawi's deputy commissioner for lands, is that someone else could have an earlier deed and claim to be the rightful owner. In fact, there were many conflicting claims.

Because of the ambiguous nature of the system, transactions were quite costly, as lawyers were required to search the deeds registry. According to Mr Makono, "lawyers' fees were very high and this meant that only wealthy people could afford to be involved in this system."

The deeds system was also a problem for the government: maintaining the registry was cumbersome, since large facilities were needed to store the files, which had become unwieldy.

"We needed some sort of land registration system that could bring together in one document all the important history and information about a parcel of land — like evidence that a sale had been transferred, the details about the property such as its size, location, liens, and if it enjoys rights of way over other land. If we had this, all that would have to be changed at the time of a sale is the name of the new owner," Mr Makono says.

Under the new system, property owners were supposed to fill out claim forms that would provide details on the properties and allow the land department to convert the latest transaction into a title. But the public resisted, since the government attached a 40 Kwacha fee (about US$15) to filing the claim. "People didn't see any need to register and they didn't want to pay the fee. So they continued to sell land under the old system. And what developed was a situation where we were running two systems at once," explains Mr Makono.

As part of a 1985 World Bank-supported urban housing project, all the land in the city of Blantyre was to be registered. Landowners were to take surveyors around their properties, and together they would plot the area on a map and place markers on the boundaries. Problems arose again, however, this time centred on the project staff: surveyors who were expected to go to the field to identify boundaries were employed at another agency, where they had other responsibilities. Moreover, people were rotated, which did not allow for a permanent staff to follow through. Further, the project lacked an adjudication officer who could oversee the registration process and settle boundary disputes. Finally, there was only one vehicle for demarcation officers to take to the field.

"Blantyre properties were supposed to be registered in five years, but after four years, not one property had been identified and not one map had been plotted. Frankly, there was not much incentive for staff to work on the project, since they already had another job from which they were not relieved. And the extra work didn't bring extra pay," says Mr Makono.

Roberto Chavez, a senior urban planner at the World Bank, notes that to correct these problems, additional funds were included to hire a demarcation/survey/recording officer, appoint two surveyors, and hire additional temporary staff (labourers) to help mark the boundaries. Equally important, bicycles and other vehicles are being bought to take adjudication teams to the field.

Moreover, as it is felt that not all property owners can afford to pay claim fees, the law is being amended to eliminate this provision. "We have learned that if the project is to involve low-income people, we shouldn't saddle it with a claim fee. As long as it won't cost people anything, they'll take part," Mr Nyirenda says.

To publicise the registration activity, notices are being run in newspapers and on radio, and are being posted in schools, churches and district offices. Although publicity of this sort was attempted before, it stated that claim fees would be charged, so people didn't respond. Mr Chavez notes that the area of Mapanga, in Blantyre, has now been surveyed and the next step will be to adjudicate the claims and record the titles. In addition, another area of the city, Soche East, is being surveyed.

erty holders take the form to the temporary field office, resolve any conflicts, and within six weeks the agency issues their documents (called either titles or land certificates) which contain all the important information.

He notes that the field approach is superior, since, with economies of scale, a registry for an entire neighbourhood can be compiled systematically. Each team can adjudicate and survey about eight properties a day (up to 160 a month), plot them (with diagrams) on a map which, in turn, becomes part of a city's record. In this way, a map of the area is built progressively, as each new parcel is added.

According to Mr Holstein, the problem with the office approach, which is the one most commonly used, is that "it is hard to resolve conflicting claims and boundary disputes solely from the information on forms people have submitted. So the claims become backlogged, the person who filed one dies, and someone else must start the process all over again. It can go on for years. It has the advantage, however, that the process is propelled by the users or beneficiaries, which means less government interference and that the users pay for the registration."

Some argue that deeds registration, rather than title registration, is adequate and far less costly to administer. But, Mr Holstein maintains that in a number of countries, bribes are paid to have false deeds placed on file; and unless a copy of the true deed is entered on to microfilm or a similar register that is difficult to alter, or many copies are made and placed in many files — to ensure that they can't all be removed surreptitiously — the deed system is readily open to fraud.

William Dillinger, a municipal tax specialist at the World Bank, notes that the registration of titles does bring security to property owners and allows them to use land as a commodity — selling, mortgaging it, or using it as collateral. As a means for municipalities to collect property taxes or fees, however, it is useful but not essential.

To begin with, he says, it is very difficult to determine the legal owners of property. Often, people simply will not give this information or will purposefully misinform authorities.

"If the purpose of registering land and establishing legal title is to impose property tax, there is a simpler way to achieve that end. And this involves using a broad definition of liability."

He notes that developing countries generally opt for the latter method and bypass the time-consuming legal registration system. Instead, they send staff to neighbourhoods to make street maps and create lists of those who are liable for the tax, knocking on doors to find out who owns or lives in a unit, or is the agent for an absentee landlord.

However, problems arise after the list has been compiled, when authorities have no way or are unwilling to enforce penalties for non-payment.

"If they won't put a lien on a legal title or fine the liable person, then merely having records won't help the government collect revenues.

"An interesting case is Brazil. Property tax yields were quite low, so beginning in the early 1970s, the government sent staff to nearly 2,000 municipalities to administer a programme — mapping neighbourhoods, valuing properties and printing bills. But once the process was completed, local officials decided it was politically unwise to impose a high tax rate on a few big property owners or go after many small owners. So, while the scheme was well designed and technically successful, the taxes were still not collected, because the programme ran aground on the politics," Mr Dillinger says.

The lesson, he observes, is that large sums should not be invested in developing a fiscal cadastre if it is politically unfeasible to put into practice.

He also stresses that where a municipality intends to impose a tax, because its citizens have made it clear they want certain services and are willing to pay for them, then a tax base can be created inexpensively and quickly. "One should avoid waiting until tenure has been established on all properties, with precise boundaries and thorough determination of ownership. If you want a comprehensive legal cadastre, you will wait for ever." Further, if the process is very expensive, then authorities will have to raise property tax rates which people will resent.

Mr Dillinger adds that these reservations about fiscal cadastres also offer a strong argument against attempting the even more detailed cadastre that combines both legal and fiscal objectives.

Some observers state that, in many poor developing countries, where there is a chronic shortage of trained staff, even simple fiscal cadastres are difficult to produce. Thus, they argue for a scaled-down, incremental approach that involves simply naming streets (since many are unnamed) and assigning numbers to properties on each block. Once this is accomplished, a list of those occupying each unit can be compiled and tax bills sent (if that was the purpose of the exercise). Then, only after this effort has been completed and authorities have found it politically acceptable to impose property taxes, should they consider moving to anything more elaborate.

Those advocating the minimalist approach also point out that most countries do not make housing loans, so the process of creating a fiscal cadastre (of any complexity) should only be undertaken if housing finance is available. ■

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The development of housing finance in Chile, 1930-1988

THE Inter-American Housing Union has published a study: *The Private System of Housing Financing in Chile 1930-1988.* This article summarises the study which was prepared by Dr Guillermo Le Fort.

The 1930s — the Mortgage Bond

In the 1930s, mortgage bonds accounted for a significant proportion of the total volume of finance in the Chilean banking sector. In the early 1940s, a large proportion of gross internal savings was represented by this method of attracting financial resources. It is clear that the mortgage financing system in Chile at this time played an important role in financial intermediation, and housing financing was mainly carried out with resources obtained from mortgage bonds.

The 1940s and 1950s — Social Service Banks

With the high rates of inflation that developed in the 1940s the return on mortgage bonds became negative and they were no longer used as a method of financing.

Social service banks were found to be the best source of funds for housing. These were autonomous public bodies which obtained their funds from subscriptions paid by entrepreneurs and workers for retirement pensions and gratuity funds. All workers were affiliated to one of these social service institutions depending on their jobs. For example, there was a Social Service Bank for Private Employees, a National Social Service Bank for Public Employees and Journalists, the Social Service National Defence Bank, and even the Social Service Bank for Employees of the Horse-riding Club.

As these institutions had to make long-term reserves for old age pension payments, they invested a large proportion of their funds in housing loans granted to their subscribing workers with 30-year repayment terms.

However, this mechanism suffered from the problem that interest rates on housing loans were lower than the rate of inflation. The funds that each social service bank had were accordingly reduced in real terms but very few people obtained the benefits of a housing loan.

Over the years, social service banks gradually lost their housing role to the extent that by the end of the 1950s hardly any housing loans were made. This withdrawal of housing finance activity brought about a contraction in economic activity, particularly in respect of housing construction.

It was considered that it was appropriate to create a massive housing market which was accessible to the population. After extensive studies it was decided that the best solution was a scheme to attract popular savings.

The 1960s and early 1970s — the savings and loan system

The earlier experience made it essential to create a scheme whereby a person buying a home would pay the balance of the loan in real terms and a person depositing money would be able to save without losing purchasing power. The formula found was that of periodic adjustments to the value of savings accounts and loan balances. A decree dated 5 April 1960 authorised the constitution of legal, private corporations of mutual and regional nature referred to as savings and loan associations. Their main objective would be to attract public savings for housing financing. The decree also created the Central Savings and Loan Bank to control savings and loan associations, provide them with financial assistance and serve as insurer for certain operations.

In order to increase the participation in the system the opening of savings accounts were made exempt from all taxes as was interest paid.

The new mechanism soon became part of the development plan and was considered a key part of the plan due to the multiplier affect of housing construction on the economy. It was established at the time that Chile had a housing deficit of 375,000 units, with an annual population growth rate of 2.5% a year. Chile required 35,000 new homes a year in addition to 45,000 to 50,000 homes to replace losses from the stock.

There were five features of the new system—

(a) It was intended to consolidate individual and family home ownership. Therefore financing would be granted only to new home owners.

(b) At first the associations only financed the purchase of new homes. However, as the market was not capable of satisfying demand, they also began to finance older homes.

(c) The system was intended to meet the housing requirements of the middle and lower income groups.

(d) It was considered necessary for the board of an association to comprise representatives of relevant activities.

(e) Increasing resources were attracted into the system, mobilising the mortgage portfolio of the associations and the Central Bank. The associations placed the re-adjustable mortage securities in the market while the Central Bank issued re-adjustable promissory notes.

Initially, the system had contributions from the Chilean government and from USAID as well as savings from the public. The public soon perceived the system's serious, secure and profitable nature. However, the funds obtained were insufficient to give loans to those who, for example, had saved 20% of the price of their homes for six months. To overcome this difficulty foreign aid was resorted to.

The 22 associations began the active task of granting loans, projecting an image of efficient performance which helped them obtain an ever-increasing number of clients.

The associations helped to finance housing co-operatives and they increased their role such that they accounted for 80% of private sector financing for housing in 1970. The system also became a powerful instrument for the development of the housing sector and the national economy.

Four factors are given as the cause for the success of the system—

(a) The application of monetary correction to maintain the purchasing power of savings.

(b) The regional nature of the associations.

(c) State insurance of savings accounts.

(d) Government assistance and foreign aid.

Between the end of 1964 and the end of 1970 the system consolidated. Over 69,000 loans were granted and the number of clients served increased to over 320,000.

By 1965 a high rate of self-financing had been achieved and the government withdrew its contributions to the system.

After the 1970 Presidential election, the demand for savings increased and the system paid off the debt it had contracted with the Central Bank. However, the population was less willing to borrow as a result of an uncertain political situation and insecurity. There was an excess of cash in the associations which was deposited with the Central Bank. Savings captured by the system accounted for over 50% of total local savings. This stage ended with the military coup in September 1973.

In October 1973, the associations began to use their excess resources to purchase land, to build their own buildings. However, the associations were not sufficiently experienced in this and were unable to reimburse re-adjusted funds as quickly as was required. The excess cash situation quickly turned into one of lack of liquidity. The Central Bank also decided not to continue holding the excess liquidity from the system.

Accordingly, the system had a lack of liquidity and the state had to cover the difference. A 1975 law blocked withdrawals from the system; this caused a loss of confidence in the associations. This in turn led to a series of mergers and only seven institutions continued to operate. The savings and loan system gradually disappeared and now there is only one institution which does not seek to attract new resources but merely administers the mortgage portfolio obtained by the system.

From 1977, multiple banking began to develop in Chile whereby mortgage banks and commercial banks carry out various operations without there being any difference between them in this respect. Mortgage operations have been re-adjusted so that they can be protected against the effects of inflation. Commercial banks, development banks and mortgage banks, including the Chilean State Bank, grant housing loans at 15- or 20-year terms. Loan amounts are limited to 75% of the value of the home. Loan values are expressed in the development units (UF) with a peso value that changes daily according to fluctuations in the consumer price index. Loans are issued through letters of credit made out to the bearer by the lending bank. A secondary market is therefore generated. Letters of credit currently carry interest rates of between 5% and 11%. Borrowers must also pay the bank that is financing the loan an annual commission of between 1.9% and 4%. The main investors in this new instrument are pension funds and social security funds.

In 1978, when the new housing finance system first began, mortgage loans represented 1.9% of the total banking loans. The figure increased to no less than 24.6% in 1981.

Among the problems this system has had to face was a lack of correspondence between the consumer prices index and the wages and salaries index. The latter has been considerably lower than the former. This has been reflected in a higher level of arrears.

To facilitate access to housing for lower income groups there is a system of state subsidies. The subsidy is received in the form of a certificate for an amount expressed in development units. If the price of the house is lower than the subsidy plus savings the buyer will apply for a housing loan for the balance which is granted on the usual basis. ■

The Private System of Housing Financing in Chile 1930-1988, Inter-American Housing Union, Cuaderno No 141, May/June 1989.

Housing finance in crisis: the Chilean experience

By Ramon Undarraga Montes

THERE have been major changes in Latin American housing finance systems in the 1970s and the 1980s. Such systems have suffered from high inflation and unemployment rates, and have had to operate with fixed, and artificially low, mortgage rates while paying short-term higher interest rates on deposits.

The channelling of long-term resources into housing finance has been more difficult and loans to finance house purchase have been scarcer. Investors in most countries have not been protected against inflation and funds invested in mortgage lending have not had a positive yield.

Because of high budget deficits and the heavy commitment arising from the need to service foreign debt, the public sector has been able to direct fewer resources into the long-term financing of housing.

Housing finance institutions in many countries have contributed to the problem by increasingly relying on short-term financing, diversifying and transforming their organisation structure in a way to cause a move away from the initial objective of long-term housing finance.

The situation described so far has brought about a decline in the availability of housing for lower income groups. Savings for housing have been redirected to other sectors.

Chile and Colombia are among the Latin American countries that have been able to deal most successfully with the crisis.

Chile's housing finance system

There have been seven major features of the system adopted in Chile to deal with the increasingly adverse macro economic situation—

(a) Subsidies have improved access to housing for the lower income groups where the housing problem is most concentrated.

(b) Permanent and consistent resources have been aimed at the construction and acquisition of houses and the integration of housing finance into the capital markets, with the objective of ensuring the continuity of presence of these resources in housing.

(c) Savers and investors have been stimulated and protected so as to enable them to achieve a real return by means of monetary correction.

(d) Long-term loans and funding have been matched through mortgage instruments that have an attractive real return on a well-developed secondary market.

(e) Development of the subsidiary role of the state through the granting of subsidies to correct distortions in housing accessibility. The subsidy is directed to demand principally through a grant and permits the acquirer to spend it as he wishes.

(f) Full development of the private sector, stimulating it to assume the responsibility for the whole house finance process with the state concentrating on cases of extreme poverty.

(g) Establishment of clear and permanent rules to stimulate the private sector to project itself in its housing action towards the massive production of low-cost housing, obtaining a substantial reduction in construction costs and incorporating advanced techniques, so as to make better use of resources.

These major features have permitted the development of the secondary market of mortgage instruments with the principal investors being social security funds and insurance companies. The private sector has undertaken over 70% of Chilean housing activities. The state has been able to reduce to a third the budget resources required to produce the same number of houses that it constructed when it was a producer.

The private sector

Among the major features of the role of the private sector in housing finance in Chile are—

(a) The contribution of the purchaser has been stimulated through him being granted a housing subsidy as well as through savings.

(b) The housing subsidy system has permitted access through formal financing channels of low income families with a monthly income of between $75 and $280, these families being given a free choice as to how to use the subsidy.

(c) Institutions that cater for the demand of low income sectors have been developed and strengthened substantially.

(d) The private banking sector has participated in the financing of mortgage lending through issuing re-adjustable mortgage bonds that are acquired by social security and insurance companies.

(e) The state facilitates the process, adapting the regulatory aspects to the needs of each special situation, to be able to achieve most efficiency and permitting the housing subsidy to be an effective instrument. ■

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The largest US thrifts

AN article in the July/August 1989 issue of *Savings Institutions,* the journal of the United States League of Savings Institutions, analyses the thrift institutions with assets in excess of $1 billion at the end of 1988. The article, by Michael Wilson, associate director of research at the United States League, lists the largest 100 institutions in asset size. A total of 229 institutions held assets in excess of $1 billion.

However, the analysis has been complicated by the trauma in the thrift industry, and some institutions have had to be excluded because they simply lack data. This includes two of the largest thrifts, both based in Stockton, California – New West Federal and American Savings Bank. These two institutions are, in fact, the result of splitting up the former Financial Corporation of America, the nation's largest thrift, which had been in severe financial difficulties for some time.

The major feature of the table is that the largest thrift institutions now almost all have a stock charter and most of the very largest are based in California. Table 1 lists the largest 10 thrifts, all of which have a stock charter. It will be seen that the first seven institutions by asset size are all based in California and four of these are based in the Los Angeles area.

Of the 229 billion dollar thrifts, 71% had the stock form of ownership, but these dominated the largest 100 institutions, outnumbering mutuals by 85 to 15.

Table 2 lists the largest five mutuals, the largest of which ranks 37 in the total list.

The largest 10 thrifts accounted for 16.6% of the industry's total assets compared with only 6.3% in 1961.

The article also analyses the capital and profitability of the largest thrifts. The median generally accepted accounting practices capital to assets ratio was 4.25%, and the article comments that "only 9% of the billion dollar thrifts are insolvent on a GAAP basis."

The three insitutions which ranked well on all profitability measures (The Federal Savings Bank of Puerto Rico, Bayamon; Washington Federal, Seattle, Washington; and Hunter Savings, Cincinnati) all ranked outside the 100 largest institutions. ■

Table 1. The Largest 10 Thrifts

Rank	*Institution*	*Base*	*Assets ($m)*
1	Home Savings of America FA	Los Angeles, California	34,778
2	Great Western Bank FSB	Beverley Hills, California	30,837
3	California Federal	Los Angeles, California	26,239
4	First Nationwide Bank FSB	San Francisco, California	26,203
5	Glendale Federal	Glendale, California	24,313
6	Great American First Savings Bank	San Diego, California	16,928
7	World Savings	Oakland, California	15,356
8	Citicorp Savings	New York, New York	16,421
9	Home Federal	San Diego, California	16,261
10	Crossland Savings Bank FSB	Brooklyn, New York	15,356

Table 2. The Largest 5 Mutual Thrifts

Rank	*Institution*	*Base*	*Assets ($m)*
67	First Federal	Rochester, New York	5,371
62	Community Federal	St Louis, Louisiana	3,697
68	Midwest Federal	Minneapolis, Minnesota	3,402
69	First Minnesota Savings Bank	Minneapolis, Minnesota	3,399
76	Capital Federal	Topeka, Kansas	3,027

Competition in banking: level playing field needed

BANKING has been going through a period of rapid and profound changes, including new technological capabilities for processing and transmitting data, the growing interdependence of economies and interpenetration of financial markets, and the breaking down of barriers between financial institutions. To shed more light on these developments and their implications for policy, the Committee on Financial Markets of the Organisation for Economic Co-operation and Development (OECD) has carried out an extensive enquiry into banking structures and regulations in the OECD countries. The enquiry covers six areas:

(a) The internationalisation of banking.
(b) Banking and electronic fund transfers.
(c) Banking and monetary policy.
(d) Prudential supervision in banking.
(e) Asset and liability management.
(f) Competition in banking.

OECD has now published a report, *Competition in Banking,* prepared by Mr G. Broker, head of the Financial Markets Division of OECD, with the assistance of national experts. Following is a summary of the report.

The competitive structure of the markets for financial services has undergone profound changes since the early 1960s. The pace and scope of structural changes affecting competition in these markets, notably as regards institutional features of the supply side, have considerably increased since the mid-1970s or so under the impact of an accelerating and self-reinforcing process of domestic financial deregulation and international liberalisation, a much more volatile national and international economic environment and rapid advances in telecommunication and computer technologies.

Retail banking has become a most important sector within the financial services industry in OECD countries. Product competition has become particularly sharp in the markets for household savings as this large and ever-increasing pool of investable funds has attracted an increasing number and a widening range of competitors from inside and outside the banking system.

One feature of the retail markets has been that the rise in incomes and wealth has meant a considerable improvement in the household sector's debt service capacity which has increased the scope for household sector borrowing. For example, household sector debt as a percentage of liabilities of all domestic non-financial sectors increased between 1960 and 1984 in Australia from 22.3% to 32.1%, in Japan from 15.9% to 22.5% and in the United States from 29.1% to 33.7%.

'Surge in demand for loans'

The 1960s and 1970s saw a considerable surge in demand for housing loans for the construction and acquisition of owner-occupied houses and dwellings, including secondary residences. Not all countries were affected by the boom in consumer loan and housing loan activity in the same way. Differences in the level of income and wealth played a considerable role in explaining country differences in this field. In some countries demand for housing loans was particularly strengthened by public policy designed to promote private home ownership. In other countries housing loans were restricted in the context of structural economic policy designed to promote industrial development and the growth of export industries as a matter of high priority.

Initially, those types of financial institutions which traditionally had close links with small savers, such as savings banks and building societies, benefited most from the expansion of private income and financial wealth. Larger commercial banks often reacted at a later stage. In some countries commercial banks were prevented from moving massively into the retail market through both branching restrictions and controls on interest rates applying to retail deposits.

Australia illustrates the position well. Between 1960 and 1970 the balance sheets of "other deposit taking institutions" increased by 10.3% per year compared with 7.2% for commercial banks; between 1970 and 1980 the other deposit taking institutions had the edge with a 16.9% growth rate compared to 14.5%; however, between 1980 and 1984 commercial banks showed a 22.6% growth rate compared with 13.5% for other deposit taking institutions. Canada, Japan, the Netherlands and Sweden show the same pattern.

One paragraph concentrates particularly on competition in the

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housing finance sector. This is reproduced in full in the accompanying box.

Financial policy in OECD countries has increasingly focused on the objective of improving the efficiency of the financial system without, however, neglecting the objectives of ensuring the stability and soundness of the financial system and maintaining an adequate level of investor protection. A wide variety of measures has been taken, including:

(a) Deregulation of interest rates and fees and commissions for financial services and prohibition of cartel arrangements.
(b) Increasing the number of competitors through providing more scope for de-specialisation and diversification and by removing obstacles to the domestic and cross-border expansions of banking networks.
(c) Increasing investor and borrower choices through encouraging the creation of a wide range of new financial assets and debt instruments.
(d) Removing obstacles to free lending and investment decisions of banks and other institutions by abolishing or easing direct lending controls and mandatory investment regulations.
(e) Improving the visibility of financial service markets through better information.
(f) Forestalling the anti-competitive concentration movement in banking and finance by merger and ownership control.

It is widely accepted in OECD countries that free price competition in the financial services markets has a favourable impact on the functioning of the financial system and on the allocation of resources. Supporting the general trend towards de-specialisation by widening the range of permissible activities and products of financial institutions has been increasingly accepted as a policy approach towards promoting competition and hence improving the efficiency of the financial sector. Formerly highly specialised financial institutions have thus been enabled to seize more flexible and dynamically new business opportunities.

It is accepted that a number of conditions need to be fulfilled to ensure that market forces work properly and that competition is maintained at an appropriate level. These include:

(a) Competition should take place on a level playing field, that is, market participants should compete on equal terms and conditions so that there is equality of competitive opportunity.
(b) Competition should be subject to agreed rules of the game.
(c) Club arrangements should not give rise to anti-competitive practices and co-operation agreements.
(d) Anti-competitive effects of concentration and dominant positions of market participants should be avoided. ■

Competition in Banking, OECD, 1989.

Competition in housing finance

HOUSING finance is an area which in many countries has been subject to considerable government intervention designed to promote social housing, to facilitate access of families to private home ownership, or to improve the mechanisms for channelling more savings into the housing sector generally. Moreover, the scope for competition in this segment of retail banking has been subdued in many countries. Nevertheless, in those segments of the housing finance markets in which market forces have been allowed to play a role, increased competition, often stemming from commercial bank entry into the housing loan market, has resulted in wider choices available to private customers as regards suppliers, financing techniques and instruments and has led in some countries also to a conspicuous reduction in borrowing costs. Particularly noteworthy is the proliferation of innovations in housing finance that was experienced in countries in which high and volatile rates of inflation and interest rates created considerable problems for the debt service capacity of private households. Loan characteristics designed to bring the time path of debt service payments more in line with the expected time profile of private household income received special attention. Another area of noteworthy improvement concerns the administrative procedures connected with housing finance operations and with changes in house ownership and a related transfer of debt to the buyer. Banks have increasingly offered special services which simplify such procedures for the customer, notably if various sources of housing finance such as employer loans, and first and second mortgage loans are involved. Thus, a policy of more reliance on market forces, ie on private institutions' initiatives and innovative skills, has, on the whole, led to an increase in the availability of funds for housing finance purposes and an improvement in the quality and convenience of related services.

World Bank publishes report for 1989

THE World Bank published its annual report for 1989 in September 1989. The report provides a comprehensive review of the activities of the Bank. This article briefly summarises those parts of the report relevant to housing and housing finance.

A HIGH-level task force has recommended ways to strengthen the private sector's contribution to development in the developing countries. This has led to the formulation of an action programme which focuses on four priority areas, one of which is the financial sector development and expansion of the transfer of resources to the private sector.

The World Bank suggests that the ability of the financial sector to mobilise an adequate volume of savings and channel resources effectively to their most efficient uses is one of the most important ingredients for successful private sector development. A modern, efficient market-based economy is inconceivable without an efficient financial system to mobilise savings and channel them to the most productive end uses.

World Bank adjustment operations have consistently promoted reform of interest and exchange rates and although suitable progress has been made, these policy reforms have not always generated the expected supply response, in part because of rigidities and inadequacies in the financial sector. The Bank's operations and support of local financial intermediaries have sometimes tended to focus too narrowly on meeting the credit needs of particular end-borrowers and may not have given due attention to the requirements and importance of overall financial sector development.

The Bank's operations that involve the financial sector will be designed and carried out within the context of a coherent country-specific strategy for financial sector development. The Bank will emphasise four specific and closely related areas:

(a) The Bank will expand its operations in support of financial sector restructuring and reform, and the International Finance Corporation will expand its collaboration with the Bank in this financial sector work by helping to review policy and regulatory issues and identify ways to fill institutional gaps.

(b) The Bank will ensure that its activities are consistent with the overall strategy of encouraging greater reliance on markets. Progress will be gradual, but over time Bank-supported financial institutions, however owned, will have to withstand the test of the market.

(c) Because the scarcity of equity capital is a key constraint, the IFC will expand its capital market work through the establishment and strengthening of capital market institutions, supporting links between domestic and international capital markets and advising on the creation of appropriate regulatory frameworks.

(d) The Bank group will expand its efforts to increase the transfer of resources to the private sector, acting both as a catalyst and as a provider of direct financing through the IFC.

The report lists the projects approved for financing by the Bank and its affiliates during 1989. Loans under the heading of urban development are shown below.

At 13 June 1989, the Bank had outstanding urban development loans of $7.1 billion out of a total loan portfolio of $171.5 billion. ■

The World Bank Annual Report 1989, The World Bank, 1989.

ARGENTINA: IBRD — $300 million. The government will be supported in its efforts to reform policies in the housing sector through an increase in productivity in the housing programmes financed by FONAVI, the national housing fund, improvements in FONAVI's financial performance, and a reduction (with concurrent improvement of targeting) of subsidies. Total cost: $608 million.

BRAZIL: IBRD — $100 million. Technical assistance, training and equipment will be provided to municipalities and urban-sector institutions in Parana state to strengthen their financial management and overall administrative capacities. In addition, investments in urban infrastructure will be provided to municipalities throughout the state, and a pilot project for low-income, self-help house construction will be financed. Total cost: $226.9 million.

BURUNDI: IDA* — $21 million. A second urban project aims to strengthen the economy of secondary towns through provision of neces-

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sary infrastructure and community facilities, as well as employment opportunities, and through the establishment of an institutional and financial environment that would help these semi-rural agglomerations evolve into actual urban centres. Total cost: $24.1 million.

CAMEROON: IBRD – $146 million. A second project, which constitutes the cornerstone of the new urban policy, seeks to consolidate the basis for sustainable and replicable urban-development operations through components designed to mobilise urban resources; rehabilitate priority infrastructure in Yaounde, Douala, and secondary cities; and implement sector policy reforms, including parapublic-enterprise reform. Total cost: $253.5 million.

CHILE: IBRD – $200 million. A second housing-sector project supports governmental efforts to increase the number of housing solutions for low-income people, offer a greater variety of new housing types to meet their needs and preferences, introduce programmes to upgrade the existing housing stock, improve cost recovery, and improve the resource mobilisation and efficiency of the private mortgage-financing system. Total cost: $1,134 million.

CHILE: IBRD – $75 million. An institutional capability to manage effectively future urban street maintenance and rehabilitation will be developed, and a programme to bring the urban-transport system back to a condition of maintainability will be financed. In addition, the technical, economic, and financial viability of less costly exclusive bus/tramways to accommodate increased demand and reduce public transport costs will be demonstrated. Total cost: $150 million.

MOZAMBIQUE: IDA – $60 million. The deterioration in basic urban infrastructure and services in Maputo and Beira will be stemmed, and the social effects of structural adjustment mitigated through the implementation of a programme of urban rehabilitation and employment generation. Co-financing is expected from FINNIDA ($6.1 million) and Spain ($3.9 million). Total cost: $83.8 million.

NEPAL: IDA – $41.5 million. The effective planning, delivery, and maintenance of infrastructure and municipal services in town panchayats (municipalities) will be supported. In addition, the government will be helped to reconstruct housing damaged during the August 1988 earthquake, construction standards will be incorporated into building codes. Technical assistance is included. Co-financing is expected from the UNDP ($5.1 million) and the GTZ ($1.7 million). Total cost: $54.8 million.

RWANDA: IDA – $32 million. The government's urban-sector reforms, which aim at reducing the central government's role in urban development and strengthening that of local governments and the private sector, will be supported. Co-financing is anticipated from the UNCDF ($2.9 million), the FAC ($1.1 million), and the UNDP ($1 million). Total cost: $66.2 million.

SUDAN: IDA – $75 million. An emergency flood-reconstruction project seeks to restore productive facilities and essential infrastructure damaged during the floods of August-September 1988, restore social services and destroyed housing, and outline requirements for an early-warning system against future flooding. In addition, the institutional framework needed to carry out the reconstruction programme will be strengthened. Total cost: $83.8 million.

TUNISIA: IBRD – $58 million. The supply of affordable low- and medium-income housing programmes will be increased as domestic savings are mobilised by the newly formed Housing Bank, to be supported through a line of credit and technical assistance. In addition, the share of the formal private sector in land and housing development, as well as in surveying activities, will be increased. Co-financing is expected from USAID ($15 million); $2 million in additional co-financing is being sought. Total cost: $200 million.

ZIMBABWE: IBRD – $80 million. Subsector loans will be made to specific urban authorities for their next five-year capital-investment programmes for primary infrastructure. In addition, steps will be taken to maximise the role of non-governmental investors in housing as a means to relieve the government's financial burden. Institution-building and technical assistance are included. Co-financing is anticipated from the Federal Republic of Germany ($21 million) and SIDA ($3 million). Total cost $580 million.

Note: Abbreviations are as follows:

- IBRD International Bank for Reconstruction and Development – the formal name for the World Bank itself.
- IDA International Development Association – the "soft loan" affiliate of the Bank.
- IFC International Finance Corporation, which is legally separate from the World Bank but which shares some services with it.