TAKING HOUSING FINANCE TO LOWER INCOME BORROWERS

Housing is one of the most fundamental needs of an individual and any state which is welfare orientated has to consider to what extent this need is fulfilled and in case of significant shortcomings, has to intervene. Urban housing presents further challenges due to population density of cities and the need to reconcile number of objectives ranging from rational space usage, productivity, cultural-sensitivity to ensuring the basic human rights and longevity of the community. The role of the state becomes especially important when dealing with the provision of affordable housing i.e. to the needy segment of society. In the following paragraphs the matter is seen from three perspective viz the Government inducement of fund flows to the affordable housing sector, the Supply Side Measures that help such affordable housing to be delivered and the Demand Side Measures that allow such affordable units to be purchased by those who need it.

A. Governance Inducement of Fund Flows to Housing Sector

Housing provisions in controlled economies varies from that of economies where market forces are allowed to operate. Market forces have as a result of Adam Smith's "invisible hand" a very important role to play in allocation of resources and satisfaction of market demands. The free market mechanism arbitrates between sizeable consumers and suppliers and through the price mechanism arrives at a rational benchmark level for commitment and consumption of resources for nations. However, in markets that have inequitable distribution of wealth or income, to start with, a large number of consumers could find that they are unable to come up with the affordable price. The inexorable logic of this is that the free market, left itself, would decide that these segments of the population who cannot afford cannot be served i.e. markets alone will not satisfactorily house a nation's needy citizens. Since market forces will never provide housing they can afford – and they never will have the ability until they cease being poor – in order to overcome the result of the diluted efficiency of the free market to meet the needs of the needy segment, it is up to the government to stimulate the creation of sustainable affordable housing. Slums scattered towns and those deprived of housing are certainly indicators of the weakness of the free price mechanism: but if they continue to exist for long and are not addressed it is more a matter of societal failure, since society is a mixture of both the haves and the have-nots, and no society can adopt a mechanism which ignores the needs of one sizable segment which could be the majority without attempting to redress those problems.

As nations advance, government can pay a key role in including fund flows to the housing sector e.g. by having laws enabling environment for capital formation and capital flow; Public-private partnership as the cost-effective vehicle for delivery; and Subsidy at the margin to go where pure market forces will not.

These aspects are as detailed below:

- **Creating a Conductive Capital Environment**
  Capital always flows based on the risk and return parameters of the investment. Higher the certainly, lower the risk and greater the attraction of capital to those opportunities. By its very nature, housing is in asset class where the tenor of investment/repayment tends to be the longest: related as it is to the high capital asset value combined with low individual repayment capacity. In addition, the long tenor present risks of its own, starting from interest rate risk, reinvestment risk to obsolescence and cyclical risks to mention a few,. Capital innovates by using the legal framework to either insulate or price in those risks but still continuing its flow towards those opportunities. If the framework is missing or unreliable, the cost of preceding are significantly raised, and impede its flow. The legal framework is also important in facilitating subsequent efficiency of the market in allowing fresh capital to step in i.e. roll over transactions (as involved in re-sales of but property to prospective second time buyers).. hence, here should be protection for property rights both of lender and borrower, including enforcement rights to allow capital to flow in and take the risk. If the theoretical legal framework exists but in practice enforceability is too difficult, it means existing borrowers are protected, but the downside is that capital will hesitate to assume such risk, and mew flows (and hence funding to those waiting) will be impeded. This is especially in the case of low income groups where the risk perception is high (being sole self-occupation) but pricing cannot be stepped up commensurate to risk due to inability of borrower to bear the higher risk premium. So, a pre-requisite for a conductive capital environment is the existence of a clear legal framework, in theory and practice, as applicable to all aspects of housing and the housing financing cycle.

  Additionally, this will also mean creating the means of directing funds flow into the housing sector for example by developing

  - Transparent and reliable capital markets and institutions with sound regulatory capacity and practices, to enable primary issues for raising capital as well as subsequent intra-market transfers
  - Mechanisms and means of aggregating financial instruments and selling financial investments, under clearly defined rules, protective of both the buyer and seller

- A commercial and investment banking system that is robust efficient and fair
- A range of risk-tuned and diverse real estate capital instruments – such as mortgage, loans, and bonds and
- Establishing SOEs (state owned enterprises) specialize in housing finance, to stimulate these markets, such as Mexico's Sociedad Hipotecaria Federal (Federal Mortgage Company) ad Thailand's Government Housing Bank or smaller secondary market makers like Malaysia's Cagamas, Singapore Development Banks, or TOKI Turkey

- **Fostering public-private partnerships**

  Experience gleaned from government intervention in the housing sector, over numerous decades in various countries, involving billions of dollars of expenditures has demonstrated that government intervention is rarely an unqualified success and often results in very poor direct provision of social housing. Examples include "council housing" in the United Kingdom, public housing in the United States, and the cités HLM in France

  Having noted that private capital is constrained by hurdles at times, and that Government is usually not very good at execution and implementation, an experiment that has been tried is to pool the two together, so that together the achievement is better than on an individuals basis; often this is described as public-private partnership.

  To ensure that the expectations f both participants are met is a key to making such co-operation successful. Thus, in a public-private partnership, the private sector should be provided with clean boundary rules, prompt and consistent administrative guidance, even-handed selection and judicious enforcement of law. Profit is the engine of the private sector and in attaining that it organizes its decision-making processes accordingly which are quite different from the government's bureaucratic method; it is imperative hence, to acknowledge the profit motive, accept the efficient decision-making even if it not the most cost-effective per bureaucratic norms, and finally render the private sector participants protection against political pressures and unjustified journalistic vilification.

  Conversely, there should also be a well-though out commitment by the private sector on a basis that they are accustomed to in free market operations. This implies that when in participation with the public sector, the private sector participants should do what they say they will do i.e. not rely on bureaucratic laxity to under-deliver; be financially accountable; have real equity at stake i.e. not restrict itself to mere execution but bring in funds commensurate or relative to its participation; accept financial risk i.e. the financial consequences when the project outcomes are unexpectedly adverse, whether through errors, incompetence or misjudgment; and finally not rely on an eventual transfer of risk to the government or public sector participant in case of mishaps i.e. seek bailouts in case of project failures.

  A good example is the South Africa 2003 financial sector charter. This was a landmark effort to develop an appropriate relationship between the government and those who provide capital. The specific roles are structured such that Government identifies the targets and gives capital encouragement, and the owners of capital are then required to innovate toward achieving the specified societal outcomes, some of which are qualitative such as an increased black homeownership and redevelopment of former black townships.

  The role definition of the two sectors – private and government – and a clear understanding of these, is crucial to the success of the outcome of any public-private partnership. Government has to firstly take a lead role in conceptualizing and initiating such programs and then a facilitative role by establishing institutions, agencies to effectively oversee and administer those programs that make sovereign resources, such as borrowing capacity and credit enhancement, available to the private sector, however, the entire exercise should be underlined by the clear statement that these sovereign resources and support systems will be available to the private sector only if the private sector undertakes to deliver at an agreed affordable price, a home of agreed specifications or within specification boundaries, for the benefit of a target customer group. Any such program, if it is to work as a sustainable model should be well-balanced between the interests of the private and the government sector. Further projects are taken based on the successful model and to ensure that the model in its entirety is not scuttled by fierce (albeit perhaps justified) criticism.

- **Providing subsidies and financial contributions**

  Although public-private partnership is a mechanism that optimizes the strengths of the relative participants, it cannot meet the entire challenge delivering affordability. The main benefits of a partnership are that it contributes to efficiency, risk tolerance, and provides for some risk transfer; however, in terms of impact these, though positive, would only account for a small increase in affordability. In terms of total delivered cost, for the segment of society on the economic fringe, even after the reduction in cost due to the positives of a public-private partnership, the final housing cost is unaffordable and unacceptable and minimum shelter, difficult to attain.

The State, given budget and deficit constraints may look to securing affordability at calculated acceptable cost to the state exchequer, but in a market place that is largely free, the various input cost, whether by a way of material or skills are generally non-dictated and the gap between practical delivery price and affordability by the low income segment persist continuously true affordability for the population's lowest-income segments necessitates financial contributions by the government. The art lies in designing the right mix and augmenting it with appropriate subsidies and incentives to an economic system that has blended the resources of both the sectors in a synergetic public-private partnership. Provisioning of the state's resources can be done in a variety of ways:

- By providing land for such projects on a nil cost basis on highly concessionary terms;
- By increasing the supply of higher-density inclusionary zoning in exchange for a portion of the created value;
- By extending appropriated grants, such as down payment assistance or loans;
- By giving ongoing subsidies or partial waivers of repayments; or
- By extending fiscal incentives

- **Directing Credit/Funds Flow to the Housing Sector:**
  Various measures are used to achieve this some of which are mentioned below:

  - **Credit Direction**
    In India, the concept of priority sector lending is used to direct flow of credit from commercial banks to sectors identified as requiring funding on a priority basis e.g., by setting quantitative targets for such priority sector lending to the banks. The lending under such priority segments also has prescriptions as to the cost; a lower than usual commercial risk rate being mandated for them. This combination effectively increases the supply of funds for housing whilst simultaneously reducing the financial cost of house acquisition.

    In the USA Restrictive lending practices such as "redlining" (i.e. demarcating areas considered not to be safe for lending), and other discriminatory lending practices based on race, gender and other personal characteristics triggered laws seeking social correction (such as Fair Housing Act 1968, Equal credit opportunity Act 1974); these laid groundwork for extending the concept to loans for those economically disadvantaged i.e. the Community Reinvestment Act 9CRA) which encouraged the flow of credit to poorer/low income borrowers. Lest a co-relation be made between such loans and delinquency and an adverse assumption made, it may be noted that lending under the CRA did not turn out to be riskier or less profitable than non-CRA loans. Various comments made by informed observers, including the former CEO of Fannie Mae, suggest that most of the CRA loans were responsibly made and were less delinquent than the loans made by non-regulated/non-CRA programs and that only a small percentage of risky loans originated as a result of the CRA. The point being underscored here is that lending to the affordable segment (i.e. poorer segment) is not inherently riskier than that to the normal higher value buyers, if it is done prudentially with appropriate state support.

  - **Contractual Approach**
    In South Africa, it was necessary to accelerate the flow of funds into the affordable segment after the ending of apartheid segregation. The government envisaged the Community Reinvestment Bill, and the private sector financial institutions responded with the Financial Sector Charter (FSC). Under the FSC the private sector financial institutions have been encouraged to fund the low income sector. Broadly, under this either they directly fund credit worthy borrowers or alternatively fund other wholesale institutional lenders for onward lending to the sector.

  - **Mortgage Guarantee Schemes**
    Mortgage Guarantee Schemes are risk mitigants offered to private sector lenders, usually by the state. The individual structuring may vary in its details, but essentially if the loan to the affordable segment borrower goes sour, the guarantee kicks in and the lender is protected from the effects of the delinquency. Where affordable sector lending is considered riskier, or there has been reluctance to lend into this segment, various countries have adopted this measure in order to overcome the reluctance by mitigating the risk of the mortgage loan or by overcoming the legal hurdles to enforceability faced by lender. Consequently, private sector financial institutions have been induced to direct credit to the low-income group which otherwise they may have refrained from in terms of risk perception.

- **Channelising Domestic Savings**
  Countries at times facilitate the flow of domestic savings into the housing sector by permitting the issue of Housing Bonds, availment of long term concessional loans to specialist wholesale institution for onward lending, purchase or securitization offerings by such institutions etc.

B. Supply Side Measures

- **Preference for Accommodation Type**
  The choice is between providing rental housing and ownership possession. Regarding the preference to subsidize either house ownership or house rental, there seems to be no clear pattern, with decisions being country specific depending on cultural elements and traditions. For example, low-income housing assistance in provided only through subsidized rental in the Netherlands, while in Spain subsidized ownership is almost the rule.

  In Bahrain, the aspiration would appear to be ownership, rental being viewed as a shorter term arrangement. Even within this preference, there is a sub-preference for villas rather than apartments, partially as a result of cultural factors and partially as a result of villa ownership being the traditional norm and the possibility of scaling up liveable-space in case of owned villa. Land being a scarce and expensive input, the acceptability of apartments would allow for better utilization of existing land stock available for affordable housing. There could however be a possibility younger demographic constituent and by innovative developmental offerings.

- **Mix**
  It is appropriate to relay more on supply-side incentives in the short-to-medium term. In longer run, demand side subsidies more efficient as they are linked to income.

- **Involvement of Suppliers**
  As noted earlier, there are two approaches to increase the supply of housing stock…. Whether rental or ownership. One approach is where the Sate acts on its own (i.e. state is sole supplier of affordable housing, taking the entire responsibility of funding, constructing, providing and collecting for shelter provided); the second approach is where the state co-opts the private sector developers with the government providing various facilitatory and concessional measures or in a combination of the two approaches (i.e. state and the private sector are joint suppliers of affordable housing). Historically, in many countries the state has started off with the first approach, and then due to resource constraints and other factors, either switched entirely to the second approach or attempted to run both approaches in parallel.

- **State as Sole Supplier**
  In Bahrain, for example, this has been largely and traditionally the approach adopted, with accommodation being built and supplied to the eligible citizens both on rental basis and ownership basis.

  - **Supply of affordable housing on rental basis**
    Rental apartments are considered only as a stop-gap arrangement until an ownership unit is delivered to the citizen. Affordable rental apartments are built by the Ministry of Housing and if an eligible citizen is allotted the rental flat then up to 5 years he is required to pay an affordable rent. Thereafter, if he is required to pay an affordable rent. Thereafter, if he does not get an ownership unit but continues to reside in the rental unit, no rent is charged to him, i.e. The accommodation is free (i.e. state bears the entire cost). Recently, ??? units have been made available to the citizens on rental basis.

  - **Supply of affordable housing on Ownership Basis**
    Under this program, affordable housing (most often in the form of villas) is built by the ministry of Housing. These are then sold to eligible Bahrainis at the constriction cost. The price of the house is collected in monthly installments over a period of 25 years through Eskan bank, the specialized financial housing institution of the state. No finance charges are added to the initial purchase price. Presently, units have been made available to the citizen on ownership basis.

However, with a waiting list of ?????/ houses which would involve conservatively an amount of BD ???/ million, the capacity of the Bahraini state to be the sole supplier of housing stock has had to be re-examined. The necessity of such re-examination of the role of the state as the sole supplier of affordable housing has been further accentuated by the expected demographic swelling of the population, with the country having a considerably demographic profile.

- **State as supply facilitator**

  This approach envisage the state taking measures to attracting Private Developers into the affordable housing arena and also taking measures that will enables such housing to be delivered on an affordable basis to the citizens. Some measure used to make affordable housing achievable are as follows:

  - **Profit/market up restrictions.** Affordable houses in Chine are developed and sold by real estate development corporations after winning the bid with a profit limit of no more than 3% of the development cost.

  - **Inclusionary zoning.** This refers to municipal and area planning ordinances requiring that a given share of new construction should be to affordable/low-income groups.

    Another form of this would be the granting of Density bonuses. Density bonuses are granted for projects in which the developers agrees housing units. Essentially, for every one unit of affordable housing a developer agrees to build, the municipal authority allows the construction of a greater number of market rate units than would be allowed otherwise. Density bonuses are very popular in the US to favor higher density housing. Such density bonuses could also be explored in Bahrain which would enable the inclusion of affordable housing units in large private developments.
  - **Direct subsidies to developers.** This could be by the way of a one-time specified percentage of the agreed project cost or by way of running annual subsidies for a specific period, which would help raise the project IRR to a level that interests the private developers. In Bahrain, where there is largely a no income tax environment, subsidy could be given to the builder/developers by way of refunds on taxes levied on material costs, refunds of statutory costs/contributions/fees in respects of labour employed on such projects, concessions in terms of utility charges until project delivery etc.

  - **Land grants to developers.** This method has been used with either the whole or the part of the land cost being borne by the State. To ensure proper usage, at times a stipulation is attached for the concession to be withdrawn if the units as required are not delivered within the specified period.

    In the case of Bahrain, the land grant mechanism is being used for the delivery of affordable housing through Eskan Bank, the financial housing arm of the state. The bank is tasked with developing 2500 housing units on lands received as grant from the state by putting together the entire development finance, construction and mortgage financing package and overseeing the construction and delivery of the units to the end users.

  - **Offtake guarantees.** In places where the cost structure is within the risk appetite of the developer but there us hesitation to accept the market risk of the sales of the affordable apartments (e.g. due to apprehensions that the target segment will not be able to obtain the required bank funding, or that there could be cultural resistance etc.), the state may at times seek to neutralize this risk for the developers by giving offtake guarantees either for the full delivery price of a part thereof e.g. cost. At times this could by taking away a key risk, attract not only the developers but also debt/equity funding for such project.

    A prime example of this approach is the joint development formulated by the government in bahrain with Naseej, a private sector real estate real estate development of affordable units plus units which are priced higher than the affordable ones. Offtake guarantee is given by the State for the full price of the affordable units, and for the other lot too the offtake is guaranteed 9if the developer is unable to sell within a specified period) but limited to the construction cost.

  - **Classification changes.** Land classification shifts from commercial to residential use could increase housing stock.

  - **Process Streamlining.** Bureaucratic and administrative streamlining to reduce processing costs and time. Malaysia and Canada are good examples on the positive impact of the streamlining of administrative requirements through fee waivers and fast-tracking procedures.

- **Combinations of options.** A combination of above could also help e.g. in Malaysia, the government has establishes public-private business partnerships under which the state provides land for low-income housing and streamlines administrative procedural aspects, while the market provides financial resources, supports the program's implementation and delivers the units. Government regulations include minimum size requirements, and inclusionary housing quota of 30% affordable units in any new development, a ceiling price on private developers, and additional incentive are extended for developers who wish to exceed the 30% quota, such as access to fast-tracking windows, lower land premiums subsidized infrastructure and utilities, etc.

C. <u>Demand Side Measures</u>

The demand side measures address the problem by looking at the matter from the borrower's side e.g. in terms of eligibility, affordability etc.

- **<u>Govt Capital Grants</u>**

  In the housing sector, capital grants are one-time subsidies to households that they can us to purchase, build, or complete (new or existing) units or to rehabilitate existing units. Capital grants have been popular in South America. Latin American countries have tended to implement variations on the so-called "Chilean model". Also, in South Africa, political pressure to improve the housing situation rapidly probably prompted the government to adopt the capital grants approach.

  In Bahrain, Capital grants have been effectively given although in two modified forms as follows:

  - Concessional Interest: Loans are given for Purchase Construction or Repairs to eligible borrowers under a loan program and is popularly called as "social loans". The loans are extended and administered by Eskan Bank, the financial housing arm of the state, with the credit risk being underwritten by the state. The first element of the grant comes in the pricing of these loans. A fixed rate is applied over the loan tenor (maximum years) as against floating rates available in the market from other housing finance lenders. Further, the rate is on a highly concessional basis of 3%. The subsidized pricing relative to market rates may be considered to be a grant over the loan period.

  - Waivers of Outstanding: Additionally, form time to time, substantial portion of the outstanding loans of the borrowers are waived by the State. Thus for example, 50% of the outstanding was waived for the borrowers in 2006, and then subsequently 25% was further waived on the same loans in 2011. In such cases, effectively, 75% has been given as capital grants being outstanding waived, and the installments are recovered only for the remaining 25% of the original loan.

- **<u>Govt Housing Allowances</u>**

  A housing allowance is a regular ongoing subsidy to households that offsets some of the costs of their housing and housing-related services. allowances can take two basic forms. But, these can be varied depending on the need.

  - **<u>Norm based</u>**

    Under this approach, the household receives a fixed subsidy based on norms of the typical prices prevailing in the housing market and must pay the difference between this amount and the total payment for its housing unit. As a result, each household's contribution will vary depending upon how successful it is on finding an economical unit. If the household finds an acceptable unit that costs less than the subsidy amount, it may keep the remaining amount of the allowance.

    In Bahrain, the housing allowance is given to those who are on the affordable housing waiting list for 5 years, but have not been given any accommodation. Such eligible citizens are given a monthly housing allowance of BD 100 until such time accommodation is delivered to them.

  - **<u>Burden Limit</u>**

    Under this approach, the government specifies a fixed amount of money that a household must pay towards its own housing costs (usually a percentage of its income) regardless of the total amount of its payment for the housing unit. The government pays the difference between what it deems that the household is able to pay and the housing-related expenditure.

The attractiveness of this approach is that a household can be sure that it will have to pay no more than a fixed percentage of its income on its housing0-realted expenses. This approach is sometimes called a burden limit.

The burden limit approach is followed in Bahrain in respect of affordable housing delivered through the state. In case of loans given through Eskan Bank, the monthly installment amount that can be recovered from the borrower is capped at 25% of the salary.

Further, the same concept is being considered in a new initiative being formulated for development of a "fast track" scheme for affordable houses in co-operation with the private sector. Under this proposal with the private sector. Under this proposal being evolved, the private sector puts together the entire package for the delivery of the affordable units as per government specifications, including the land, the financing and construction, and based on the total cost the monthly repayment burden (EMI) is computed. The state then bears the excess of such EMI over 25% of the borrower's income.

- **Eligibility Norms**

The monthly EMI (Equated Monthly Installment) payable by the borrower and the Downpayment required from him, are significant factors that affect the flow of credit to the individual. The former is captured by debt-servicing criteria such as Debt Service Ratio (DSR) (i.e., maximum % age of EMI/Income) and the latter by Loan to Value (LTV) ratio (i.e., maximum loan amount/value of property). The DSR is also affected by the loan repayment duration; lengthening the period has the effect of reducing the EMI (and DSR) and hence increasing the affordability.

  - In the case of low-income groups, some financial institutions in the UK already have dropped the downpayment to as low as 5% i.e., dropped the LTV to 95%. As against this, the LTV in Bahrain is about 75-80%. A reduction in the LTV would boost the offtake of loans by the low-income group.

  - The maximum tenor or mortgage loans is usually about 25 years. But, in some countries longer duration is offered e.g., DBS Hongkong gives even 40 years.

Repayment capacity is often a function of the residual income left with the family after debt-servicing; if it is insufficient for the family's needs delinquencies are sure to arise. As residual income criteria are not universally mandated, the DSR can be considered to be good indicator of residual income, i.e., a parameter which has very strong negative correlation with residual income, since generally speaking, higher the DSR, lower the residual income. In view of the strong co-relation between residual income/DSR and delinquency, increasing the DSR maximum is not a favoured method as higher DSR imposes extra burden on the family, and could increase risk of defaults.

D. Summary

Making housing finance available and affordable to the lower income groups involves government encouragement, and actions on both supply and demand side.

The supply side action would make units available at lower prices, so that the loan amount/EMI reduces making it affordable.

The demand side action would again permit such low income borrowers to qualify for funds.

And, overall the Government support and subsidy would facilitate such housing to reach the low income group, along with the institutional and financial market development measures outlined above.

Specifically, in the case of Bahrain it can be seen that it has been using a variety of measures to promote affordable housing and to ensure that citizens burden for shelter is reduced. However, these have been largely measures that have had a direct impact on the state finances. In recognition of the limitation of an approach where the state by itself attempts to provide the entire financial and implementational solutions of affordable housing, various innovations and initiatives are being formulated involving public-private sector partnership. Along with institutional changes and changes permitting optimization of land utilization, it should be possible to maximise the flow of funds towards the affordable housing sector such that maximum shelter can be delivered with the available resources of the society as a whole.