Development from Inside Out – The Making of National Housing Finance Policy

Introduction

Housing a country's population is an extremely difficult, yet extremely important function, impacting the quality of life of every citizen. Adequate housing is the cornerstone of a well-developed social order. Security of the person, social stability, better health and crime reduction are all proven to result from better housing, and are very good reasons to strive for housing excellence. The housing objective for countries in transition is talked about regularly and many reports have been written by international and foreign institutions. Many countries in transition would like to pursue such an objective, however the political and institutional process to reach the goal is complex and challenging.

I would like to provide some insights from my personal experience in helping countries in transition develop the field of housing finance. I have identified the most fundamental factors that must be present in order to realize an effective housing finance program, as well as some of the key issues that we face regularly in trying to establish a new housing finance system in transition countries. Most important among those issues is the need for a well-organized government Agency with the mandate to take the lead on the orchestration of the various agencies to agree upon and achieve the desired goal.

Housing Issues

The private housing and construction industry in transition countries has not historically been very strong, since housing was considered to be a social good. Today, major constraints to the accessibility of decent dwellings exist, due both to the lack of private enterprise and the lack of budgetary funds to meet the needs. In my meetings with senior officials and business representatives, there have been four major issues of common concern to transition economies: availability of affordable loans, cost of housing, problems with enforceability of the mortgage contract in the event of default, and the need for a consistent policy for the development of housing and mortgages.

In most developing economies there is no housing credit system as exists in Western Europe, North America or Australia. Loans are generally short term, the equity requirement is high and interest rates are variable. In many cases, houses are financed on installment contracts with the developers. In fact, people may prefer this method, since they may not want to obligate themselves to a long-term mortgage when their economic future is uncertain. The combination of low wages and high costs of financing (downpayment and interest) make it very difficult for most citizens to afford a home.

Construction costs are high due to the use of old technology and materials to build housing units. Builders have not modified their construction methods to increase their productivity and gain efficiency in the past decades. Other costs include excessive taxes and land transfer fees. Those concerns, along with the question of legal enforcement of mortgages, have been discussed in great detail by others.

The issue that has received less attention is the general lack of consistent direction, cooperation and follow-up with government housing policy. All participants in the housing industry, including all levels of government, financial institutions, promoters and builders of housing units, must work toward a shared vision. Each one must define its goals to reach this vision and must be held accountable. In Canada, this responsibility rests with both the public and the private sectors. This public and private partnership is a result of the cooperation of a multitude of stakeholders all with a common purpose of providing their citizens and clients with the best housing of the entire world. This partnership did not just appear on its own; it was consciously created, nurtured and has continuously evolved as the needs of the marketplace have changed. One institution in Canada that was charged with shepherding this cooperative effort through changes in the political and financial environment is CMHC.

Canadian Mortgage Loan Guarantee Program

One way for the government to support affordable housing development is to provide credit risk insurance to the private sector lenders, in order to entice them into under-served markets. (Editor's note: see Elliott article for more detail) The Canadian Loan Guarantee Program is a national program delivered through a network of approved financial institutions. It provides increased access to housing by guaranteeing high ratio mortgage loan for homeowner in Canada. Here are some its key features:

- The premium structure is geographically invariant for borrowers who meet minimum acceptable terms and conditions of the Program.
- Within the Guarantee Fund, cross-subsidization of risks is available from low risk geographic areas and low risk borrowers to higher risk areas and borrowers.
- The premium increases with loan to value ratio since it is the known key determinant of risk of default.
- The one-time up front premium payment covers approved financial institutions against risk of borrower default for the full amortization period of the mortgage loan.
- To further assist in accessing homeownership, the one-time premium may be capitalized in the mortgage loan amount.
- The guarantee or insurance policy covers 100% of the balance of the mortgage loan and the interest for a determined period with approved financial institution other costs against losses.
- Both the lender and the guarantor can foreclose on the security as well as pursue borrower covenant to cover part of or all losses incurred in the event of borrower default.

The Mortgage Guarantee Fund is operating on a commercial basis and is managed prudently on an actuarial basis to break even over the long term. The Government of Canada is paid a reinsurance premium for the guarantee it provides to the Mortgage

Guarantee Fund should the Fund find itself in financial difficulties and become financially insolvable. No call on this government financial backing has ever been done by the Mortgage Guarantee Fund. However, the success of the Fund rests on the solid foundation of a strong market infrastructure.

Feasibility conditions

When working with a country that wishes to adapt the Canadian guarantee model to their market, it is necessary to have a good understanding of the entire environment affecting the efficient working conditions of a mortgage loan guarantee system. Some key characteristics must be considered in developing a strategic implementation plan. The assessment of these characteristics will lead to many actions to assist in and to fully implement the strategic plan. The speed with which the strategic plan can be implemented, is directly related to corrective actions taken by the intervening sector participants to attain success for the housing program.

Specifically, the implementation of a mortgage loan guarantee system requires sustained minimum market demand in the future, supportive economic and institutional policies from all levels of government, availability of mortgage loan financing and adapted financial products, and stable incomes to afford modest housing. Last but not the least, adequate management capacity to administer the mortgage loan program must exist including the management of a mortgage loan guarantee fund. A successful guarantee program must be actuarially sound, but fundamentally it must 1) avoid moral hazard concerns, 2) share risk with lenders, customers and investors, 3) contain sufficient motivation for all parties to fulfill their contract obligations under the mortgage. Hence, a strategic analysis of the current environment is required before the insurance program can be put in place.

There must be a **sustained minimum market demand** in the future. This housing market demand will exist when there is a consumer commitment to home ownership and its responsibilities, and when there is an unmet demand or a continued growth in demand for home ownership. Potential clients must also have stable incomes sufficient to afford modest housing units and have the availability of mortgage loan financing from financial institutions. But the most important point is the government support for accessibility to affordable housing for its citizens.

For planning purposes, statistics about the housing stock situation and about the level of income of its citizens, as well as data about overcrowding, housing quality, age of housing units, housing infrastructure, construction permits, rural and urban housing stocks are necessary. In some cases, there is information available, but not in the right format for the kind of analysis that is required to fully appreciate the housing market risk and performance. Similarly one must be very careful in reviewing and assessing any data, and attempt to verify against other sources. For example, in transition countries, historical data collections were done for centrally planned government operations not for market oriented operations, which can affect their reliability.

There must be a **supportive environment for economic and institutional policies** from all levels of government. Local social pressures from international development institutions around the world as well as those from government in countries in transition force action into the housing field, in particular the housing financial aspect. Some governments are taking actions to solve their housing issues. Government now allocated and prioritized their limited amount of funding available. Some countries in transition have for all intend purposed no funding flexibility what so ever. In some instances they never add any. Since home ownership and related activities have been modified by many government decrees in the past 40 years under previous government regime, today governments feels they must rewrite mortgage law to give better credibility.

As an example in Romania, the government has drafted and passed two laws of major impact in the field of housing. The first one is the law creating the new National Housing Agency. This law has been promulgated on July 13, 1998, and has authorized the National Housing Agency to make mortgage loans through banking institutions to

Romanians with special loan facilities. Initially housing funding is made available by the government. It also creates for the Agency the possibilities to issue mortgage obligations and to institute a mortgage obligation guarantee fund.

The second law, promulgated in June 1999, will formalize the mortgage credit system including the issuance of mortgage bonds and of mortgage backed securities. The objectives of this law are to help and protect Romanians (physical persons) in accessing homeownership, to explain the rules of mortgage law and its process, to authorize and entice the local financial institutions to grant adequate mortgage loans, to generate funding for mortgage loan purpose through mortgage bonds and mortgage-backed securities, and eventually to activate the housing industry. The rewriting of laws is a long process particularly for countries operating under the Civil Code. The procedures and institution roles must be spelled out in detail in the regulations prior to implementing the new law, which means further delays in implementing the envisaged mortgage loan process.

Once a decision is made on housing policy by a government, it should be consistently supportive of the direction taken. The overriding policy objective has to be clearly communicated to all stakeholders, but expectations have to be managed so that measurement of results and progress is realistic. Any new institution created to assist in the implementation of these housing policies should be mandated to coordinate its concerted efforts amongst all others. A leadership and coordination role of all housing efforts should be well established and all institutions related to housing activities held accountable for actions taken and result.

For example, the government of Algeria has taken some concrete actions to move its housing industry into a market driven economy. It has created the Caisse Nationale du Logement (CNL) to help improve access to homeownership, the Société de Garantie du Credit Immobiler (SGCI) to guarantee mortgage loans made by the financial institutions for home purchase or for promoters of homeowner housing projects, the Société de Refinancement Hypothécaire to refinance long-term mortgage loans made by financial institutions, the Fonds de Garantie et de Caution Mutuelle (FGCM) to guarantee advance payments made by housing unit purchasers to promoter, and has modified the bank act to authorized all banks to grant mortgage loans for housing purposes.

It is preferable in my view for economic policies to encourage private sector involvement in the provision of housing for all residents, including low-income population. Its focus for economic housing policies is to support diversification of the housing industry as a whole rather so that it can be sustained without direct government expenditure for housing development or lending.

Construction and rehabilitation financing is important. In most developing countries, the primary need is for new housing construction and financing. In the transition economies, there is a greater need for financing the purchase of existing units as well as much-needed repair and rehabilitation. Construction loans are not generally available through financial institutions, nor are they desired by developers, due to the interest costs and added requirements of the banks. However, construction financing allows the development and delivery of more units, which lowers the incremental cost of construction. A properly constructed guarantee system could also facilitate the availability of this type of financing, and at the same time encourage the growth of more efficient home construction businesses. And, it can increase the availability of financing for home improvements. All of this activity will inspire growth of the secondary market for home sales, which improves the overall risk in the system for lenders and owners alike.

The **mortgage loan financing and products** must be affordable. Since 1989, wage growth has been modest at best in most transition countries and incomes have not kept up with inflation. This means that at least two incomes will be required for most households to afford a new housing unit. Low or no wage growth and high inflation in recent years have also reduced savings. Some limited mortgage financing is available through private, foreign sources, but primarily from specialized state banks. The source of funding for the state banks is primarily citizen deposits guaranteed by the government. Mortgages are generally short term, high rate, variable rate and payment, with minimum of 30% downpayment (plus transaction costs). Due to high inflation, to local currency on-going devaluation and to client potential risks, the mortgage loan rate fluctuates greatly. There are other important issues that constrain access to homeownership. Limited serviced land is available for new housing constructions from municipalities. Setting up and developing the domestic residential infrastructure is an issue. The procedure of getting a residential construction permit is long and expensive. Approval of new technology and material standards by government agencies and laboratories are very expensive and take a very long time. All of these problems limit further access to homeownership but ultimately affordable mortgage financing appears to be the key issue.

Management capacity of financial institutions to administer and to deliver a mortgage loan program, inclusive of a mortgage loan guarantee system, must be adequate. Currently, lenders obey very strict underwriting guidelines, target only the upper income markets and have been successful in avoiding losses in the past ten years. There is basically no risk to the financial institutions and very little activity in housing finance. Due to this lack of experience bank lenders are likely to be less skilled in dealing with borrowers at the margin, and in identifying risk-mitigating actions. There is a need for additional training in risk assessment for financial institution members who will be delivering mortgage credit to low and moderate income buyers, especially under the requirements of a mortgage guarantee system. Since a mortgage loan guarantee program protects mortgage lenders from loss, there is less incentive for them to be prudent in underwriting, hence well-documented policies and procedures and an excellent operational audit program is necessary.

Financial institutions also have limited knowledge and experience in servicing mortgage loans. In most cases, the ultimate risks of mortgage lending (especially medium to long term lending) are unknown since high delinquencies have been attributed to a lack of attention in servicing the real estate portfolio or catastrophic economic shocks. I have found that training in underwriting must also be accompanied by training in servicing techniques and loss mitigation strategies, particularly where the ability to foreclose the property and evict tenants is still limited.

Most first time buyers and loan customers are not versed in the requirements and responsibilities of homeownership or a mortgage (this is true everywhere). Therefore, credit officers should also receive training in consumer education. Consumer education, prior to making the decision to purchase a home and to agreeing to a mortgage loan commitment, will become more critical for financial institutions in serving lower income clients with little or no savings. Financial institutions will have to rely on such options as individual counseling, video presentation, first-time-buyer seminars and marketing material to deliver its services.

Finally, In most countries in transition there has been no formal professional training for mortgage loan underwriters, residential inspector and appraisers. Similarly the housing market analyst function does not exist and must be developed. These professions have to be created and be formalized in order to have a strong sustainable housing industry.

A Housing Agency

As mentioned earlier, one of the greatest problems in implementing housing finance policies in emerging markets is the lack of a single accountable entity that has the mandate (and the funding) to coordinate all efforts related to housing policies.

I strongly believe that any strategic plan for implementation of a housing finance system should include a mortgage guarantee system. It will increase and provide equitable access to reasonably priced mortgage loans. It will assist the country to move to a market economy. It will contribute to the development of a strong regulatory environment and support financial sector reform. And the ability to utilize modern financial methods such as securitization and secondary mortgage market institutions could follow.

One thing I have learned is that no developed country system can be transferred "as is" to a new market. All systems must be adapted, to the local culture, local custom and local economic conditions. However, it is possible to learn from the experiences of other countries and to bring in the technical and operational expertise that is needed to obtain desired efficiency. These operational steps can certainly be "leap-frogged", but the political, economic and legal framework that supports the activities of mortgage lending should not be developed without careful planning and consideration, including the engagement of all stakeholders, public and private.

When I have been called upon to advise governments in the development of housing finance methods, I find that somewhere, sometime in the past, in some agency of the government someone has commissioned a review of the existing housing situation. Perhaps it was done under another administration, under the auspices of one of the international aid agencies. In this case, what will be needed is not one more study but an action plan. The area where the greatest technical support is needed is project management - to coordinate and communicate with all involved parties at each stage of implementation, to help manage the political and public relations process, and arrange necessary training for the institutions and the public. On the job training is extremely valuable where possible.

I have found that in countries where I have worked, the locals are well educated in finance and understand the principles and the mathematics of housing finance. What was lacking was clear direction from the government about implementation, and clear understanding of all stakeholders of their obligations and the incentives to them to support the new program for the long term.

Conclusion

In conclusion, I believe that a strategic implementation of a mortgage loan guarantee program would provide access to mortgage financing for greater opportunities to homeownership and would greatly assist in developing a mortgage market in countries in transition. Planning and implementing such national mortgage loan guarantee program would greatly assist the local lending institutions to move quickly into residential lending operations to facilitate accessibility to home ownership. Government support has been key to improved housing conditions of developed countries, and it is also true for developing markets.

Initially a government-sponsored agency is needed and must be mandated by the government to take the lead role in all aspects related to the housing industry, in particular housing finance. Appropriate processes and procedures must be developed to deliver the housing program in participation with interested organizations. A liquid and solvable mortgage loan guarantee fund must be instituted. Financial institutions must be trained in the mortgage loan initiation process and in mortgage servicing activities for not only guaranteed mortgage loans but also for conventional mortgage loans. A major consumer education program must be undertaken to explain to its citizens how they can access and afford a home with the new program.

A national mortgage loan guarantee program would contribute to the development of the market driven economy by:

a) assisting lending institutions in making viable mortgage credit loans to citizens and stimulating the housing construction industry;
b) helping promoters and housing construction builders in obtaining construction financing for residential housing units from approved lending institutions;
c) bringing standardization to the local mortgage loan industry where all participants would understand the mortgage products available for their citizens and its financial and risk implications;
d) giving the required transparency presently lacking in those countries in transition,
e) increasing volumes of profitable mortgage lending and opportunities to retain and offer other services to their clients for financial institutions;
f) promoting standardization required for securitization purposes by assisting potential local and foreign investors in assessing the risk associated with mortgage loans;
g) contributing to increased access and democratization of housing ownership

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