

HOUSING FINANCE

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This is a draft of the Quick Guide on Housing Finance. It was prepared by Prof. Babar Mumtaz.

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Introduction

The objective of this 'quick guide' is to provide an introduction to the essential concepts of housing finance in order to provide an overview and understanding of housing finance and its operation. It also provides an outline and information on various proven and innovative approaches and methodologies to finance housing, especially for low-income urban households.

Purpose of the guide

The guide aims to help build the capacities of national and local government officials and policy makers. It is not aimed at subject specialists, but instead targets those who rapidly need to enhance their understanding of finance issues, especially for low-income urban households. It introduces and outlines the central concepts and approaches, and gives examples of practice and presents key lessons and messages.

Why Housing Finance – An Overview

Housing is a basic and fundamental right, since it not only provides shelter and the space for households to live and to carry out their living functions, housing also provides the point of reference through which households can access other services and utilities. Access to Housing – that is, which households have access to what sort of housing and on what terms – is a key determinant of urban conditions and of the social status and well-being of the households.

Modern housing is an expensive commodity, often costing as much as 9 or 10 times a households' annual income. Even under the most favourable conditions, housing is likely to cost 2.5 to 3 times a households' annual income, and as such it is unlikely that many except the very richest of households could be expected to have the funding necessary to acquire housing readily available.

It is possible for a household to set aside and save the money required to purchase a house (or the materials and components required to build one), but given the large amount required compared to annual income, it is likely that this would take a long time. Most households

cannot expect to devote more than a third of their income to housing (though many devote up to 50%), and setting this aside would require 15 to 20 years before a house could be bought – longer if in the mean time the household also has to spend money (rent) to live somewhere! For most households, this is too long to wait. The obvious alternative is to reverse the process, and borrow the money to acquire the house first, and then take the 15 to 20 years to pay it back.

However, that requires finding a lender, willing and able to provide the household with the money up front, and not charge an exorbitant fee (interest) to do so. Traditionally, the sources for such loans have been family members who are better off, and they are likely not to require paperwork and guarantees and to take a lenient view of delays and defaults in repayments. But such a system cannot be relied upon to find and fund the housing needs of large numbers of households.

On the other hand, conventional lenders, such as banks and financing houses (or indeed money-lenders) do their business by lending to known entities, with established credit records and ratings, and prefer to lend large amounts to a few people for short periods, thereby keeping their risks low and their profitability high. Some of these might also lend for housing, but it ties their money up for a long period and while the risks are low, they would have to deal with people who are unlikely to bring repeat business, and if they were to default, the courts would be inclined to give the benefit of the doubt to the borrower. Indeed in many countries, until relatively recently, it was almost impossible to recover money on a housing loan by rendering the household homeless.

Over the years, specialised institutions have developed whose main business is to lend money for housing. Housing Finance deals with the whole process by which households obtain the funds to acquire housing: that means the households and the institutions that lend the money, including the rules, regulations, processes and procedures by which it is done. Housing Finance also covers the provision of funds and finance to those who build and develop housing for selling to the households; and it covers the whole set of financial markets within which housing finance institutions operate and where they themselves acquire and access funds to lend for housing. However, in this Guide, we shall be focussing mainly on the first of these aspects of Housing Finance.

The Guide is in 4 sections, which deal with housing, households, finance and financing strategies as follows:

1. **Housing and Housing Conditions** *This section shows how the general state of housing – its production, consumption and regulation – impacts on the costs of housing and determines which households can access it.*
2. **Households and their Ability to Pay** *This section shows what households can pay for housing, and discusses ability to pay versus willingness to pay. It looks at ways of determining affordability and the relationship with incomes. It examines demand and how to assess what the demand for housing and housing finance is likely to be.*
3. **Finance and its Operations** *This section looks at the technicalities of finance and the financial sector and its operations in general, and at housing finance in particular. Its intention is to unravel some of the jargon of housing finance and increase awareness of the tools and techniques used in the sector. This is further facilitated by the use of a **Glossary**, attached as an Appendix.*
4. **Housing Finance Strategies** *The high costs of housing, relative to income, have tended to limit access to housing to those with higher incomes. Where land or finance is*

provided through the formal processes, access is further limited to those in formal employment who can provide the necessary paperwork to support their application. In situations where the informal sector is large and many households are new or recent migrants, the needs of these, mostly low-income households, goes unmet. This section looks how these problems may be overcome using conventional and unconventional, formal and informal mechanisms.

1. HOUSING

This section shows how the general state of housing – its production, consumption and regulation – impacts on the costs of housing and determines which households can access it.

1.1. Housing conditions and the need for housing finance

Even a brief review of the current conditions and likely future trends in the countries of the region highlights the relatively poor levels of housing and access to housing. In most countries, a large proportion of the urban population is unable to afford adequate housing, and has to make do with smaller housing or has to locate at considerable distances away from their place of work, or to social, commercial and recreational services.

On the other hand, there is an increasing need for intervention that meets the scale and the rapid pace of growth and development in conditions of accelerated rural-urban migration as well as economic transition. With increasing globalisation, the relatively low-paid but often highly skilled workers are now in great demand, leading to a revival in the fortunes of the cities in the region.

Unfortunately, this new and growing economic prosperity has yet to find ways of resolving the housing needs and demands, especially of the lower-income households. In many countries, the traditional, conventional relationships between housing and housing producers and households has undergone a radical change and have been replaced by new, market-driven forces. Many of those responsible for the production, delivery and direction of housing are not familiar with the operations of market-driven mechanisms of housing finance.

The conventional methods and systems of housing finance that operate in other parts of the world have not been able to operate as effectively in such a situation of rapid change and transition. Therefore, the mechanisms that were introduced and should have enabled the market to deliver affordable and acceptable housing have been ineffective, leaving many urban households bereft of the previous support systems and unable to access the current housing finance systems.

1.2. Housing Production – needs and opportunities

On the assumption that each group of people that want to live together as a household, should be able to do so in a

house – whether in a block of flats or as a stand-alone structure – the number of houses (or housing units) need to be equal to the number of households (or people units).

To respond to the changing needs over time, there would have to be housing units produced to accommodate new-formed household, though some of these could take over units vacated by households that have moved out or ceased to exist. In the same way, housing would have to be produced to replace those housing units that become deteriorated, or substandard, or in other ways are no longer acceptable.

The production of these units can be done by the households themselves, or by specialist producers to the demands of the households, or they can be produced speculatively by developers who would then sell them to households, or they can be produced by the government or its agencies or by employers – and offered to households according to the criteria of the producers.

So far, no system has emerged that is able to perfectly match the production of housing to the actual needs – and there is inevitably either a surplus or (more often) a shortage, and many households have to live in units that are not quite what they need, want or can afford.

Housing is made available to households either permanently (sold) or temporarily (rented) under a variety of arrangements and in return for payment in cash or in kind, also in a variety of ways.

The production of housing in the Region, as elsewhere, has been determined essentially by the form of socio-economic system in operation in each country or territory. Where there has been a socialist, command economy, housing has largely been seen as a basic right, and its production and provision seen as the responsibility of the State. Often, therefore, access to housing was determined more by need than by ability to pay.

In most developing countries, the production of housing has been managed by the households themselves, with little direct intervention by Government until relatively recently.

Under conditions of rapid urbanisation, it has not been possible to provide serviced land at the rate and scale required to meet the growing need for housing, and this has often led to the construction of housing modelled on that of the rural areas, both in terms of building styles, materials and levels of services – these have resulted in large areas of slums and informal settlements, unsuitable and unacceptable to the needs of cities.

The following sections discuss some of the ways and

1.2.1. Government and public sector housing

means of housing production and types of housing.

In different countries and at different times and situations, Governments have acted as producer, financier, regulator or manager of housing, and sometimes, as all of these.

Many governments moved, from an initial laissez faire attitude to housing (assuming that housing problems, such as slums, were only a temporary phenomenon), to one where they took it upon themselves to provide housing, usually in the form of low and medium-rise flats in large estates on the expanding periphery of cities. It was thought that mass-housing would be cheaper and faster by being able to use economies of scale, The high costs and bureaucracy meant that most of this housing was neither low-cost nor sufficient to meet the need. More-over, undertaking large housing projects was a time-consuming process, rarely able to keep pace with demand

In some countries, where the governments claimed to be actively engaged in housing production, in fact only produced some 7 to 10% of the total housing units. Even in highly-centralised bureaucracies, with only a marginal private-sector, much of the need for housing was met by individual households producing their own housing, usually at a lower cost than that produced by the public sector.

Now, taking a more realistic approach, governments are taking an enabling approach to housing by shifting from a focus on constructing housing, to supporting the housing efforts of households with regulatory and financial frameworks designed to increase access to housing.

1.2.2. Private Sector housing

As indicated above, the private sector is the major player in housing production, and is engaged in the production of housing in three distinct ways. Firstly as the producer or supplier of inputs to the housing process – including land, finance, building materials and components and labour; secondly, it is engaged in the production of houses itself, as a contractor, managing and operating the process for the government or individuals; and thirdly, it produces houses as a commercial, speculative product.

For each of these, the needs for finance are different, ranging from project finance to set up or finance production or assembling processes, to housing finance for its end-users, the households. Of course, the private sector is also engaged in providing, procuring or making available finance itself as a product or commodity.

In most developing countries, the private sector produces housing “to order” for individual private clients, rather than as a speculative process as a “developer” for the

1.2.3.Owner-occupied Housing

market. A widely-used process involves the “developer” selling units “off-plan” to households who contract to provide the finance for construction in stages. While both processes considerably reduce the risks for developers, they reflect the difficulty of obtaining project finance. One consequence of this is also a constraint to the development of an efficient housing sector.

By far the largest proportion of housing in most developing countries is owner-occupied, across the income range. To a large extent, the type and costs of housing produced have a direct correlation with the income of the household. The form and source of housing finance and the production process also varies by income group.

Many households, particularly in the upper income groups, use the opportunity of their own housing construction to build more than one unit on their (often) allocated plot of land. The additional units are sold off to finance their own housing. Some times, the additional units are rented out and sold later or used to house offspring when the need arises.

In many countries, at the lower-income end too, households acquire additional land or build more than their immediate needs, with the express purpose of using the surplus to finance their own housing. Renting the surplus in the interim is also a common practice.

For all income groups, but especially for the lower-income, housing is a process, completed incrementally, in stages rather than as a pre-conceived project, designed and implemented to plan. While this is more responsive to cash-flow (especially in the absence of housing finance) and is able to capitalise on market fluctuations, the quality (and quantity) of housing is often below acceptable standards.

1.2.4.Rental Housing

In most developing countries, with little serial-mobility, rental housing plays a significant, but not a major role in housing, particularly for those who are, or see themselves, in transit – either in the city or economic or social category. For most of them, housing in their present city is, at best, a secondary priority to income or the need to accumulate savings and make remittances home.

Rental housing usually came into its own during the first influx of in-migration to the city from the rural areas or smaller towns. This was accompanied by a shift out to new, modern housing areas on the outskirts, leaving city-centre property available for rent. With increasing demand, rents started to rise, while incomes stayed static or even fell with increased in-migration.

In an effort to control rising costs of housing, many

governments brought in regulations designed to control exploitative landlords. With rents frozen in an environment of increasing costs, maintenance and upkeep were the first casualty. Ironically, in many cities, those enjoying the controlled rents often moved out and sub-let the units at more realistic or even exploitative rents.

In many countries, therefore, the rental stock is largely made up of units that have been subdivided or illegally occupied or under dispute. Often, these once-fashionable, city-centre houses and apartment blocks turn into slums and end up rented by the poor

In practice, rent controls made it unprofitable for the private sector to play any meaningful role in the provision of rental housing – except in the informal sector where small, single-room or subdivided units of sub-standard accommodation can be let to poor and migrant households.

However, there is still a viable, and often vibrant, rental housing market – one for foreign tenants or those on temporary assignments with “housing allowances”. This niche market can allow their owners a return of investment upwards of 20-30%, and with rent-advances, the capital costs can be recouped in 2 or 3 years.

The other is where housing (or a sub-let-able part) has been constructed against future needs of the owner – and is rented in the interim.

Finally, in the absence of other secure avenues for investment, and/or where access to land or other opportunities have presented themselves, households may undertake the construction of one (and up to four, or even eight, units), which are rented out at or below the market rate of return, the “loss” being made up at the time of the sale of the unit in the future.

All of these can be made more attractive and rental market can play a greater role with appropriate support and regulation and the provision of housing finance.

1.2.5.Social Housing

For those that cannot afford to own or rent acceptable housing through the formal sector, the concept of social housing has been put forward as a tool of housing policy. If only a small percentage of the population were in this category, it could be a workable solution, but the reality for most developing countries is that the majority would need social housing, making it unaffordable for the government, and therefore limiting its use as an effective policy tool.

Social housing, properly used, can be an effective tool in keeping production costs and therefore prices low, since it allows for wages (which have to cover the costs of housing) to be kept lower than otherwise. Subsidising

housing, however, means that employers are being subsidised rather than the households, and is therefore seen as inefficient or unfair.

Nevertheless, in situations where some households cannot access any form of housing through the market, the provision of social housing becomes necessary and justified, though care needs to be taken to avoid the unscrupulous from taking advantage or otherwise skewing and spoiling the market.

On the other hand, social housing must not be so designed or located as to stigmatise those entitled to it.

1.3. Slums and squatter settlements

In the absence of an appropriate response, the demand for housing has been met by the proliferation of informal housing and settlements. While these have enabled cities to grow and even prosper at the expense of the social costs of its labour force, there is an obvious and urgent need to upgrade and transform slums and squatter settlements into efficient, serviced housing areas. Given that more than half the population of most cities has been housed in these areas, with little or no access to housing finance, there are many lessons that can be learnt regarding both the need and how to meet it.

See separate Guide on the Upgrading of Slums and squatter settlements

1.4. The Costs of Housing

The costs of housing, relative to incomes and affordability are an obvious area of consideration and concern. If costs could be reduced, there would be an obvious impact on housing, and would reduce demands on housing finance. The primary components of housing are land, infrastructure and services, superstructure and fixtures, features and fittings. Depending on the situation, these could all be provided in a single, pre-assembled package, designed to order, or brought together through a series of actions and interventions by the householder.

The following sections look at some of the ways and means suggested for reducing the costs of housing.

Also, see separate Guide on the acquisition and service of land for housing

1.4.1. Mass production

Hong Kong and Singapore have been cited as examples of how mass-housing can provide a successful solution, but as is evident in China, mass production in itself does not bring costs down to an affordable level.

There are two broad categories of mass housing: one through high-rise blocks of apartments and the other through detached or semi-detached units. In the first type, the cost reductions are largely through a reduction in the unit cost of land and secondly through standardisation; whereas in the second, it is presumed

that standardisation alone will lead to reduced costs.

The actual cost-savings achieved are dependent on the relative costs of land and labour versus materials and equipment. While the savings in land costs for high-rise construction seem obvious, to produce acceptable housing, only housing that is more than 12 storeys begins to make economic sense, but is often at the expense of social and infrastructure costs. Therefore, they are more effective for middle or upper-income groups and economies.

For low or medium-rise dwellings, where labour-intensive techniques can be more effectively used, mass-production, in the form of “cookie-cutter” housing – to one or a limited range of designs and options – the savings are dubious.

However, mass-production need not mean a large number of units built by one contractor in a single project. Instead, a programme of mass-housing that allows for production by a large number of developers, contractors and owner-builders, in multiple but parallel projects, can be more effective if it is undertaken in a regime that provides for a smoother flow of funds, materials and regulatory procedures.

Similarly, mass production should not be limited to the complete units themselves, but, and perhaps more effectively, should include the mass production of components, ranging from bricks and blocks to beams and lintels, tiles and panels.

Incidentally, in looking to Hong Kong or Singapore, it is the housing policy and the processes involved that are worth emulating rather than just the design of the housing blocks.

1.4.2. Self-Help

In contrast, some have advocated the use of self-help housing to reduce costs and make it affordable to low-income households, and in support, the vibrancy of the informal sector has been cited.

Self-help is rarely an optimal process for an urban environment, where few households have the time or the skills to apply to their housing. This is in contrast to traditional, rural environments, where the economy is dominated by agriculture which is in turn governed by seasons that require varying inputs, including periods where time can be devoted to non-agricultural activities. Furthermore, building skills and materials are those that have not changed for generations and which are usually available locally and amongst most households.

In urban areas, this is rarely the case, since “local” materials are still produced by the market, and need to be purchased, while learning building skills that may only be used once is inefficient. In any case, any household

that puts a high priority on housing (as opposed to shelter) probably has employment that pays more than purchasing construction labour would cost, making it expensive to undertake self-construction rather than paying for it.

In fact, the key to the success of much of the informal-sector housing is not based on self-help construction as on self-managed processes. These could be made more effective if they were supported by appropriate financing mechanisms that helped reduce the uncertainties in self-help housing and made it more accessible to more households.

1.4.3. Standards and regulations

It has often been suggested that housing standards have been set too high and are responsible for the high costs of housing. While there is some truth in this, in many instances, it is the regulations and their implementation that is responsible for an increase in costs and, ironically, a reduction in the standards of construction. Certainly, the introduction of more appropriate standards and their application in ways that correspond to the needs and realities of low-income communities would help reduce housing costs

The biggest problem with regulations and standards is that they are often not adhered to – especially if they are seen to be adding to costs. In most cases, this is because there is very poor understanding of the regime or of its advantages. Moreover, standards and regulations seem to favour long-term returns over short-term costs.

There has to be both a greater involvement of households and communities in the framing of their own local standards – only from the understanding and comprehension that that brings will there be compliance. Secondly, the conventional regime of inspectors and controls needs to be replaced by one of facilitation and support. The purpose of standards and regulations is, after all, not to penalise or criminalise householders, but to improve and make their housing more effective.

2. HOUSEHOLDS AND THEIR ABILITY TO PAY

What housing a household can have depends very much on how much money they can borrow, and that depends primarily on how much they are able to pay.

This section shows what households can pay for housing, and discusses ability to pay versus willingness to pay. It looks at ways of determining affordability and the relationship with incomes. It examines demand and how to assess what the demand for housing and housing finance is likely to be.

This section shows that the household plays a very significant role in accessing housing because it is the households' decisions that are critical in determining whether they can access the sort of housing they want.

2.1. Ability and Willingness to pay

Many of these decisions cannot and must not be made “on behalf” of the households by professionals or community representatives or leaders.

At its simplest, the ability to pay (ATP) of a household is determined by how much money they can devote to pay off a (housing) loan. There are three ways of arriving at this figure:

1. By using a percentage of income – based on the average of payments made by other households in similar circumstances;
2. By subtracting expenditure from income and adding to it current expenditure (rent) on housing; and
3. By letting the household decide.

The first of these is the easiest, and perhaps therefore, the most frequently used. The general rule-of-thumb, for low-income households is to use a figure between 20 and 40% - and usually 30% is used. Because of its simplicity, it is a good initial figure, but (as shown below) should not be used to select or eliminate households from consideration or eligibility.

The second method is better, because it takes both income and expenditure into account, and therefore is more reflective of the realities of a particular household. In practice, it is rarely used for establishing the ATP of individual households – rather averages across the group are used. To an extent, this then reduces its advantage over the first.

Both these methods use aggregated figures of income (and expenditure) to set the ATP threshold. Thus, if the target group was the lowest quintile, the process involves using the monthly income earned by that quintile, say \$100 (meaning that 20% of the population earn less than \$100/month, then, using a 30% monthly repayment figure, would give an ATP figure of \$30/month. Using a simple formula (see below), the capital amount that can be borrowed can thus be calculated.

Most calculations, unfortunately, tend to forget that this is the maximum ATP for that group, and not the target! In other words, only the households earning at the top of the group could access such a loan – and the vast majority of the quintile would be left out!

The third method is better still, because it allows both **Ability** and **Willingness** to pay to be taken into account – and the need for housing can only translated into demand if there is the willingness to pay. But, because it depends on the decision of each household, it is less useful for planning purposes than it is for implementation.

Willingness to pay (WTP) attempts to answer the question of what households **will** actually pay, rather

than what they are **able** to pay, and therefore a more powerful concept. Willingness is not an abstract concept but relates to “push” and “pull” factors that range from the attractiveness of a particular type of housing in a particular place at a given time – and may not be there if either timing,, location or design were radically altered. On the other hand, present or anticipated circumstances may force the acceptance of housing that it would not otherwise be willing to consider.

Establishing WTP requires undertaking market research around actual cases, informing the households and explaining the possibilities and the consequences and commitments expected of them.

2.2. Need versus Demand

While Need is a statement of the fact that something (housing of an acceptable standard, for example) is lacking, demand arises through an assessment of the numbers of units (of housing) that would be “bought” if they were made available. Need is useful for planning purposes, but for producers, demand is the key to decision-making.

The difference between need and demand is demonstrated by houses lying empty even where there is a housing shortage. Though the houses are obviously needed, there is no demand, because of the price, design, location or whatever.

In planning the likely housing volume, therefore, it is necessary to look carefully at figures of housing need and try and estimate the likely demand based on the types of housing that will be produced.

2.2.1.Types of demand

There are other problems in assessing demand since it is dependent on both price and availability. Surveys and applications or waiting-lists for housing may give a misleading picture since households base their decisions, on whether to seek housing, on price and availability. Thus, in a very constrained market, where housing is unavailable, people may decide to continue staying with their parents, but if housing became easily available, many young people may opt to move out. Thus, the concept of suppressed, latent or pent-up demand is a useful consideration for policy makers and planners.

It means that demand is not static, and even the very fact of a successful policy is likely to increase demand, purely by making it more possible to access housing.

2.3. Affordability

Very often it is not that housing is not or could not be made available, but rather that it is not affordable – or at least, not by those for whom it was intended, leaving the housing empty (or bought by another group of households)and the housing needs of the target households unmet.

Affordability assumes that the purchaser of a product has

2.3.1. Determining affordability

the means and the ability to make the purchase – using their own resources or by accessing additional resources that are or could be made available, for example, by borrowing.

Since affordability is determined not only by the currently available resources, the ability to have recourse to additional resources becomes a very important criterion. Thus, current savings are an important resource, but borrowings and loans may be an even more important factor. For both, income and expenditure play a crucial role, but the availability of lending mechanisms and funds are perhaps even more important.

In housing, the available resources may only amount to 10 or 20% of the price of housing, while the remaining 80-90% would need to be borrowed. How much a household can borrow depends on the actual terms and conditions at which the loans are available which also determine whether the household can access a particular loan.

2.3.2. Calculating affordability

There are two aspects to calculating affordability. The easier one is to deal with the mechanics of calculating how much money can be leveraged by a given input (repayment) by the householder. For this there are a number of formulae, calculators and rules that allow the easy derivation of loan size based on any number of variations and assumptions. The other, more difficult aspect is calculating the inputs that a household can provide. At the simplest, this is a function of income and expenditure (see below) and both can be adjusted by the household – but only if they are willing to do so (see above). To the extent that any externally derived assumption can, at best, be considered notional, the affordability thus arrived at should not be used as a selection or eligibility criteria.

A simple equation for affordability is given by the expression:

$$\text{Available funds} + \text{borrowed funds} \geq \text{cost of housing}$$

Available funds of the household include their income plus past savings in cash or in kind that can be converted to cash plus any sums it can obtain from friends and family;

Borrowed funds are those that the household can borrow from various sources against future repayment. The cost of borrowing (interest and charges) is included in this component;

Cost of housing includes the cost of land, infrastructure and connections and any fees, licences and charges, as well as the cost of the house itself.

Each of these terms is complex and not always straightforward to determine. The following sections discuss some of the issues of **income** as they relate to households' ability to pay.

2.4. Income

Income, or the earnings of a household are crucial to determining affordability (see above), but what exactly constitutes "household income"?

2.4.1. Definitions of income

While the definition of income as earnings is relatively straightforward, in relation to housing and housing finance, it becomes complicated by having to determine whose income, and at which period of time. Usually, the term used is "household income" when in practice what most financial schemes consider is the "applicant's income" – usually the de facto head of the household.

However, in most households, and especially the poorer ones, there is usually more than one income-earner, and often each or many have more than one income. Not only that, but these multiple incomes may not all be in the formal sector, regular or even monetised. This means that it is often difficult for the household to certify or document, and sometimes, disclose or even know, their total income.

Secondly, in considering the incomes of other members, or indeed the applicants' own secondary incomes, should they be considered in whole or in part? Should only the proportion or share being contributed to the household be considered? To simplify matters, most financial institutions use rules-of-thumb to assume the proportion of income that is available to repay a loan (the rest being needed for essential living expenses) – but if a household sub-lets a room in order to increase its repayment capacity, should all of that income be counted as being available for repayment, or should it be assumed that some of it will be used for other expenses?.

Finally, further complications follow when not only present incomes and income levels but also future incomes and income streams are taken into account. A household may have children just below working age at the time of application, and know that they can count on an increased income when they start working. How should this additional income be treated in the financial calculations? How could it be guaranteed that it will become available?

2.4.2. Determinants of income

In a fairly stable economy, where most households are employed in regular jobs in the formal sector, determining current and even future incomes is relatively simple. In developing countries, especially those in transition or undergoing rapid change, the incomes of urban households may be quite difficult to assess.

However, when it comes to secondary or supplementary incomes, whose existence and level depends on both the economy at large and on the decisions, abilities and determination of households, it becomes more difficult to predict.

Moreover, the real focus lies not in the income per se, but the “disposable” income available to the household – that is the amount left over after meeting (essential) expenditures, since it is this that will be used to make repayments and will therefore determine how much a household is able to borrow.

All the caveats and cautions regarding incomes apply equally to expenditure as well, making the determination of residual, surplus or disposable income somewhat tenuous.

2.4.3. Calculating income

Calculations that are based on those incomes and income levels that can be verified are very likely going to miss out on many opportunities, while if assumptions are made that there are, or will be, supplementary, secondary or future sources, the household may be hard put to meet its financial obligations if these do not materialise. In each case, assumptions made by anyone other than the household or at least without involving them are likely to be not only misleading but also unfair.

When assumptions regarding expenditure are applied, based on some given percentage, the results may be less than accurate, even for planning purposes. Perhaps, as for affordability (see above), the “calculation” is best left to the household, who should be supported by provision of the information required to make judgements regarding their ability to service a loan, given the state of the economy and externalities.

In any case, assumptive, external calculations should not be used as eligibility or exclusionary criteria.

3. FINANCE AND FINANCIAL OPERATIONS

This section looks at finance and the financial sector and its operations in general, and at housing finance in particular.

3.1. Financial Markets

Housing finance is a sub-set of finance, and as such, its operations and mechanisms are closely linked to it. Certainly the more efficient, effective and generally vibrant the financial sector, the more likely it is that the housing finance sector will also be so. Where there is transparency and good governance in the financial sector, it is also likely to exist in the housing finance sector.

If anything, the housing finance sector is likely to lag behind overall finance in terms of efficiency and operations since most of the operations and participants are made up of one-off players that are unlikely to undertake serial or sequential transactions.

The financial market consists of all the buyers and sellers

and the transactions that take place between them. The Housing Finance market, therefore, consists of the end producers and the consumers of housing and includes those that produce and provide the major inputs, such as finance.

A market works best when there are willing buyers and sellers operating in a level playing field, since openness and transparency assist fair competition and competitiveness ensures a fair price for both buyers and sellers. The role of the government and public institutions should be to encourage and ensure the development of an efficient market rather than intervening or participating directly.

Financial markets are made up of a large number of interlocking sectors, actors and transactions, and for many purposes, it is easier to consider parts of it as markets in their own right, or as “sub-markets”

3.2. Secondary markets

Increasingly, the inability of the housing market to reach and serve the needs of all those wanting and needing housing has been attributed to a shortage of funds in the housing sub-market.

It has been suggested that the housing finance markets have limited funds because of the socio-political nature of housing. For example, recovering funds from defaulting households is more difficult and time-consuming than it is for other types of loans that are not so politically emotive. The housing market is made up of a large number of relatively small loans, making their management relatively more expensive. Though the risk associated with housing loans may be low, the repayment capacities of their borrowers make them long-term and therefore less attractive than other forms of lending.

Therefore, in order to increase the funds available to the housing finance market, the creation of a “secondary market” has been suggested that would act as an intermediating buffer. This would convert the many individual housing loans that could be consolidated and traded, allowing the financial markets to deal “in paper” rather than with houses and housing.

The process of creating a secondary market consists of the creation of institutions and regulations that allow for housing loans to be de-linked from the individual housing units and households. For example, if those who hold portfolios of housing loans can be allowed to use them as security to borrow against, by floating bonds or selling shares, then other players can buy and sell these in the same way as any other stock.

The primary requirement for this process is to ensure liquidity of the housing loans – and that means being able to easily repossess and sell properties. A

fundamental requirement for this is to be able to identify property uniquely and accurately through legally acceptable documents, based on cadastral surveys and land and property ownership registers.

While there is merit in this approach, it should not be assumed that creating a secondary market is either easy or necessarily going to resolve the problems of housing finance, especially in a situation where the financial markets are not efficient, or where there are easier or more attractive opportunities for investment.

3.3. Informal Markets

As indicated above, the formal housing finance transactions account for only a minority of the total in most developing countries. The formal financial markets have little penetration down the income levels, and even those households that do access or have recourse to formal housing finance have to supplement this with other, informal loans. Therefore, there is a burgeoning informal financial market that provides quick and easy access to housing finance for those unable to meet the terms and conditions of the formal sector. However, though meeting a need, it does so at a cost. Interests are often exorbitant, amounts are relatively small and loan periods are limited to a few years. Defaults and delinquencies are often dealt with by the use of force and other draconian measures.

Ironically, since these transactions often make up to 80% of all housing finance, this is a very significant financial sector and needs to be understood and supported.

Lessons need to be learnt that would allow the informal sector to operate more effectively and efficiently. Lessons need also to be learnt from the informal sector by the formal sector to make housing finance more accessible to the majority of the population, especially the poor.

For example, most informal markets operate best because the lenders know the borrowers – and often have prior links and connections to them that both borrower and lender know are important and not likely to be lightly broken by defaulting on the loan. This is not dissimilar to the principles of client relationships, credit history and credit-rating used by formal institutions. The lesson to be learnt is that it is possible to build a client relationship through mutual trust and cooperation rather than on legal documentation alone. It also suggests that small, localised operations may be more effective, allowing for personal knowledge to replace legal paperwork – this is specially useful if the context places little value on the legal paper, or if it cannot be enforced.

On the other hand, informal operations may not have the capacity to serve the scale of need that exists and would

have to be supported by drawing-in external funds and resources. Having a cascading organisation of institutions helps maintain the local flavour and advantage while still allowing for a link to a wider market and resources.

Informal operations often mean that should things go wrong, the parties may have little recourse to external support, through the legal system, for example. Therefore, a minimal level of paperwork may be necessary – but it has to be stressed that the actual need for and utility of each should be carefully analysed before it is introduced.

The need for good governance – transparency and openness cannot be stressed enough as a basis to good, successful operations and management.

3.4. Availability of Loans

What loans are available, and the amount and volume of funds, depends on having in place an effective and accessible housing finance market that is responsive to the needs of the majority. It requires a better understanding of how to attract funds to the sector and how to manage them effectively and efficiently.

The possible role that a secondary market can play to attract funds to housing finance have been outlined above. However, there is another untapped source, the households themselves. They are, by and large, left out of formal market altogether. In most cases, far more can be done by creating the right vehicles for savings. For most people, the opportunities to save just do not exist. Or, if they do, they are not easily accessible. Wherever such attempts have been made, they have found a tremendous response from low-income households to save, particularly when these have been targeted for housing.

3.5. Attracting Funds

To attract funds, it is important to know the motivations and objectives of those individuals and institutions that have the surplus funds to invest and to make sure that there are mechanisms, schemes and instruments that meet these objectives in a secure and acceptable manner. Since the comparative advantage that housing finance has for investors is their low risk – this should be used to promote the channelling of funds to housing by investors and as a hedge against losses in the more volatile sections.

In many countries, the government makes use of this to allow commercial banks, which are required to hold assets equivalent to a given proportion of their overall lending as a guarantee against bank or market failures, to use housing loans and/or investments in housing loans, as part of such reserves. This ensures the diversion of some funds from the general financial market to enter the

housing sub-market as capital for loans.

Funds can also be channelled towards housing through the creation of compulsory or contractual savings – whereby a percentage is deducted from the salary checks of workers and put in a dedicated housing bank account. These are then available for housing construction as well as for housing loans.

A variation on this is to declare a specific tax – for example a luxury tax on imports – aimed at providing funds for housing. Or even to establish a lottery or prize draw whose earnings go to the housing fund. Again, these funds are available both for housing development projects (the idea being that it would allow for economies of scale) as well as for loans to individual households for their own housing. The biggest drawback to such mechanisms seem to lie in their success – both directly (for the exchequer who finds such large amounts easy targets to divert to other uses) and indirectly, since they tend to exert an inflationary pressure on housing costs.

The key to attracting funds is to have in place proper controls and regulations, and institutions that are well and effectively managed. Transparency and efficiency are needed to assure investors of the safety of their funds and a decent return on investment.

Targeted savings – that are aimed at potential borrowers and can make loans dependent on having prior savings not only attracts funds for housing, but the process of operating a savings accounts develops a familiarity with financial institutions that can be very useful tool for loan-management.

To attract savings, the mechanism must be locally available, with suitable opening hours (that allow access outside the normal working hours, for example) and have flexible operating procedures, with the minimum of paperwork. With proper support and training, community-based collections can be introduced, thereby reducing management overheads.

Using local and community-based groups provides for both easier management in terms of collections, for example, but also adds peer pressure for the savers, and socialises the process.

3.6. Managing Funds

The effective management of funds ensures not only that more funds are made available, but that they are retained, and more importantly re-circulated to increase their impact. The need for transparency and openness has already been stressed. It is important that the operation and management costs are both known and kept to reasonable levels. The costs of managing housing funds should not exceed that of other institutions, and kept below 2% wherever possible.

The actual institutional set-up can be either a private (for or not-for profit) organisation, or a mutual or co-operative organisation working for its savers and borrowers. It can be a specialist housing finance institution or be a “window” within a general finance institution. Each of these has advantages and disadvantages, and what is best depends on the particular circumstances, including of course the regulatory regime. The important consideration is whether the set-up can effectively and efficiently manage the financial tasks required of it.

In general it can be argued that specialist institutions are better, and mutual ones are best suited to meet the housing finance needs of their borrowers – for example by keeping interest rates low for them, while still attracting savings by their promise to provide easier access to housing loans. While that may be true, it might also mean that other investors, with surplus funds, are not attracted because they do not have the same housing needs to tempt them. By limiting themselves to only housing-liked savers and borrowers, they are limiting the funds that are available.

Perhaps the only caution is against the setting-up of a government or public-sector institution that takes a bureaucratic approach to its operations rather than a financial or banking one. The temptation for such an institution to respond to political pressures at the expense of commercial and business considerations are far too great to make for successful operations. While it may be necessary for the government to provide the start-up funds for a housing finance institution, the aim should be to make it independent as quickly as possible and get it to operate in a commercially viable manner.

3.7. Loan Terms, Conditions

Who has access and to which loans is determined primarily by the terms and conditions that are attached to the loans. The terms of a loan refers to the rate of interest being charged and the period over which the loan must be repaid. The conditions refers to the other criteria that define eligibility and exclusion, and are usually included by the lender to reduce risk and increase the chances of and ease the process of repossession, should that become necessary. Naturally, this works to limiting the eligibility of borrowing to those who possess the best credentials and these are usually the better off and those on secure, long-term employment in the formal sector.

The major problem arises from the housing finance institution drawing up its terms and conditions mainly to protect its own needs and interests. While this may seem like good business sense, it can work against the institution, if it results in a less-than viable take-up of the

business. In many cases, the loan terms and conditions are overly protective without necessarily adding to security or lowering risk.

It is not uncommon for housing finance institutions to set terms conditions such that it makes it virtually impossible for any but the select few to borrow. Perhaps the biggest obstacle is the need to have title to land. This means, first of all, that it is rarely if at all possible to borrow for land acquisition.

Secondly, the loan often does not cover more than half the total costs of housing, leaving those with limited prior assets unable to borrow for housing. The need for the loan to be for less than the total cost of housing is to allow the institution to be able to realise funds from the sale of any repossessed property quickly, without having to wait for the right price to be met. In a market where housing prices are rising, the value very quickly far outstrips the original price. Ironically, the longer the loan has been serviced, the lower the risk – both of default by the borrower, and by the proportion of the loan to value of the property.

Perhaps the greatest obstacle for borrowers in developing countries is the need to demonstrate a regular and documentable income stream. In a situation of rapid change, households often operate with multiple jobs, one or more of which is their own enterprise and in the “informal” sector, and incomes are virtually impossible to “prove”.

3.8. Interest rates

The interest rate represents the cost of money – and is set to equal the opportunity rate of capital – that is to ensure that it would earn as much for the lender in an enterprise, as it would in any other – though of course the rate is modified to take into account the level of risk involved and the length of time the funds are lent. The basic rate of interest in an economy is usually set by the Government, or by the financial markets at large. This is used as the reference, or base rate, with housing finance institutions adding points to reflect their market, of perhaps 2% above the base rate.

There was a time when interest rates were stable over relatively long periods of time, and it was simpler to fix the rate for the duration of the loan. Increasingly that is not the case, and interest rates are likely to change dramatically over the 15 to 20-year period over which a loan is often repaid. Therefore, nowadays, most interest rates for loans are not fixed at the start of the borrowing period, but rather allowed to “float” to reflect changes during the loan period – though with a fixed link to the base-rate.

Since the rate of interest has a direct bearing on the cost

of the loan, and therefore on access, there have been strong demands for it to be subsidised to make the loans more affordable for the lower-income households. While this may be so, it is a self-defeating strategy if it reduces the attraction of housing finance to the financial market at large – the limited funding cannot meet the needs of all households, thereby unfairly treating those fortunate enough to be able to access them, and penalising those that cannot. In fact, there is no real reason to resort to interest rate subsidies until other alternatives have been tried.

3.9. Loan period

The loan period is the period of time for which the capital of the loan is borrowed, and is usually fixed at the outset, though there is usually the possibility for later adjustments. It has been assumed that the longer the loan period the more affordable the loan. However, that is only true to the extent that annual (or monthly) repayments reduce in absolute terms, but, on the contrary, the increase in total repayments necessary increase considerably. Often dramatically. As a result, a long term loan, of say 20 years, may mean that the borrower ends up paying 4 or 5 times the cost of the original loan amount – the bulk of which is in repayment of interest.

The original intention behind the 20-year loan period was to reflect the calculations of building societies in the UK during the 1950s and 1960s, that at the then interest rate of 3%, housing that cost 4 times annual income could be paid off by a household devoting 25% of their income to repayment.

In the 1970s, the Economic Commission for Africa calculated that at the prevailing interest rate of 8%, housing that cost 2.5 times annual income (what the ICA called “the affordable house”), could be similarly paid off by households devoting 25% income to repayments.

Now, with basic housing in many cities costing 9 times annual income or more, and with fluctuating interest rates, a rethink is required regarding loan terms to reflect the realities faced by low-income households. The housing finance strategies discussed below show what the possibilities might be.

3.10. Security and collateral

Lenders try to protect and preserve their investment in two ways: first, by charging a price, reflected in the interest rate, (see above) for any depreciation in the value of their funds and secondly, by reducing the risk of non-repayment. Amongst the ways of ensuring the latter, is by getting the borrower to deposit something with the lender that has greater value than the amount lent. This acts as an incentive for the loan to be repaid, and if it is not, can be sold by the borrower to recover the

outstanding amount.

To be meaningful, such a security needs to be small and portable so that it can be easily kept by the lender. The likely alternatives are to have the borrower deposit gold, jewellery or even the cash equivalent to the value of the loan. However, in the case of housing, many households simply do not possess sufficient amounts of alternative assets that they could offer as security. As a result, the most common way of doing this is for the lender to hold the title deed of the land on which the property is being developed until such time as the loan is fully paid up. In many countries and cultures, there was, until relatively recently, no need for such titles. Land was not seen as a commodity that could be owned, but rather was considered a shared communal resource that members of the community could make use of. While there were ways of identifying individual parcels of land, and even lists and registers of who had the rights to it, the need to have clear titles was not as important as having the boundaries of the land clearly, and physically identified on the ground. Therefore, amongst other things, this has necessitated the creation of individual, identifiable land titles as legal instruments that can be held and kept safely as security. The process of doing so has often been slow and cumbersome, and often misused to deprive communities and the poor of their land rights.

Ironically, since the land is used as security, often, the loan amount is not allowed to exceed the value of the land. As a result, if there are no other resources, land makes up over 50% of the total cost of the house – when, without this constraint, it would not exceed perhaps 25 to 30%. On the other hand, since any repossession against default would require the household to give up the house as well as the house, it means surrendering property worth two or more often three times the original loan, even without taking any appreciation in value.

Nevertheless, the use of land title as security seems to have become almost universally adopted. Quite apart from distorting the local land market, this also means that it is now virtually impossible to obtain a loan to buy land, which is in fact often the first pre-requisite in the process of obtaining housing.

It also means that the use of land as a community resource has become difficult, if not impossible. Where communal or public land is converted into individual free-hold title, it becomes more difficult for households to resist pressures from developers to sell their land – often for short term personal gain and at the expense of the future needs of the community.

The section on housing finance strategies (below) looks

3.11. Loan administration and management

at some of the ways and mechanisms for providing acceptable security and collateral for loans without negatively impacting on the poor.

The effective and efficient operation of financial markets, and especially housing finance institutions requires the creation and operationalisation of regulations, procedures and processes dealing with loan applications, repayments, defaults, delinquencies, possessions etc.

It is important that housing finance institutions, as much as any other financial institutions, not only have clearly worked-out procedures and processes for each of these, but that they are transparent and open. Moreover, the primary purpose of having such regulations is to make it easier for clients – whether savers or borrowers – to understand what the procedures are and to assure them that they are being treated in accordance with the laid-down procedures rather than arbitrarily or, worse, being discriminated against.

In many institutions, particularly those established and managed by the government or the public sector, the operational rules are either not framed, or it is not clear what the rules are. If they do exist, they often reflect their bureaucratic origins, and seem to have been framed primarily to cover the institution rather than serving the needs of their clients. Usually there is an unnecessarily high reliance on having a large number of documents, in a number of copies. Staff then have to spend hours filing and storing these documents, usually in a way that makes for difficult retrieval.

When dealing with clients, the staff members seem to focus more on making sure that the required documentation has been properly produced rather than assisting applicants.

The requirements should be minimised and restricted to those that can easily be produced by the client group. These should be made readily available to the public and provision should be made to assist applicants to understand what the process is, and the implications of various actions or their lack or delay. Any penalties and the ensuing remedies should also be clearly spelt out and explained at the outset.

During the course of loan administration, any actions such as sending out warnings, notifications and taking any action should be done promptly and with due regard to the support and facilitation required to ensure that future repetition is minimised.

4. HOUSING FINANCE STRATEGIES

The high costs of housing, relative to income, have tended to limit access to housing to those with higher incomes. Where land or finance is provided through the formal processes, access is further limited to those in

formal employment who can provide the necessary paperwork to support their application. In situations where the informal sector is large and many households are new or recent migrants, the needs of these, mostly low-income households, goes unmet by the formal housing finance mechanisms and institutions.

The sections that follow summarise the strategies that have been tried to overcome these issues and attempt to make more housing finance more easily accessible to more households.

4.1. Conventional Strategies

Conventional housing finance strategies are based on a separation between housing production and housing finance. The housing is produced, as large or small public or private sector projects, that households are expected to purchase as and when it suits them. The objective of the housing finance strategy is to provide loans to households to enable them to do this, most often using mortgage-financed loans.

The Housing Finance strategy consist of making sure

1. that there are one or more institutions capable of handling mortgage finance;
2. that they have the capital required to lend for housing. This may require providing seed or start-up capital if the institution is being established by the government;
3. that procedures and processes for accessing additional funds or raising funds are spelt out, including any concessions, etc;
4. that rules and regulations clearly indicate who is eligible to borrow, under what conditions and at what terms, including any concessions or subsidies;
5. that there is a Board of Governors or equivalent that can provide guidance for the management of the institution as well as having a Body that can provide a wider oversight of its functioning as a financial institution;

Additionally, it may be necessary to ensure that

1. the legal basis for making loans, borrowing and repaying exist;
2. the legal basis for repossession and recourse to other legal measures exists or is created to enable the recovery of loans;
3. land cadastres and legal titles exist or are created that enable individual plots and their ownership to be identified;

Finally, to ensure efficient operations, it may be necessary to

1. train or build the capacity of staff to enable them to operate and manage the institutions;

2. to make it possible to insure against non-payment of loans, and/or to spread the risk in other ways;
3. to allow for the trading of mortgages and housing loans, if necessary, in a secondary mortgage market.

In general, though, such measures are unlikely to meet the needs of the majority of the population, and there is usually the need for some recourse to a variety of direct and indirect subsidies on housing costs, interest rates and repayments. However, as indicated above, these are rarely sufficient to overcome the inherent problems with conventional finance mechanisms, and are only likely to assist a select and fortunate few, leaving many more outside their scope.

4.2. Non-conventional Strategies

In the face of the limited efficacy of conventional strategies, increasingly, attention is being paid to the use of non-conventional strategies that are based on the practices and procedures used by the informal sector to house itself. The idea is to support these processes, thereby making them more efficient and more effective. Broadly speaking, there are two approaches that underpin these strategies. The first aims at reducing the cost of housing, while the second focuses on access to housing finance.

1. Reducing the cost of housing through Housing/Ownership strategies

Assuming that the best that can be done is done to reduce the cost of housing such as design efficiencies to minimise the size of the unit, standards and types of fittings and finishes and materials; construction efficiencies in terms of economies of scale, waste minimisation, etc, etc, the resulting “low cost” house may still not be affordable in the sense that the households for whom it is intended cannot afford to buy it. Their current resources, combined with the amount they can borrow, still do not equal the cost of the housing unit.

The strategies proposed aim to resolve this by creating less-than-full ownership of the unit by the use of a mix of owning and renting. The household maximises its resources and acquires that proportion of the housing unit that it can afford – say 75%, while the remaining 25% is rented from the mediating institution. The mediating institution, usually a not-for-profit organisation, receives a rent on its investment until such time as the household either takes on the full property by taking out an increased or additional mortgage (perhaps because its income has increased, say through the addition of an income-earner), or upon the sale of the unit, at which point the investment is returned. The capital gains made

as a result of the property sale are used by the household to increase its equity in buying another property.

Financial strategies – these are based on varying the standard mortgage instrument to better reflect the circumstances of the borrowing households.

The **escalating mortgage** assumes that at the time of initiating the house-buying process the income of the borrowing household is the lowest it will ever be. Therefore, over the first few years the repayments do not cover the interest+capital repayments expected of standard mortgages. The shortfall is added to the loan amount, and results in increasing the capital outstanding. However, in the subsequent years, when the household's income is expected to have increased, and it can make higher levels of repayments the increased loan amount can be paid off. By making assumptions of repayment capabilities at the time of borrowing and in subsequent years, it becomes possible for the household to borrow a larger amount than it could under conventional mortgage schemes.

Index-linked mortgages relate the loan and repayments to an index rather than to monetary values, making it easier for coping with inflation and assure the lender that the real value of the loan is recovered

Income-linked mortgages relate repayments to income, by making them a fixed percent of the borrowers' income. If income rises, the loan can be repaid quicker, thereby reducing the overall cost of the mortgage.

Because of their success in income-generation and other areas of development, **micro-finance** is increasingly being suggested as having a place in housing finance. However, some of the real advantages of micro finance and micro-loans are not easily applicable to housing finance. The advantage of micro finance is that they can use group or peer pressure instead of legal instruments to ensure repayment of loans, and by giving a series of small loans, the borrowers credit-rating can be built up. Finally, as has been pointed out, housing requires a larger amount of capital than is usually covered by micro-finance. Perhaps the best use of micro-finance for housing is to include housing as an eligible activity for financing, once the borrower has built up sufficient credit rating and standing. Indeed, that is the way that the most successful micro-finance operation, the Grameen Bank uses it to finance very rudimentary housing that can be gradually improved by the borrower.

Judiciously used, these alternatives allow greater choice and can improve and increase options and opportunities for households to access housing finance.

4.3. Incremental housing

In the absence of capital or loans with which to build or

Strategies

buy a house on the market, households, especially in informal housing usually resort to incremental construction and development of housing. This is a process-, rather than project-based approach, making it more possible to relate housing production to the financing capacity of households.

In the case of informal housing, the incremental process also allows the households to gradually increase exposure to the risk of legal action or intervention by the authorities.

However, unsupported, the process is inefficient and its course uncertain, leading to delays and increasing costs.

In the past, governments and institutions have recognised the usefulness of incremental housing, with alternatives such as core or basic housing, or even sites-and-services where the household acquires an initial asset which it then adds to and improves over time. However, the housing finance associated with these schemes has usually been based on conventional mortgage systems, with 15 to 20-year repayment periods, which largely negates most of the advantages of incremental housing.

4.4. Community finance Strategies

A newer and growing response has been to use community groups to undertake savings and borrowings to develop not only their housing but also to build and develop community – the process of bonding plus economies of scale increases access to housing and improves urban areas.

There are two approaches to group or community-based schemes. The first, more commonly advocated approach is to make “group loans”, and make each member of the group equally responsible for its repayment. The presumption is that such an arrangement will also reduce collection, operations and management costs. In practice, this is not a very effective solution, unless the “group” has already been in existence and then decides to opt for a loan. Otherwise, it is too restrictive since it does not allow individual members to efficiently respond to their needs. Nor, is it very easy to penalise an individual member for the default of other members of the group – over whom they have no hold – legal, or social. Indeed, if the group decided to renege, it may be more difficult to take action against them than if they had been individually responsible for the loans.

The second approach is to think of the “group” as an operational entity in a cascading arrangement between lender and individual borrowers. Here, the emphasis is on the economies of scale that are possible, rather than the social or peer pressure, and assumed collective security.

On the other hand, there are other ways in which

community or groups can be used effectively – for example by creating a group title to the land, from which individual titles could be created upon repayment of loans.

Communities are often easier to target, where subsidies or special terms are being considered, and they can be an easier way to provide information, and building capacity.

One of the more successful such schemes is the **Community Mortgage Programme** of the Philippines, where both land registration and titles and subsidised finance is provided to communities – with the local government and other institutions legally responsible for housing the poor make contributions to the loan funds.

Using community-based schemes is also recommended for housing improvements – for example through the formation of condominiums and development companies whereby members pool their resources.

4.5. Developing Housing Finance Strategies

To develop an effective housing finance strategy the following basics should be kept in mind:

1. To be effective, housing finance strategies must be demand-based and not supply-based. This means designing a programme that meets the realities of the households rather than seeing which households are eligible to participate in existing or modified financial schemes;
2. Housing finance must be seen within the total housing context and not as an isolated function or add-on component;
3. Finance mechanisms must not be restricted to housing alone – the same mechanism should be available for a variety of purposes from income generation to housing;
4. Subsidies, especially interest-rate subsidies, are generally not required to make housing affordable; where households are unable to access housing and housing finance, and are in need of “social housing” – this should be handled as a social issue and not as part of the financing mechanism;
5. The need for having accessible and attractive savings mechanisms is at least as important as having borrowing or lending mechanisms;
6. Long term loans are much more expensive than short term loans, especially where interest rates are high;
7. Sequential loans for incremental housing allow the flexibility needed by households and can be much more responsive to changing needs and circumstances;
8. Informing households and providing them the

tools to assist in the decision-making process is crucial for a successful housing finance system;

9. A simple, easily understood system that covers most situations is better and more effective than one that covers every eventuality but is complex and complicated to explain or to enforce;
10. Learn from informal housing:
 - a. Allow incremental construction – lend for improvements and extensions – not just new or complete housing units;
 - b. Allow serial, sequential loans to households – this reduces lender's risks and exposure; use successful repayment of a loan as a guarantee for a subsequent loan;
 - c. Allow households to sub-let or use their house to undertake income-generating activities;
 - d. Do not expect the householder to buy the land first by asking for title as collateral – use group or community land titles or rent out land until the house is completed. Use the last not the first loan to purchase land;
 - e. Encourage the formation of groups to assist in savings and loan-management;
 - f. Incorporate flexibility in all aspects of the scheme and system;
 - g. Incorporate a system of support and facilitation instead of inspection and regulation.

GLOSSARY

ACCELERATED REPAYMENT MORTGAGE	Sometimes known as the "low start" mortgage this method provides for the monthly repayments to increase at a regular amount throughout the repayment period. This enables the initial repayment to be lower so lower-income groups can be eligible to borrow. The rationale is that both incomes and property values increase over time (through inflation) and this should be taken into account. In the early years, repayments do not cover all of the interest due, so that the amount of the capital borrowed actually increases. This might put the lender at risk if the loan is near 100 per cent of value and recovery has to be made. With rising property values, in most places, the risk to the lender is probably small.
ACCEPTABILITY	Refers to whether the method is (or could be made) acceptable to most people in the target group.
ACCESS TO HOUSING	The possibility of having the secure use of acceptable shelter whether through ownership, rent, or other arrangements.
ACCESSIBILITY	Refers to whether members of the target group can and are able to use the particular method.
AFFORDABILITY	An assessment that relates a particular housing solution to the amount that can be paid for without unduly stretching the payer's resources.
ARREARS	Amount of debt still outstanding due to delayed repayments. See also DEFAULT.
BALANCE OF PAYMENTS	This is the difference between the income and expenditure accounts of a country, and is usually calculated at regular intervals. The most significant components are the balance of trade, which effectively records the difference between a country's imports and exports, and the movements of capital between countries.
BOTTLE-NECKS	Anything stopping or slowing the flow of a process. See also CONSTRAINT.
BRIEFS	Thorough instructions, or information relevant to what needs to be done.
BUDGET	Estimate of income and expenditure.
BUILDING SOCIETIES	Institutions established for the purpose of providing members with access to housing finance.
COLLATERAL	A form of security afforded to the lender by the borrower by pledging assets (usually in the form of property deeds or titles) as a guarantee for the repayment of money. Ideally the value of the property so pledged must not be less than the amount borrowed, and the property must be possessable and capable of being liquidated for cash by the lender.
COMPENSATING BALANCE	A lending system also known as the "blocked-compensating balance", where the borrower makes a deposit with the lender which is blocked, i.e., not refunded, until the loan has been paid off.
CONDITIONS (of loan)	Refers to all the requirements set by the lender, and may relate, for example, to such things as downpayments, possession of legal

CONSTRAINTS	<p>title, secure employment, nationality etc.</p> <p>Anything that stands in the way of an objective. Few things or situations are in themselves constraints, but become so because of what needs to be done. Altering an objective or course of action can transform a constraint to an opportunity or a resource. See also BOTTLE- NECK</p>
CONSUMPTION	<p>The opposite of savings and investment, refers to the utilisation of resources for immediate gratification.</p>
COSTS	<p>These are the expenditures incurred in producing a r product such as a house, and do not necessarily equal its value or price.</p>
CREDIT LEVEL INCOME	<p>The level of income of a person or household which financial institutions assess as being the minimum to which money can safely be lent for housing.</p>
CREDIT RATING	<p>An estimate of a person's or household's ability to borrow and repay loans. The higher the rating the lower the risk to the lender. It is usually assessed on the basis of income and past performance regarding loans.</p>
CRITERIA	<p>A system of conditions that need to be satisfied, and which are used as a yardstick for evaluation.</p>
DEFAULT	<p>Failure to pay or to meet financial or other obligation. See also ARREARS.</p>
DEMAND	<p>The desire of would-be purchasers or users for a commodity. DEMAND is distinguished from NEED in that the willingness to acquire must be backed up by an ability to pay. DEMAND, therefore, is related to price and varies inversely to it. The demand for a product will be determined also by its desirability to the buyer, which may be a function of its attractiveness or the degree of desperation and need of the buyer. HOUSING DEMAND is therefore an estimation of the number of households that would be willing and able to acquire a particular housing solution or package.</p> <p>EFFECTIVE DEMAND is that which is backed up by a real ability and willingness to purchase a product that is offered, whereas POTENTIAL DEMAND is one that may exist in the future or is currently latent, either because the product does not exist, or because there are other conditions that prevent buyers from putting their preferences into action. PENT-UP DEMAND is a special case of POTENTIAL DEMAND, in that it is currently present but remains unexpressed largely because of socio-political constraints rather than purely material considerations.</p>
DEPOSIT	<p>See DOWNPAYMENT</p>
DEPOSIT TAKING	<p>Accepting and agreeing to hold other peoples' money in return for interest.</p>
DOWNPAYMENT	<p>Or DEPOSIT, refers to the money that has to be paid as the first instalment of a series of payments in a repayment scheme. The downpayment is seen as an additional security for the lender/seller as proof of the buyer's/borrower's financial capacity, and by both as proof of intention to go ahead with the transaction. Most housing finance schemes do not lend for the whole amount of the</p>

	<p>property to be acquired, the difference being met by the borrower in the form of a downpayment which is usually larger than the subsequent payments (often between 10 and 20 per cent of the total price).</p>
ECONOMIC COST	<p>The cost of all inputs to a product at market prices. Thus, the time put in by the household in the construction of its own house would be costed at the prevailing labour rate.</p>
ECONOMIC RENTS	<p>The level of rents that give the same return had the landlord invested the capital cost of the house elsewhere.</p>
ECONOMICS OF RENTS	<p>The calculations that relate to rents, particularly renting as a viable investment.</p>
ELASTICITY	<p>Here refers to whether the method is capable of coping with increased scale of operations that would be implied if it were incorporated into the Strategy.</p>
ENDOWMENT INSURANCE	<p>Form of life insurance with payment of fixed sum to insured person on specified date, or to the estate on earlier death.</p>
EVALUATE	<p>Calculate or assess the value of a product using pre- determined criteria.</p>
FINANCIAL INSTUTIONS FORMAL	<p>Organizations concerned with lending and borrowing money and/or bringing lenders and borrowers together or advising them. Any system that is legally instituted, usually registered and recognized by the public authorities. Its operations are usually subject to scrutiny and report as required by applicable legislation. The formal "sector" consists of all the known and "visible" entities and enterprises, as opposed to the informal "sector" which is largely "invisible" because it is not subject to regulation and does not appear in official statistics.</p>
GRANTS	<p>Money given, usually in accordance with certain criteria, without asking for or expecting it to be returned.</p>
GROUP MORTGAGES	<p>Loans to a specified number of people, all of whom are collectively responsible for repayment. This both spreads the risks and also lowers costs through the administration of a single loan, rather than a number of smaller, individual ones.</p>
GUARANTOR	<p>Person or institution giving assurance, or providing security to the lender on behalf of a borrower.</p>
HOUSING BANK	<p>A bank which specialises in lending money for house construction, acquisition extension and/or improvement.</p>
HOUSING FINANCE	<p>The capital made available to a household to acquire, extend, or improve a house. Acquiring a house may mean building a house or buying one that has been built by someone else. The house may be bought from any of a number of sources, including the builder, another household or even one's landlord, and the seller may be an individual or institution. The amount of housing finance required will depend primarily upon the gap between the costs of acquisition or improvement and the amount already available to the purchaser. However, the demand can only become effective, if the household is able and willing to borrow the amount. Its ability to borrow will depend on the terms of the loan as well as its own financial circumstances; its willingness is likely to depend upon its</p>

view regarding the value of the house or improvements.

Generally speaking, the amount of capital made available represents the difference between the price of the house, and the currently available resources of the household, and is made available in the form of a loan to be repaid over a period of time with interest. From the point of view of the household, it is different from other forms of finance in that the amount is likely to be large in relation to current income (between two and four times annual income). For the lender, housing finance is also different in that in case of default, recovery can pose particular problems.

HOUSING MARKETS	The whole range of households and producers that demand and supply housing, including the labour and materials required to produce it and the land on which to locate it.
IMPROVEMENT	This includes any and all additions and alterations to an existing house that increase its space, comfort, utility or its life. These may range from building additional rooms, repairing or renewing the roof, obtaining a water connection or renovating the entire house.
IMPUTED COSTS	When actual costs are not known, because materials or services are not paid for, or paid for at special or concessionary rates, costs are assumed or imputed.
INCREMENTAL LOAN MORTGAGE	Sometimes called an open-ended mortgage or a sequentially escalating mortgage. A series of small loans can be made under a single mortgage document (which helps to reduce costs), a subsequent loan being available when an earlier loan has been repaid. It can match the loans to construction stages with the first loan, perhaps, for the serviced site, the next for the first stage of construction and so on. It limits the exposure of the borrower while enabling him to know that further funds can be borrowed. It may also, however, slow down the completion of construction.
INFLATION	A general increase of prices and resulting fall in the purchasing value of money.
INFORMAL	Any system where the rules and regulations defining its operations have not been formally constituted, but are based on custom and practice. As a result, it is also likely to be unofficial and unrecorded, and probably not subject to legal codes. Informal has also been described as being the opposite of formal, or its dual. In practice, the two are not isolated, but are likely to exhibit a high degree of interaction, and probably form a continuum.
INTEREST RATES	The amount of money paid annually, monthly, weekly or even daily, for borrowing money, usually expressed as a percentage.
INTERNAL RATE OF RETURN	The rate of interest (or return) which would make the initial investment outlay exactly equal to the discounted present value of the expected net flows of funds.
INVESTMENT	The act of putting resources to work to produce future returns. This is distinguished from SAVING which, if not placed in formal institutions, takes resources out of circulation without necessarily putting it directly to productive use.
INVESTMENT MULTIPLIER	The number of times a particular investment will be increased through positive reactions in other activities or sectors of the

	economy.
LAND TITLE	A legal document confirming the right of the holder to the exclusive use of the defined piece of land.
LEGALITY	Here refers to whether the method is legal or recognized as a bona fide way of obtaining finance.
LENDING	The act, activity or process of making money temporarily available to someone else.
LOAN	The money made available through the lending process.
LOW-INCOME HOUSEHOLDS	This is a relative term to distinguish between those with (for example) high, middle and low incomes. While it covers those with the lowest and indeed no incomes, low-income households are not necessarily those below the poverty level, nor do they all have the same needs or express the same demand.
LOW START MORTGAGE	A form of mortgage finance in which the repayments start off low in the early years and gradually increase over time rather than staying constant as with the conventional mortgage. This has the advantage that the repayments match incomes which are expected to rise over time.
MARKET	Place or opportunity for the exchange of goods and service at freely determined prices.
MARKET ECONOMY	An economy which operates on the principles of the market rather than being controlled or "planned" by the State
MONEY LENDER	A person who lends money to individuals, usually at high rates of interest and ruthlessly enforced conditions, particularly those relating to repayments and defaults.
MORTGAGE	The handing over of title to a property by a borrower to a lender as security for a loan, especially one incurred in order to purchase the property, with the understanding that it shall be returned when and only when the loan has been fully repaid.
MORTGAGE PROTECTION	Obtained through insuring the life of the borrower for a sum equivalent to the capital amount so that the successors receive an unencumbered property upon the borrower's death. This is usually done through a single premium which is added to the original sum borrowed. As the amount of outstanding loan reduces, so does the value of the life insurance.
NEED	Requirement or necessity. A need exists whenever the item in question is not available or is in short supply. To identify those in need, it is sufficient to identify those without. HOUSING NEED, therefore, is the quantification of those households without housing. However, to be meaningful, "housing" has to ~, be qualified using standards of acceptability, and "availability" by conditions of supply, and "households" by demography and social change. Consequently the measurement of need is complex and more dependent upon definition than on computation.
OPEN-ENDED MORTGAGE POTENTIAL MARKET	See INCREMENTAL LOAN MORTGAGE. The level of demand that is capable of coming into being or action, latent.

POTENTIAL SOURCES OF FINANCE	These include all those that are not currently being used by the target groups. Thus, they include those that exist locally but are not used by them, those that do not exist locally, those sources that are not currently used for housing finance and also those that need to be created.
POVERTY LEVEL	A level of income that cannot afford a basic minimum of goods and services as defined in a particular context. Most countries have an officially recognized (if not set) poverty-level income.
POVERTY LINE	A line drawn at the poverty level of income.
PRICE	This is the money charged for a product, and is usually equal to the seller's costs plus profits.
PRIVATE SECTOR	Those firms, organizations and individuals whose business decisions are not directly controlled by the government or the "public sector", and are thus "private".
PROGRAMME	A series or sequence of actions that have a schedule or timetable for their expected or likely occurrence.
PUBLIC SECTOR	Those firms, organizations and institutions whose business operations are directly controlled by the State, and are thus "public".
RATES OF RETURN	A calculation of the annual percentage profit or income to be had from a particular investment. The higher the rate of return, the more profitable the investment. Arguably, anything with a rate of return less than the rate of inflation plus the rate of growth of gross national product is not worth investing in.
RECOMMENDATIONS	Set of actions proposed in order to achieve stated objectives.
RISKS	Possibility or likelihood of an event taking place. The higher the risk, the greater the uncertainty and therefore the greater the need to protect against the ensuing consequences.
SAVINGS	The surplus of income over expenditure. It is assumed that the higher the income the higher the level of savings possible. Savings are usually thought of as money deposited or invested in "formal" institutions, but in fact include savings in kind, either as easily convertible items or, as building materials. In situations of high inflation and rising prices, the latter may be preferable and make more economic sense.
SECURITY	The assurance that money lent will be returned and that if it is not, the lender holds something of the borrower that can be converted into money equivalent to, or greater than, the capital sum borrowed.
SEQUENTIAL LOANS	When an additional loan is made on the repayment of the first. Currently, many lending schemes exclude those who have had previous loans. This is acceptable only if the loans are subsidised and the purpose is to spread the subsidies; however without subsidies such a restriction eliminates those who demonstrate their credit-worthiness. It also encourages taking loans larger than the borrowers can actually afford since they know they will not get another chance.
SEQUENTIAL MORTGAGES	Security documents that make sequential loans possible.

SEQUENTIALLY ESCALATING MORTGAGE SOFT TERMS	See INCREMENTAL LOAN MORTGAGE. Terms of a loan that are set below the generally prevalent market rates and/or conditions.
STATISTICALLY SIGNIFICANT STRATEGY	A number or figure large enough to minimise a chance result. A set of actions so designed as to achieve a set objective in accordance to a pre-conceived plan.
SUBSIDISED CREDIT SURVEY	Money that is made available on 'soft terms' such that the lender loses money in comparison to other lending possibilities. The act or process of finding out opinions or facts through any of a number of means of observation and enquiry.
TARGET HOUSEHOLDS, AND GROUPS	Those households or groups who are intended to be the primary beneficiaries of the housing-finance proposals of the housing-finance strategy. Unless these are clearly identified, both qualitatively and quantitatively, it will be difficult to ascertain whether the objectives of the proposals are, or are not, being met. In a demand-based approach, it is the demand of the target group that has to be identified and met, and therefore it is particularly important to be clear as to who constitutes this group.
TAX BENEFITS	Those benefits or advantages that come about as a result of the way taxes are levied.
TAX CONCESSIONS	Those concessions or relaxations that are permitted in the way tax is levied, which mean that certain transactions are encouraged or treated preferentially.
TERMS	Refers to the rate of interest at which money is lent and the period over which it must be repaid. These may be fixed at the beginning or be varied during the loan period. Variable interest rates may nevertheless be "fixed" by relating them uniquely to another interest rate which may itself vary, such as the "base" rate set by the Central Bank. The period may similarly be varied, for example in order to keep the monthly repayment amount fixed.
TERMS OF REFERENCE	A set of directives that set out the parameters that the performer or contractor who undertakes a task will be expected to meet, including both what is expected to be achieved, with what resources and over what period of time. How it is achieved should be left to the ingenuity of the performer.
TYPICAL	That which exhibits the characteristics most common to a particular group, and is an exemplar for its category.
VALUE	This is the worth or price of a house as the finished product, and may be different in different markets. For example, the user value (i.e. the worth of the house to the user of that house) may be more than the market value and both may be more than the sum of all the inputs that have gone into producing it, including the imputed costs for labour and for profit. A typical user value is location, viz. proximity to employment, schools or to other family members.
VARIABLE REPAYMENT OPTIONS	By which unequal payments can be made as funds permit it. This is particularly important where the borrowers do not earn regular incomes. Administrative overheads could be minimised if the

payment was in the form of books of saver stamps, using existing Revenue stamps. These could be "checked periodically to equate them with "regular" payments if required.