HOUSING-FINANCE

MANUAL

FOR

DEVELOPING COUNTRIES

A Methodology for Designing Housing–Finance Institutions

United Nations Centre for Human Settlements (Habitat)
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FOREWORD

The shortage of finance for housing has long been recognized as one of the obstacles to the provision of housing for low-income households. Currently, for every house built using funds from formal financial institutions, another three to five are built with personal savings and funds from other informal sources. Most households are unable or unwilling to use formal financial institutions which have not been designed to cater for their situations and do not meet their needs. Consequently, much of the funding that goes into housing does not enter the formal financial system. With appropriate housing-finance institutions, households could be encouraged to save for housing, increasing the resources for housing finance. Unfortunately, many who are involved with housing do not fully appreciate housing-finance mechanisms, and many in financial institutions need to know more than they do about housing. It is in response to this need that the United Nations Centre for Human Settlements (Habitat) has been providing training and institutional support to member countries, and has commissioned this Housing-finance Manual.

This Manual provides the necessary instruction for devising housing- finance strategies appropriate to the needs of developing countries. The Manual can also be used to provide the basis for a course of training in housing finance, for the evaluation of housing-finance policies and proposals, and for the preparation of briefs or terms of reference for such evaluations. The Manual has been developed by J Babar Khan Mumtaz and Ronaldo Ramirez of the Development Planning Unit (DPU), University College London, in collaboration with Alan Knight and the staff of the United Nations Centre for Human Settlements (Habitat). The Manual has been tested in training courses at DPU, with participants from Africa, Asia and Latin America.

Arcot Ramachandran
Under-Secretary –General
Executive Director

HOUSING-FINANCE MANUAL FOR DEVELOPING COUNTRIES

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The Manual introduces a seven-stage approach for developing a housing-finance strategy. Each stage is presented as a series of Tasks for those unfamiliar with the action required. For clarification, there are Notes that provide an introduction to the salient aspects, and a set of Readings has been included to provide further background information. Sources are cited, and "Rules-of- Thumb" provided for situations where actual information is not readily available.

As a training tool, the Manual can be used for individual or group training, with or without the help of an instructor. Depending on the time available and the depth required, training based on the Manual could range from one to six weeks. If an instructor is available, the Readings can be supplemented or replaced by lectures or other material more appropriate to the particular situation.

If the Manual is being used for group training purposes, please read the Appendix: NOTE FOR RESOURCE PERSONS first.

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INTRODUCTION

Housing finance is the provision of finance or capital for housing. There are three ways of interpreting this: housing finance can be taken to mean the capital required for the construction of housing or housing projects, the resources required to acquire or access housing by households, or the credit supplied by (housing) finance institutions.

The first of these interpretations is really **project finance**, except that it happens to be for housing projects. The third interpretation could best be termed financial institutions, focusing on those that supply or deal with housing. In this Manual, we shall not be dealing directly with either of these sorts of housing finance except insofar as they influence and interact with housing finance in the sense of capital for access to housing.

To purchase housing, households might have to layout as much as four times their annual income, and, therefore, few are in a position to buy a house from their own current resources. One obvious solution is to accumulate or save small amounts of capital and defer house purchase until the required total is reached. Even assuming that 20 per cent of current income could be devoted to such savings, this procedure might imply a wait of 20 years or more, provided that costs do not inflate more than the interest accrued on savings in the meantime.

Individual saving, therefore, is not a very attractive proposition. A way to overcome this is not only to use one's own savings but also to borrow the savings of others, to acquire the capital to purchase a house now, and to repay the borrowed amount back over time. For this, a group of prospective house-purchasers could get together and pool savings. Provided .not all the members wanted to borrow from the pool at the same time, we could have a workable system, and the larger the pool, the more workable it would be. This is, of course, the basis of mutual savings-and-loans associations that exist in many forms in many countries for a variety of purposes, not just housing.

However, to get a sizeable operation going, an association of savers alone will not suffice, and other savers must be attracted who do not have house-purchase in view. Such savers need not only be other households but may include institutions as well. Over time, a number of specialized institutions have emerged that can play the intermediary role necessary to run such an operation, bringing savers and borrowers together. Often, governments provide incentives for savers to invest their money with such institutions, which makes them attractive.

A large part of housing finance in the developed countries consists of transactions of specialized institutions, in the form of building societies or housing banks. However, the impact of these institutions in developing countries has been rather limited. That housing-finance institutions do not work well in developing countries can be mostly attributed to low levels and high disparity of incomes.

Income/housing relationships

Generally speaking, household spending on housing increases as income increases. This relationship can be expressed by the straight line A-A in figure 1. However, there are limits to how much a house can cost. If this "limit" is the point B, there is a corresponding income level B above which the income housing relationship will not hold, but housing costs will tend to stay constant. Similarly, there is a corresponding point C below which price housing is not available. Again, this can be related to an income level C below which housing expenditure will have to remain constant, regardless of falls in income.

These two "limiting" income levels can be termed levels of "affluence" and "poverty", respectively, at least in housing terms. There is another income level, D, below which a household does not have access to credit. For example, if banks operate a lending-limit rule of, say, three times household annual income, and the typical house costs $30,000, incomes below $10,000 per annum will find it hard - perhaps even impossible - to obtain finance.

In terms of housing supply, those above the affluence level will find that not only national but even international sources of finance are available to them. Those above the credit level will, similarly, find no shortage of contractors willing to build for them and financial institutions to lend to them. The problematic groups are those below the credit level: for them, access to finance for house-purchase will not be forthcoming, and it is likely that their access to housing will be limited to the rental market. Those below the poverty line will not readily find suppliers from the private commercial sector, and they are the most likely recipients of subsidized housing provision, if it is available (1).

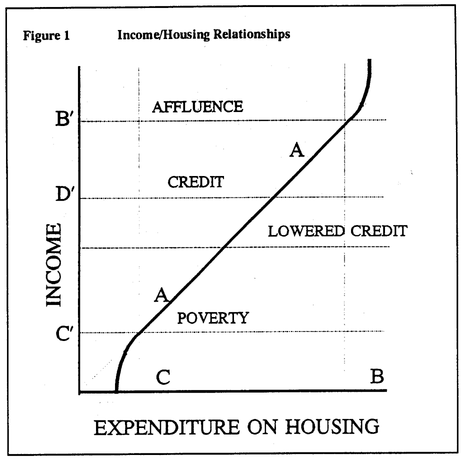

Figure 1 Income/Housing Relationships

(1) In the Third World, their only recourse may be to look for solutions in the city's illegal settlements.

Governments intervene directly and indirectly to affect the access of various income groups. Building and planning rules and regulations that impose maximum standards are likely to lower the affluence level, while those that set minimum standards will raise poverty levels. Some governments also intervene directly in housing finance, by providing subsidized credit through tax concessions or underwriting of lenders' risks: such measures tend to lower the credit level.

To look at the different impact that changing the credit level has in developed and developing countries, in figure 2, the same income levels used in figure 1 are plotted against income distribution. The income-distribution lines are plotted to show the typical cumulative percentages of households that earn given incomes. The solid curve is typical of developed countries and the broken line plots income distributions typical of developing countries.

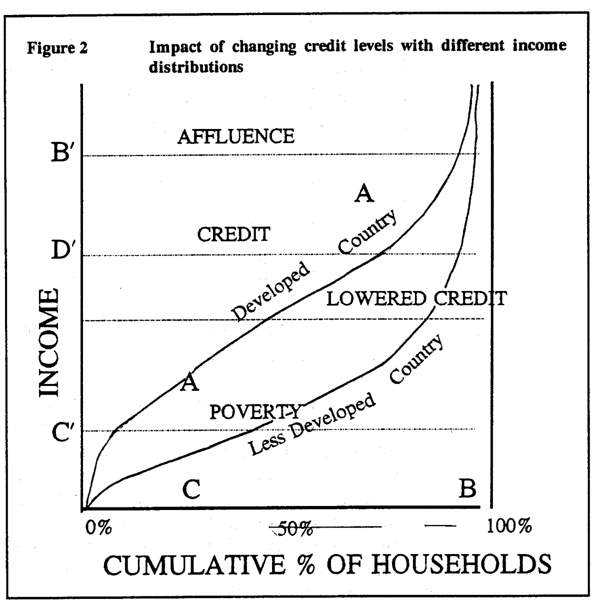

Figure 2. Impact of changing credit levels with different income distributions

By comparing the effects of a change in credit level, it can be seen that the impact on developed-country populations is far greater than on developing-country populations. A change that allows an extra 30 per cent of the former to have acres to credit hardly adds 5 per cent of the latter, which still leaves the majority unable to purchase housing. This explains, to some extent, why housing-finance measures that work for developed countries have little impact in developing countries. By contrast, look at the implications of lowering the poverty level (say through the introduction of "low standards of construction"): while developed countries would gain little (perhaps 3 per cent rising above the poverty level as a result), in the developing countries, a very significant proportion of the population can be affected in terms of housing supply (as much as 40 per cent more being raised above the poverty level).

Another reason why formal institutions modeled on those of developed countries do not work for low-income households in developing countries is that they require formal guarantees in the form of collateral. Whereas, in developed countries, most of the housing finance is required by households to purchase houses (from other households or from developers), in the developing countries, housing finance is required by households to build their houses. In developed countries, the land and the house form security for the lender, and can be mortgaged, and added security can be provided , through life insurance policies. In developing countries many households cannot produce valid title deeds to the land on which they intend to build. In the absence of life insurance policies or other securities, few, if any, institutions will finance land purchase if the only security is the land that is being bought.

Box 1. Sources or housing finance in selected states of Nigeria in 1980 (in percentage)

Source of finance	State								
	Gongola	Kano	Kaduna	Anmbra	Rivers	Bendel	Oyo	Lagos	Total
Building society	0	2	6	0	0	3	6	5	3
Bank loan	0	15	17	13	3	7	2	5	1
Total informal	0	17	23	13	3	10	8	10	4
Loan from employer	1	8	9	4	0	1	1	3	3
Loan from family	1	17	9	14	0	12	12	7	8
Personal efforts	99	58	59	69	97	77	84	79	78
Total informal	100	83	77	87	97	90	92	90	96

Not surprisingly, as boxes 1 and 2 show, only a tiny proportion of households in developing countries purchase their houses with finance provided through formal institutions. In situations where two thirds or more of the population finances housing through means other than formal housing-finance institutions, these other means should be looked at in some detail.

Box 2 Source of finance for new houses in two towns of India in 1981 (in percentage)

Source	City	
	Surat	Villapurna
Personal savings	67	53
Sale of assets	6	14
Provident fund loans	1	0
Employer loans	1	0
Insurance company loans	2	0
Mortgage bank loans	2	0
Commercial bank loans	9	4
Family loans	8	5
Other (informal) loans	5	24

These other means, the so-called informal mechanisms that make up the bulk of housing finance, allow households to purchase housing on a basis other than merely saving before building. Most commonly, households use a combination of means which allow them to:

Build while they save;
Save in building;
Save (earn) by building.

Building while saving, or incremental building, is perhaps the most common of these means, where by a household will construct and occupy a partly built house and improve and extend it over time. Such early occupation obviously allows the household to save on rent as well as provide shelter for a relatively small initial investment. In the short term, however, the household might be "inadequately housed", and the house will most likely be classified as "substandard".

Saving in building and, generally, building at costs that are well below market rates can be achieved by households, partly because through paring of construction and space standards to a minimum and partly through astute purchasing and management, haggling over every input. Additionally, households will use their own labour and that of others on an exchange basis; even professional help might be available at below-market rates from moonlighting or less-than-qualified builders.

Earning by building, through renting out rooms, is standard practice but, again, one which is not recognized by formal institutions as a source of income. One reason is that the formal institutions set up by the public sector usually lend subsidized public money and, therefore, are averse to seeing households profit from it.

There are other ways in which formal institutions tend to discriminate against low-income households and make it difficult, if not impossible, for them to borrow at prevailing terms and conditions. For example, in assessing affordability, most institutions use current levels of income, even though the repayment will be made over the next 20 years or so. Households not only take current income and expenditure into account but also know that they can squeeze expenditure temporarily, if, for example, in the near future, their children also will start earning. Households might also think of house construction as a collective enterprise and not be put off by the fact that it may be years, even generations, before the house is "complete": they see the house not just as shelter for the present generation but as a home for the family. In box 3, some of the terms and conditions of formal institutions are shown, along with an indication of the problems they pose for low-income households.

It is reasonable to assume that if appropriate housing-finance mechanisms were to be devised, a lot more than the current 20 or 30 per cent of households would and could borrow from housing-finance institutions to build houses. Housing finance alone is, of course, not enough. Legislative changes are required that make it feasible for households to build sequentially; land needs to be made available at rates that match demand and at affordable prices, and so on. These other wide concerns are essential components of a housing policy, and a housing-finance strategy should be seen as an integral part of it.

A housing-finance strategy is not a matter of choosing a particular system or establishing an institution. In order to meet varied demands, it has to be composed of a number of linked actions and initiatives by government, public-sector and private-sector institutions and households, each contributing to the provision of improved access to housing finance. A housing-finance strategy should specify which institution or group will undertake each activity; how that activity will be carried out; and which resources will be used.

Box 3 Limitations of conventional financial institutions*	
a. High eligibility criteria	**Constraints inherent for low income groups**
- An "adequate" income at a specified minimum, e.g., $6,000	- An income usually below $2,000
- Regular savings at a specified minimal rate	- Intermittent savings, at a very low rate and often not deposited
- Regular employment and place of residence	- Intermittent employment, frequent changes in residence
- Collateral in the form of conventional marketable assets	- Small assets of a form rarely acceptable to conventional institutions
b. Restrictive loan terms	**Needs of lower income groups**
- Minimum loan size is large	- Small but frequent loans
- loans for completed dwellings only	- loans for gradual purchase and/or improvement of dwelling
- High down payments and ratios of down payments to total house price	- Very small down payments
- Maturity of 25 years	- Very short maturities
- Interest at the market rate	- Interest at below-market or subsidized rates
- Regular amortization payments through banking	- Flexible loan schedules, convenient premises and business hours for cash payments
- A total cost of housing finance that frequently amounts to 20-25 per cent of income	- Allocations of only 8-10 per cent of their household income to housing expenses
- loans with terms and conditions that require considerable sophistication to understand and comply with	- loan terms and schedules that are easily understood by people with low level of formal education or literacy.
* From UNDP, *Non-conventional Financing of Housing for Low-income Households* (ST/ESA/83)(New York UNDP, 1982)	

APPROACHES TO HOUSING FINANCE

There are a number of ways in which to approach housing finance and to develop appropriate policies and programmes. These can be summarized as follows:

1. *Systemic methodologies*

One way to approach housing finance is to take a systemic look at the housing-production process, in order to identify constraints or inefficiencies. The analysis continues by further identifying those areas and activities where finance is the main constraint. Appropriate strategies can then be devised to overcome the constraints and contribute to efficient and , therefore increased housing production (see box 4).

Box 4. Developing a housing-finance strategy based on a systemic approach
The steps below summarize how a housing-finance strategy could be developed using a systemic approach to housing production.
1. Identify the main housing-production processes of the target groups.
2. For each of these, identify constraints to efficient and/or enlarged operations. Distinguish between different types of constraints, e.g., political, administrative, financial, legal, technical and executive.
3. For each financial constraint, devise strategies to overcome it. Where appropriate, combine strategies to address more than one constraint. Assign roles and resources, and programme the action.

A systemic approach is less likely to identify the needs of households for finance to acquire housing than it is to identify the needs for project finance and the capitalization requirements of firms and organizations operating in housing. The latter can be better addressed through support to business and enterprise methods than through housing-finance strategies.

2. *Supply-based methodologies*

These approach housing finance from the point of view of the suppliers of housing finance and take, as their starting point, a survey and analysis of existing institutions (see Box 5 below). This is the traditional approach adopted by the majority of housing- finance practitioners. Their intention is to examine and understand finance institutions, with a view to removing bottlenecks, improving their operations, making them efficient and enabling them to reach a large number of households.

Box 5. Six main analytical steps in developing a housing-finance strategy*
1. Assess the maturity and competitiveness of the financial markets at large.
2. Assess the relation of the housing-finance system to the rest or financial markets and the vitality of the system.
3. Determine the possibilities of mobilizing additional resources.
4. Develop several "packages" of possible combinations for increasing the volume of finance in the sector.
5. Analyse the impacts or implementing each package.
6. For the recommended course of action, detail the institutional changes needed immediately and over the long term.
* Ray Struyk and Margery Turner, Urban Institute

The advantage of such approaches is that it is easy to pinpoint the initial area for analysis and, since most of the housing-finance supply institutions are similar in their makeup and operations, it is relatively easy to