CHAPTER 14

Developing a Comprehensive Housing Subsidy Policy

The preceding chapters provided a framework for the analysis of housing finance subsidies and discussed many different housing finance subsidy mechanisms. This chapter summarizes many of the specific conclusions of the case studies above and provides two sets of practical guidelines for the development of an effective housing subsidy policy.

The first set of guidelines are overarching themes drawn from the experience in *actual design of subsidy programs* as discussed in Chapters 5-13.

The second set of guidelines is an attempt to suggest appropriate *choices for a subsidy package* within the context of a housing strategy to address specific housing problems for different segments of the housing market in low- and middle-income countries.

14.1 Summary Observations about Specific Subsidies

Nine different types of housing finance subsidies were evaluated in Chapters 5 to 13 and different varieties of each type were analyzed in the case studies. While the cases showed the importance of the details of the design of each subsidy, some closing comments were made about general lessons to be drawn from the cases at the end of each chapter. These are summarized here:

Subsidies to Retail Lending Institutions

State Housing Banks (Chapter 5):

- One of the least desirable approaches to the development of the mortgage market.
- Almost all state-owned housing banks have deterred the active pursuit of the housing finance market by private lenders.
- Most such banks are less cost efficient and innovative than private lenders, offer poorer customer service and have run up large losses on their portfolios.
- A process for phasing out the dominant role of the state bank is essential, and *not* dependent on whether private lenders enter first.

Mortgage Insurance or Guarantees (Chapter 6):

- In principle, state-sponsored credit risk sharing can be a relatively efficient and effective mode of sector development.
- It can be used to expand the mortgage finance sector in general or in ways targeted to certain sub-groups or areas.
- It can help establish a securitization market that shifts funding risks away from lenders.
- Prerequisites:

    - Significant incentives be retained for proper underwriting and servicing.
    - Underlying loan recovery mechanics be well developed
    - Politics not to undermine enforcement and recovery
    - The country is not subject to major economic or political shocks.
- Details are critical and no model should simply be imported from another country.

Subsidies to Funding Systems

Special Housing Funds (Chapter 7):

- May have a role in countries with very shallow financial systems.
- Most lack transparency, focus on small segment of eligible households (mostly middle income, formally employed) and types of houses, and support inappropriate loan designs.
- Funds should be infused on market conditions, preferably through the capital markets.
    - Desired subsidies should be added separately and transparently and for different market segments.
- If pools of private funds exist, it is much preferred to facilitate the transfer of those funds through the capital markets.

Capital Market Funding (Chapter 8):

- Improving access to capital markets can reduce the risks that lenders take with respect to funding their lending, as well as possibly the cost of funds.
- This can be as simple as a temporary tax subsidy to private covered mortgage bonds or a liquidity facility issuing bonds backed by mortgages taken as collateral, or as complex and risky as a publicly sponsored securitization window.
- Key question: What is the potential for mis-use of the state's involvement, especially of an implicit or explicit state guarantee?
    - Greatest downside is that the procedure or institution will find a way to circumvent initial restrictions (or be asked to do so by politicians) and venture into more risky ventures.
    - There should be explicit sunset provisions included, with recognition that these may be difficult to implement.

Subsidies to Households

Upfront cash grants (Chapter 9);

- Usually these are transparent and on-budget, and allow equitable targeting and portability.
- Flexible; can be applied to down-payment, loan amount, or pay for upfront costs or mortgage insurance premium; or, when not linked to finance, to capital investment in a plot/house directly.
- Commonly requires credit and/or equity contribution by beneficiary.
- In practice, upfront subsidies can be captured by developers when developers or lenders receive the subsidy to build or lend for specific types of households.

- Grant programs for low-income households need to be mediated by community support organizations, who will need to charge for their efforts.

Savings-linked subsidies (Chapter 10);

- Linking subsidies to a pattern of savings means increased equity in the house and may enhance creditworthiness of borrowers.
- Subsidies tied to special-circuit savings typically are inefficient:
    - High costs of operating separate institutions; need for deep and wide subsidies, and lack of incentive to lower subsidy over time
    - Frequent segmentation and distortion of financial markets
    - Poor targeting since open to general public; “buying out the base.”
- Subsidies linked to conventional savings for the house are more efficient, can be targeted to priority groups and used as prioritizing criteria for allocation of upfront cash grants.

Interest Rate Subsidies (Chapter 11):

- In theory, such subsidies can be a relatively efficient way of achieving a specific policy goal. They can be targeted and time delimited. If designed as a transparent subsidy to buy down market interest rates or monthly payments over a specific period, they need not distort markets.
- In practice, there are usually major problems, including:
    - Most of the benefits will go to buying out the base (households who would have taken the same mortgage loan without the subsidy).
    - They are only applicable for household groups that qualify for credit, mortgage or non-secured.
    - Accounting practices do not reflect the future budget commitments.
    - The subsidy does not phase out over 5-10 years.
    - Lenders or builders capture a portion of the subsidy.

Tax-based subsidies (Chapter 12):

- Very attractive politically, with invisible costs.
- In practice, highly inefficient, inequitable, and non-transparent, and very difficult to change. They should be avoided if at all possible.

14.2 Lessons for the Design of Housing Finance Subsidies

The subsidy instruments discussed in Chapters 5 through 13 not only shed light on the advantages and disadvantages of the specific subsidies, but also on the general features and the details that have to be considered in subsidy design. These insights, and the evaluation guidelines outlined in Chapter 2 -- efficiency, equity, transparency, degree of housing market distortion, impact on labor market mobility, presence of adjustment and exit strategies -- are the basis for the following general lessons in the design of subsidy actions and programs:

1. **Leveraging private, non-profit and household participation**. Subsidies will be most effective and efficient when they are designed to stimulate the participation of private lenders, private developers and non-governmental institutions and when they leverage the beneficiary's own resources (see cases in Chapters 5, 6, 10, 11). The goal should be to draw the private sector in, not to substitute for it (e.g., with a state housing bank).

   The private sector brings to the task its drive towards efficiency and expanding access to financial markets. Community Based Organizations and NGOs can combine individual efforts at the neighborhood level so that "the whole becomes more than its parts" and work as bridges between the formal for-profit sector and individual households (see Chapter 10).[1] Individuals also have much to contribute, not least their sweat equity and own funds, which are often more than might be expected. In addition, when households contribute equity, they are more likely to appreciate the real value of the subsidy. Participation by these different parties can also reduce administrative costs and improve program implementation. But such subsidy programs must be designed so that it is in the interest of each party to contribute and participate in the manner intended by the program.

2. **Balancing efficiency and social considerations**. In emerging market economies, it is not realistic to rely on private market players to promptly respond to shifts in demand and regulatory and institutional incentives (Chapter 9). A rather complete understanding is needed about what risks and costs the private sector is willing and able to handle, in particular in the low income sector. It often turns out that significant government incentives and a learning process are needed to move the private sector towards underserved market segments. At the same time, there is overwhelming experience showing that when government takes over construction or lending functions instead, the results are often poor and the hidden costs to government and to the general financial sector may be very high (Chapter 5 and 7). Reform or phasing out of state systems which serve the same household groups that the private sector could serve is often a prerequisite.

3. **Including review, adjustment and exit strategies in the original design.** All government interventions should be reviewed periodically to see if they remain necessary and appropriate to reach the original goal. In almost all cases, direct state interventions should be removed after a reasonable period. Subsidy incentives to the private sector can also be removed after the cumulative experience has proven to be profitable. Similarly, incentives for the participation of non-profits may gradually be reduced and be paid for by beneficiaries or lenders who benefit from their involvement.

4. **Avoiding large uncertain liabilities.** Another important lesson is to avoid state risk sharing when a risk that is deterring housing finance is truly not manageable, e.g., credit risk when there are no effective loan recovery mechanisms or when there is high volatility in real interest rates or real wages, and interest rate risk during periods

[1] Support for such CBO and NGO activities needs to be included in the subsidy package.

of macro-economic instability. These risks may be even less well managed and will grow larger by virtue of being ignored if borne by the state. In such cases, the use of upfront subsidies, possibly tied to alternative lending products and systems is the best option, e.g., short term and priced for risk.

5. **Moving to upfront commitments**. Alternative subsidy approaches can only be compared meaningfully when their costs are known -- current and future, direct and indirect costs. Because of the difficulties of injecting total cost measures into national budgets, as a practical matter, it would be desirable to design subsidies in such a way that all costs are shown yearly and upfront. Usually, that goal can only be reached gradually. The first step to rationalizing subsidies may often be to reform existing programs that have long-term and uncertain costs to the state. For example, interest rate subsidies on long-term loans can be transformed into buy-down instruments that calculate and allocate the PV of the subsidy each year, tax deduction subsidies can be transformed into tax credits or changed into upfront commitments, and blanket government guarantees can be replaced by insurance schemes with limited exposure for the state.

6. **Rethinking "social equity**." Subsidy amounts per household are frequently set very high because unrealistic minimum standards are used for the housing option to be funded and expectations of household's own contributions are set lower than necessary. Such high subsidies are often inequitable and unsustainable, so only a small proportion of qualifying households receive a subsidy or it is offered only for a few years. Another source of inequity with such deep subsidies is that they may make those who receive the subsidy better off than households with a little more income that do not qualify for the subsidy (see Chapter 2.3 on equity and Chapter 9).

   Combing a relatively modest household subsidy with better access to property rights, services or finance and incorporate a requirement for a minimum beneficiary contribution, including credit and savings where appropriate, is generally more equitable, efficient, and sustainable. (see Chapter 9 and 10).

7. **Providing consumer choice**. Experience has shown that household satisfaction, the level of household contributions and market efficiency (mobility) is greatly improved by giving beneficiaries as much choice as feasible, of location, house, delivery agent, or credit products. Comprehensive subsidy policies should include actions and programs for new housing, the privatization of social housing (where appropriate), home-improvement and options for households to move to better housing, as well as rental options. Support for the development of a resale market for low-income housing, is important in this regard. In general, subsidies tied to households rather than to units allow greater flexibility and mobility.[2]

8. **Avoiding general, non-targeted housing subsidies, in particular household income tax subsidies.** Several emerging economies have introduced finance

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[2] For example, preventing owners with a subsidy tied to the house from selling the house for several years has often resulted in informal transfers of properties at below formal market prices.

subsidies to stimulate housing consumption across all income groups. The motivation given for those subsidies is that society in general benefits when more housing is consumed than what households would choose to spend on housing (i.e., housing is considered a "merit" good), or that there are presumed other positive outcomes when housing consumption increases (e.g., economic growth). Some examples of such subsidies are tax-based subsidies to households for mortgage borrowing and widely available interest rate subsidies. These subsidies are usually very attractive politically, but in practice, and depending on their specific characteristics, are generally highly ineffective in increasing housing consumption for underserved populations and inequitable, particularly in countries where the housing finance sector is inefficient or only a small proportion of the population qualifies for a mortgage loan or files for income taxes.[3]

9. **Differentiating subsidy programs for different market segments**. The reasons for "housing problems" are likely to be very different for different segments of the market, and different from common presumptions. For example, for the lowest income groups it is seldom simply a matter of incomes being too low relative to the cost of an acceptable house. Formal housing markets in emerging economies commonly fail or are incomplete for the lower income segment, in particular the land and finance markets. These may or may not also affect the access to homeownership and the quality of housing for middle-income households. The type of subsidy objectives and approaches will, therefore, have to be differentiated for these different market segments. *This point is expanded on in the next section.*

10. **"Smart" Subsidies, not "Best Practice".** The term "best practice" has taken on an implication that it is "best" that policymakers be heavily guided by what has worked well elsewhere. But a careful reading of the case studies above will show that success comes when general lessons from experience elsewhere (such as those noted here), are adapted to the specific problems and the social, economic, financial, and political environment in the specific country, which needs to be deeply understood before any lessons can be transferred from other countries.

    Such subsidies are "smart" and simply better than implementing a "best practice" drawn from another context. There are case studies of mortgage insurance, capital market interventions, interest rate subsidies, upfront subsidies and even state housing banks where the idea worked, as well as where it was a costly disaster. Of course, many of the problems were due to poor design. But many reflect the adoption of a scheme that was inappropriate to that problem or environment.

14.3 What Subsidies for Which Problem?

14.3.1 Subsidies as Part of a Comprehensive Housing Strategy

[3] Notably, EU countries have agreed that members will not offer subsidies to any sector, including housing, on a permanent untargeted basis. Temporary or socially targeted aid is permitted.

Housing subsidy programs are all too often designed in isolation and in response to a political urgency to provide housing assistance for certain classes of the population that are important political constituencies at the time. Similarly, reforms of programs or changes in funding levels are frequently influenced by special political interest groups rather than by systematic assessments of their performance. The result in most countries is excessive fragmentation of subsidy programs and regulatory reform measures and housing institutions.

One way to limit the likelihood of such outcomes is to develop a coherent housing strategy that is based on a careful diagnosis of the most salient housing problems in the country and their causes, as they affect different population groups. Such a strategy should set long-term goals and strategic objectives for a housing policy, and agreed principles to which policy measures should comply, and the specific long- and short term measures, programs and projects that would reach such objectives. Equally important, it has to put in place the institutional architecture and competencies required for their implementation. The adoption of such a housing strategy can lend support to policymakers who have to respond to numerous special interests around housing subsidy programs, even those that are well-intentioned. A subsidy policy is one part of such a comprehensive strategy as discussed in Chapters 2 and 4. This summary section is therefore oriented around specific housing problems that might require subsidy actions, mostly in combination with regulatory reform and other policy measures.

14.3.2 A Complex Universe

What generalizable guidelines can we provide about what combination of subsidies works best to address housing problems for specific target groups? Ideally, such a summary discussion would differentiate between countries according to the level and distribution of income, the depth of the financial sector, the structure and level of development of the housing finance systems and the efficiency of the construction and land markets. These factors largely determine:

- (i) The nature of the most pressing housing problems.
- (ii) The capacities of the state to improve housing conditions.
- (iii) The ability of the private housing and financial sector to assist in solving the problems.

Such differentiation is very complex and becomes unmanageable. But just focusing on one factor such as the level of per capita GDP is unsatisfactory. Although GDP per capita and the level of development of the financial sector across countries are correlated, that correlation is by no means perfect.[4] Moreover, some middle income countries with relatively well developed financial markets have underdeveloped housing finance systems and housing markets. Consequently, it is not desirable to tailor recommendations for a housing subsidy policy simply according to a country's income level.

[4] The amount of credit to the private sector, and credit and market capitalization measured as a percentage of GDP differs greatly among countries with similar levels of GDP per capita.

One differentiation that is closely tied to relevance of subsidy options is the relative income level of the target group within a given country. The *proportion of households that have access to the formal housing market or could possibly gain access with a combination of regulatory and subsidy interventions* is highly correlated with income decile (and often related to formality of employment).[5] Subsidies that work through the formal mortgage sector can only apply to that segment of the populace. As a result, it can be useful to group subsidy policies according to the general income level of the target population.

For example, it is not uncommon to find that, even in some middle-income countries, 60 to 70 percent of households who enter the housing market each year would not be able to acquire a house in the formal housing sector. Under these conditions, subsidies to improve the effectiveness of mortgage systems and assist households to access mortgage finance, while necessary to move the mortgage system down-market, will affect a relatively small proportion of the population in substandard housing, at least initially. Instead, subsidies that are not linked to mortgage lending and conventional developer produced houses will be much more useful in improving the housing conditions of low and moderate income households.

Therefore, the discussion of housing problems and subsidy choices can be usefully organized according to these two market segments of emerging market economies:

(i) Middle and lower-middle income households who can, with some help or other market intervention, be served by the private formal market for new or existing housing by increasing their access to housing finance.

(ii) Lower-income or informally or self-employed households living in sub-standard housing or in squatter and shanty areas for whom formal housing markets will not yet deliver housing (even with a household subsidy).[6]

The relative proportion of households in each category will differ in each country, and so will the specific causes of the housing problems. But there will be some interaction between the policy solutions developed for each group. Successful approaches to assist "households at the margin", complemented by incentives to the housing finance industry to expand loans to these groups, are likely to cause an upward movement (filtering) of households into better quality formal housing, whether new or existing. Such mobility will also make it more manageable for governments to directly address the poor housing conditions of households living in squatter areas and slum dwellings, which may be a

[5] This relationship with income also depends on factors such as the degree of income inequality, level of informal employment, and the scale and efficiency of the finance and housing sectors.

[6] Some will be able to gradually improve or construct a house that complies to formal (appropriate) standards, with the help of specific supply-side subsidies and expanded access to savings and micro-credit options. Others need infrastructure and services and other direct government support to bring their housing up to standards acceptable to society.

large proportion of the urban population particularly in countries with high urban in-migration rates.

There are therefore important policy reasons to differentiate these market segments and to consider the stimulation of both even if it may mean the use of subsidies for households who are not the neediest or, in some cases, not needy at all.

The discussion in the next sections is organized around frequently experienced housing problems in these different market segments and the possible subsidy measures to address them. The summary is not meant to be complete, nor does it assess the pros and cons of each subsidy in depth, since detailed analyses of each subsidy measure can be found in Chapters 5 through 13.

In summary, the subsidies we have discussed are most applicable to specific problems as follows:

I. Middle and Lower Middle Income Groups

A. Constraints within the mortgage finance sector are causing high mortgage rates and limited expansion

1. Support informational infrastructure, research, and technical training
2. Reform public subsidized lending institutions
3. Share default and collateral risks
4. Improve liquidity in the mortgage funding market
5. Help manage the interest rate risk
6. Reduce or compensate for high transaction costs and support borrower education

B. High house-prices or mortgage interest rates, or rents

1. Upfront grants towards first-time home-purchase
2. Interest-rate subsidies
3. Rental housing allowances or vouchers

C. High down-payment requirements and up-front transaction costs

1. Upfront grants
2. Contractual savings subsidies
3. Subsidize mortgage insurance
4. Compensate for high upfront transaction costs

II. Low Income Groups

A. Lack of appropriate, legal new housing options

1. Grants in kind (serviced land) to households, possibly linked to incremental market provided micro-loans
2. Grants in kind to developers (plus beneficiary support)

B. Inadequate supply of low-cost rental housing

1. Reform of rent control laws and other sin taxes
2. Finance or production incentives to private or non-profit investors in rental dwellings or room-rentals

C. Substandard housing poses a threat to public health

This requires investment in infrastructure and services and regularization of property rights, combined with the following possible housing subsidies:

1. Individual home-improvement grants
2. Grant for newly purchased existing homes

D. Lack of access to non-collateralized lending for housing

1. Regulatory reforms and institutional support for micro lenders

Prioritizing and allocating funds amongst different segments and types of subsidies should also start from the problems that need to be addressed, as well as the ease and cost of solutions. For example, reforms of existing subsidies and implementing new incentives to improve the efficiency of the mortgage market may be a high priority, and may actually free up funds for other subsidies.

14.3.2 Housing Subsidies for Middle and Lower- Middle- Income Households

Typical housing problems faced by lower-middle income households in acquiring a house in the formal private sector include the following:

(i) A conservative or ineffective lending industry does not provide loans to otherwise creditworthy lower-middle income customers.
(ii) High house-prices or mortgage interest rates make standard-quality housing unaffordable.
(iii) Low savings relative to down payment requirements and upfront transaction costs make standard housing unattainable.

These problems may be interrelated, e.g., high interest rates or low Loan-to-Value (LTV) ratios may be the outcome of an ineffective mortgage finance industry (rather than result from macro-economic policies, for example). Irrespective, a comprehensive housing policy would need to address the deeper causes of the housing problems as well as some of the immediate effects, at least in the short term. The discussion of housing problems and possible solutions follows that logic and begins with the need to improve availability and cost of housing finance.

1. **PROBLEM: The lending industry does not provide mortgage loans to otherwise creditworthy lower-middle households or investors in rental housing for this income group**.

   The sources of this problem may be related to some or all of the following conditions:

   (i) (Past) macro-economic instability which prevents long-term mortgage lending.
   (ii) Lack of a competitive environment in the housing finance sector hinders innovation and expansion.
   (iii) Lack of information, lack of access to appropriate sources of funds, high credit risk and high transaction costs of lending limit expansion into underserved markets.
   (iv) Lack of ways to manage funding risks constrain the scale of lending.

   While housing policy cannot directly address macro-economic constraints that cause high government interest rates or rate volatility, it can pursue many legal and institutional improvements that become more applicable to housing sector development as the macro-economic constraints are alleviated. Some of these institutional improvements imply reform and transformation of existing dysfunctional subsidy instruments or institutions, while others may require subsidy incentives to stimulate innovations in the private mortgage sector. Where such incentives include partial risk transfer to the state, there is the potential that it could make housing finance markets less efficient or magnify risk bearing, through under-pricing by the public sector. Such measures need to be preceded by policy actions that would support the containment of the risks and costs which subsidies are designed to address. The main areas for subsidy reform or the use of subsidy incentives in the mortgage system are briefly discussed below. References are made to the Chapters in the main text that provide detailed discussions and cases of each example.

   Support informational infrastructure, research, and technical training for the housing finance sector. Subsidies to information collection (e.g., on market transactions and prices, credit information from financial institutions), research on the housing sector and training may be the most cost effective way to support housing sector effectiveness. Such inputs are critical components in policy design and in the development of legal and institutional systems for mortgage lending, including the preparation of mortgage laws, foreclosure laws, and consumer protection and disclosure legislation. Information and research will also stimulate innovations by the industry. (See Chapter 2.)

   Reform public subsidized lending institutions that hinder competition and the effective expansion of the industry. Reform of public subsidized institutions is one of the highest priorities for subsidy policy in countries where economies have stabilized and financial markets have improved. The current trend is to:

(i) Gradually improve the efficiency, corporate governance and supervision of poorly performing public lending institutions, while simultaneously restricting their dominance of the sector, with a view to their eventually privatization.
(ii) Retarget the housing subsidies provided through special labor tax funds to lower income households truly "at the margin" of formal home-ownership, open up the funds to all qualified lenders or allow the savings accounts to be used for the down-payment on a private sector loan, and gradually refocus the operation of these funds on maximizing the return on the savings accounts of their members. (See Chapters 5 and 7.)

However, such a transition often requires that alternative subsidies be provided from the government budget to households or through private lenders, in order not to seriously disrupt the flow of housing credit.

Share default and collateral risks. Credit risk is seen as a major barrier to more active lending to underserved groups in emerging and transition economies. Government could consider using subsidies to alleviate some of the credit risk in the following ways:

(i) Participate in a mortgage insurance institution (e.g., a public / private institution) or provide co-insurance or re-insurance for a private credit insurance agent, or agree to cover certain catastrophic risks under well defined circumstances.
(ii) Pay for a private mortgage premium as part of an upfront grant (see Chapters 6 and 9). This type of subsidy is the most transparent and has the least moral hazard problems for government and would be preferred if a mortgage insurance industry exists or could be established.
(iii) Establish a closed guarantee deposit in a financial institution to deal with late payments on specific loans (Chapter 9). [7]
(iv) Support measures to reduce neighborhood risk -- the risk that there is a permanent downturn in a neighborhood's desirability and hence housing values -- by investing in community or condominium organizations and other support institutions, and forging agreements with local governments to improve services to lower middle income areas.

A combination of improved credit information systems, foreclosure regulations and legal systems and some of the subsidies above might improve the investment climate not just for ownership housing but rental housing as well.

[7] In some communities, sudden surges in unemployment may be the highest risk for the lender, and insurance could cover a limited period of payments for laid-off workers to bridge the gap between jobs. This will only be effective, of course, if lay-offs are not part of a structural unemployment problem.

Improve liquidity in the mortgage funding market. One of the constraints in medium to long-term mortgage lending is lack of access to liquidity for lenders.[8] Subsidies may be used to facilitate access to the capital markets, either on a short-term as needed basis or in the form of longer-term or even full-term financing.

(i) Government may establish (preferably with private participation) *a liquidity facility that issues debt and provides collateralized loans to mortgage lenders, who retain the credit risk and continue to service the loans*. Such a facility might also serve to channel funds to non-bank financial institutions that are comparatively well suited to serve the low-and moderate income market segment, but lack a deposit base for the funding of mortgages.

(ii) Government may set up an entity to *buy packages of pre-approved mortgages*, possibly securitizing these mortgages and selling mortgage-backed securities to investors in long-term assets with some form of cash-flow guaranty or insurance. However, in most low-income countries, capital markets are not sufficiently developed nor are the underlying credit risks sufficiently controlled to do this without exposing the state to considerable risk.

Depending on how these subsidy mechanisms are structured, the liquidity facility is usually the most efficient and the least likely to be abused since it only commits resources if and when needed for liquidity or funding purposes and does not take on credit or interest rate risk. Since all of these institutions and measures are used explicitly as triggers for market development, they are best designed to be phased out within a given time period. Several types of subsidy incentives to funding and liquidity mechanisms, and the conditions under which they are advisable, are discussed in Chapter 8.

Help manage the interest rate risk. In many low and middle income countries, the housing finance system lacks effective ways to manage interest rate risk. The use of adjustable rate mortgages (ARM) allows lenders to manage the risk of rate volatility to some degree. This works well when rate volatility is modest, as can be seen from many advanced economies that primarily rely on ARMs to deal with interest rate risks. However, ARMs can create high default risk in times of high and volatile inflation or real interest rates. Funding with long-term fixed rates is probably not feasible in such situations, but even medium term fixity can help significantly.

Chapter 8 discussed two main methods to deal with interest rate risk, mortgage bonds and securitization. Beyond basic regulatory and legal support, policymakers may conclude that the housing finance market could be made more stable and efficient by the development of such systems and that government should support them.

The government can choose to be involved in several ways:

(i) Provide tax or other incentives to investors in such securities.

(i) Provide credit enhancement, actuarially priced, to eligible private issuers of mortgage securities.

[8] This is usually a binding constraint only when the banking sector is so weak or potentially unstable that the pool of stable deposits is too small too finance the demand for mortgage credit.

(ii) Participate in a new institution that takes on some risks in the funding markets by guaranteeing cash flows for investors. This participation can provide the entity with an implicit (or explicit) state guarantee, thereby absorbing any credit risk net of mortgage insurance or other credit enhancements. Such absorption of risk by government needs to be done with great care in order not to cause significant allocative inefficiencies in the financial system or magnify risk bearing through underpricing shifts of risks to the public sector.

However, there is no intrinsic reason that direct state intervention in the form of institutional involvement or other forms of subsidy is required. Many countries have developed mortgage bond and securitization systems without state intervention, other than providing appropriate legal infrastructure.

Compensate for high transaction costs and support borrower education. Government may also compensate lenders for the higher costs involved in lending to the lower-middle income market segment, at least initially. For example, a cash grant for loan origination and/or servicing of small loans, would be a simple and transparent way of subsidizing the loan transaction (discussed in Chapter 9). Of course, it is appropriate to streamline such costs as much as possible before subsidizing them.

Another proven and effective subsidy that decreases lender costs and credit risk is to provide support for training programs for first time home-owners (borrowers) on the obligations, rights and procedures related to mortgage borrowing.

A combination of these different types of system subsidies and institutional reforms applied to the most severe problems in the mortgage system of a country should improve the effectiveness of the housing finance market, increase the number of households that can access mortgage finance, and expand the number of lenders who make mortgage loans, whether for *rental or ownership housing.* Most subsidy measures can be phased out or pushed lower down the income ladder when the private sector gets comfortable dealing with the risks or the customers can pay for the costs.

2. PROBLEM: High house-prices or mortgage interest rates make standard housing unaffordable.

If house prices in the formal sector remain unaffordable for lower middle income households despite changes in regulations or taxation, or interest rates remain high despite improvements in the housing finance system, government may choose to subsidize first time home-owners "on the margin". Potentially useful subsidies include: (a) upfront subsidies, (b) interest rate subsidies and (c) monthly allowances towards rental payments.

Upfront grants towards first-time home-purchases. As noted in Chapter 9, upfront grants are considered one of the better ways to subsidize the financing of a house when housing markets work reasonably well. They are transparent for government and consumer, they are flexible and can be applied to lower debt or increase equity in the house, or pay for mortgage insurance or other upfront costs, but need not be tied to a financing package.

The main implementation issue, especially in low income countries, is that developers will not build houses that are affordable (with the subsidy) to this lower-middle market segment and that lenders will not make loans to these types of customers if they are creditworthy. Frequently the subsidy is, for that reason, provided directly through lenders or developers, who select the beneficiaries and may capture a considerable part of the subsidy rather than producing housing of a lower cost and for the open market. Such practices do not necessarily assist in having the market gradually produce lower cost housing, and the subsidy allocation may be less equitable than intended.

In transition economies, where upgrading of the existing formal housing stock may be the top priority, upfront grants are equally flexibly applied to assist in the improvement of existing flats for first-time home-owners[9], who take out a market based loan for the acquisition of the flat.[10]

Interest-rate subsidies. Interest-rate subsidies, if targeted and designed as an *add-on buy-down of payments on a market-rate loan*, can be transparent, efficient and relatively easy to implement. In high interest rate environments where inflation or real rates are expected to come down in the medium term, buy-down interest rate subsidies should be limited to the early part of the loan. Similarly, where wages should increase relative to the loan repayment (e.g., assisting young first-time buyers), the interest subsidy can be phased out gradually. The main weakness of such an approach is that most of the costs are in the future and must be brought into the analysis or the budgeting process will overlook them.

To be avoided are *lender-specific subsidies,* often with low fixed interest rates over the life of the loan. These are commonly applied by government lenders or special funds (see Chapter 7) and are often deeply discounted. In most cases, this type of interest rate subsidy is inefficient since households seldom need a subsidy over the life of the loan and will not prepay such loans if the subsidized interest rate remains well below the market rate. The costs of such subsidies is almost always off budget and part of the subsidy is lost through channeling it to specific monopoly lenders.

Both types of interest rate subsidies suffer from an equity problem if the subsidy is not adjusted with the size of the loan or income group. (See Chapter 11 for a detailed discussion.)

[9] Such subsidies also address equity issues related to the fact that most older households received their homes as part of the privatization programs, while the younger generation faces market conditions to acquire a home.
[10] Such individual grants may need to be complemented by grants for the upgrading of common areas in condominium housing and to establish condominium organizations.

Rental housing allowances or vouchers. Allowances to renters to pay for better quality private rental housing are potentially efficient and transparent subsidies and the preferred rental subsidy in most developed countries. However, the lack of sound income data and administrative systems to implement such schemes in emerging economies, and the sheer cost over long periods of time make such subsidies mostly unfeasible for low and even middle income countries. In some transition economies, with good information and efficient rental housing markets, such subsidies may be appropriate for a well targeted segment of rental households. Another frequent issue is that supply constraints may prevent such demand side subsidies from triggering a response in the supply market and may, therefore, have the effect of increasing rents in specific submarkets (see Chapter 13).

3. **PROBLEM: High down-payment requirements and up-front transaction costs make standard home-ownership unattainable for households that are savings/asset constrained.**

In markets where banks maintain conservative lending standards, often as a result of poor market information or past or current high interest rate and credit risk, minimum down-payment levels are set very high (often 50 percent and even higher for households with informal sector incomes). Closing costs, title registration and other transaction costs further increase the amount of upfront payments associated with mortgage loans. The savings burden placed on potential home-buyers who are asset poor, in particular first time home-buyers, is one of the most important constraints to expanding formal homeownership.

While measures to lower these risks and costs should be implemented first, several types of subsidy can be applied to overcome this savings constraint: (a) grants towards the down-payment, (b) savings linked subsidies, (c) payment for mortgage insurance.

Upfront grants. One of the most straightforward ways to bridge the savings gap is to provide *an upfront cash grant that can be applied to the down-payment or other closing costs*. These subsidies are transparent in their burden on the government budget and for the consumer as well, since the exact benefit amount is known. Upfront grants can, however, be expensive (and thus very horizontally inequitable) if they are to effectively overcome low LTV ratios on loans for fairly high cost housing (see above). These types of subsidies are discussed in Chapter 9.

Contractual savings subsidies. Another type of subsidy to alleviate upfront payment problems is a grant tied to a savings requirement for a specific period and amount, often accompanied by a promise to receive a loan. Preferably such package of savings, loans and subsidies should offer a variety of options from which beneficiaries can choose. Savings linked subsidies can enhance lenders' participation in the mortgage market, since the savings accounts may be a welcome source of liquidity in countries where access to other funds is constrained and the savings profile may provide confidence in borrowers' repayment discipline. A savings linked subsidy requires, however, savings institutions that are efficient enough so that they are willing to administer small savings accounts and not charge so much that the subsidy scheme is too expensive (to the state or the saver)

A variant is a subsidy tied to "closed" savings and loan systems (usually, but not necessarily, the Bausparkassen-type -- see Chapter 10), whereby the subsidy is received in the form of a low-rate loan. Such systems cannot be recommended, as they are unstable (the amounts of savings coming into the system determine the level of lending), untargeted, and inefficient since they involve creating a whole separate savings and lending system.

Subsidize mortgage insurance. An alternative way to address the lack of savings capacity in the potential target group is to raise the maximum LTV ratio through mortgage insurance. Government could, for example, choose to pay the upfront premium for such insurance or help establish such industry (see above and a detailed discussion in Chapter 6). An additional advantage of including mortgage insurance payments in the subsidy package is that it will frequently increase lenders' willingness to enter underserved markets (e.g., the growing market segment of informally or self-employed).

Compensate lenders for high loan origination costs. Lowering the required savings for borrowers can also be achieved by compensating lenders for high loan origination and other transaction costs (see above). Such scheme may, however, remove the incentive for lenders to seek ways to lower such costs.

14.3.3 Housing Subsidies for Low-Income Households

Housing problems of the low income groups are seldom just affordability problems, nor is it likely that more effective mortgage systems will benefit the poor directly in the short term. Employment is often informal; credit experience is uneven; land title is not established; many existing houses are unauthorized because of unrealistic housing standards; risk is high that the housing collateral will not maintain its value; and developers and investors in rental housing often find profit margins for that type of housing unattractive (especially relative to the political risks) and do not enter that part of the market. Most important is the problem of the inelastic supply of (formal-sector) land for low-income housing developments. More comprehensive support approaches are required to improve the housing conditions of the poor. Expanded access to savings and short-term credit products are a critical component in this process.

The specific problems of low-income groups in most emerging economies can, therefore, be summarized as follows:

(i) Lack of appropriate, legal home-ownership options continue the growth of informal settlements
(ii) Inadequate supply of low cost rental housing limits housing choice and mobility.
(iii) Substandard housing without adequate services poses a threat to public health.

(iv) Lack of appropriate housing finance and savings options prevent progressive, legal home-construction and resale of houses in this market segment.

The next sections look at each of those problems in turn.

1. PROBLEM: Lack of appropriate, legal new housing options.

Insufficient legal construction for this segment of the market is often the main reason why low-income households continue to live in substandard and unauthorized dwellings, even for several generations. A major problem in this regard is the regulations and procedures guiding low-cost housing development. Even with supportive regulation, however, land and infrastructure problems for low-income housing developments are often the most intractable, since the cost of serviced land in feasible locations (and therefore the total house-cost) remains too high relative to the incomes of this group, even at high densities. The following subsidy actions may be considered.

Grants in kind (serviced land) to households. In most *medium size cities* of emerging economies, housing subsidies for new low-cost housing are best designed as *investment grants towards serviced lots* (with or without a core house). The equity in the plot or house can be used to unlock debt finance and household investments to finish the house. To assist in that process, government may explicitly link the grants to stimulate savings and credit programs for housing in low-income communities and tie a savings requirement (cash or sweat equity) to the subsidy. Moreover, the inputs of community based organizations (CBOs) and NGOs is critical for the success of such programs, particularly if considerable self-management in house-construction is expected from the beneficiary. Explicit provisions need to be incorporated into the subsidy program to pay for such support. In *large metropolitan areas*, such subsidy programs are increasingly difficult to implement successfully since the schemes often have to be located far away from employment centers because of high land-prices. (See Chapter 9)

Grants in kind to developers (plus beneficiary support). In countries with a fairly well established finance industry, special land grants or infrastructure concessions may be provided to developers for the construction of multi-family units for low-income households in either infill or greenfield locations. Beneficiary households may receive an additional subsidy linked to finance to pay for the house (see above). The main constraint in this type of subsidy model is the frequent lack of maintenance of the units and common areas by a home-owner population already stressed to pay for the house.[11] Government may end up paying for such services much like it would for public rental housing.

2. PROBLEM: Inadequate supply of low cost rental housing limits housing choice and mobility.

[11] Low-rise, high density schemes generally have a better track-record than high rise developments.

Rental housing options are critical for the low income groups who need to respond to labor market opportunities and have no savings to invest in formal home-ownership. The question of whether the government should provide subsidized rental housing for the lowest income households has been raised in many emerging economies. However, such schemes have rarely been successful. Their cost has proven to be extremely high and they nearly always suffer from poor maintenance, because rents or subsidies are seldom raised to keep up with maintenance costs. Transition economies, with a long tradition of subsidized rental for low-income groups and an often considerable stock of public rental housing despite large scale privatization programs, experience the same problems with their public rental housing. (See Chapter 13.)[12]

A more efficient way to increase the supply of rental housing for low income households in emerging economies is to stimulate private landlords (mostly small scale) or owner-occupants to invest in rental dwellings or room-rentals, for example by allowing them to use home improvement grants for that purpose. Such investments may further be facilitated through the expansion of savings and credit options for small scale investors in rental housing. (See Chapter 13.)

3. PROBLEM: Substandard housing poses a threat to public health.

If a considerable proportion of the population lives in substandard housing and substandard neighborhoods, the most effective way of reducing the problem usually requires public investment in services (including education, crime prevention), infrastructure and regularization of property or condominium rights, support to community support organizations. Often additional support to individual households will be necessary, however, for the improvement of the house or payment for connection to services (often in conjunction with community-based organizations).

Individual home-improvement grants. A housing subsidy in the form of a grant for home-improvements by investors in rental housing or home-owners may be considered as part of a community-oriented subsidy package (e.g., a broad-based grant that can be flexibly applied to neighborhood and individual subsidies). The household grant may be combined with a requirement for savings or short-term non-collateralized loans for home improvement (see below). Even in very poor communities, there is a significant potential to encourage individual savings (and short-term credit) for housing if supportive community-based institutions are available.

Grants for newly purchased existing homes. In some emerging economies with relatively low population growth, the low income market is primarily served by filtering down of older housing. In that situation the housing problems of low-income households focus on upgrading the quality of existing “formal” but severely substandard housing that becomes available to low-income households. Subsidies to

[12] In some countries, incentives to employers for the building of rental units for their workers can also provide much needed rental units.

low income households may, under these circumstances, take the form of grants to help upgrade newly purchased existing housing (see also section 14.3).

4. **PROBLEM: Lack of access to short-to-medium term non-collateralized lending for housing**.
   Unblocking the delivery of non-collateralized housing finance to low income households through community-oriented savings and credit systems can support home-improvement and expansion, progressive construction of new low-income housing, construction of private rental dwellings (often as extensions to owner-occupied housing), and stimulate the resale market in low-income communities. All of these market activities are of critical importance in sustaining asset values in low-income housing areas.[13] This sector is, however, poorly developed and regulated in most emerging economies, and is often dominated by subsidized state institutions or lacks competition in the private arena which leaves interest rates extremely high.

   Regulatory improvements, such as allowing micro-finance institutions to take savings under central bank supervision, allowing them to make short-term loans for housing, or lifting usury laws, are the first priority. A second priority is the reform of existing state-owned micro-finance and cooperative institutions which often use deep interest rate subsidies and are exposed to large credit risk. These public institutions may prevent a strong private micro-finance sector from developing.

   The strengthening of this sector might further be assisted by well targeted subsidies that mirror those for the mortgage sector discussed above, and might include the following measures:

   (i) Support the improvement of *credit information systems* (Chapter 7).
   (ii) Improve access to funds through a public/private liquidity window that charges market rates (see section 14.3.2 and Chapter 8).
   (iii) Share *credit risk*. While credit risk is often less severe in this market because of the close lender-client relationship, lenders may need protection against short-term monthly payment problems encountered by irregularly employed clients. Such type of insurance can be structured as an upfront subsidy deposited in a dedicated account to make up missed payments without long-term liabilities to the government (Chapter 10).
   (iv) Invest in *staff training* and improvement of technical systems (Chapter 7).
   (v) Support *Community-based Organizations and Community Development Corporations* to assist both borrowers and lenders.

14.4 Closing Comments

[13] Such institutions can also operate as servicing agents for larger financial institution that do not have the infrastructure or corporate culture to deal effectively with low-income or higher risk clients (Rhyne, 2003).

This framework for the development of housing finance subsidy strategy is not meant to be complete. It is intended to assist policymakers in the difficult tasks of diagnosing the most serious problems in the housing sector, translating those problems into clear policy objectives for different market segments and developing a plan of action for the gradual implementation of regulatory reform and subsidy actions to reach those objectives. As we mentioned frequently throughout the previous chapters, this process is unique to each country and its specific history and policy environment.

Ironically, part of this process, and sometimes the most difficult task of all, because of the number of vested interests, is the elimination or reform of *existing* housing finance subsidies. Existing subsidies are often very inefficient, increase housing inequality, and even income inequality, and may strongly undermine the unsubsidized development of the housing finance market. This is the reason why any subsidy policy or program, no matter how seemingly well designed, needs to be subject to research and review on a regular basis.

The second major challenge for national governments is how to induce local governments to implement non-subsidy policies that expand housing development suitable for lower-income households. Few countries have been successful in doing so. One effective approach has been for national governments to make access to housing subsidies conditional upon local governments making regulatory changes and improvements in land rights and registration systems. Another approach may be the training of local governments in housing and land market analyses to improve their understanding of the consequences of poor regulatory systems and the lack of new legal low-income housing construction.

Overall, such a complex and politically difficult endeavor requires that a process is established at a high political level to guide and support the many cumulative actions that different political and technical parts of government have to undertake.