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Sustainable Housing Finance for Low-Income Families:
A Condensed Concept Paper for 383-HG-004 (Phase II)

by

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Note: For a more detailed discussion on this subject please refer to *Sustainable Housing Finance for Low-Income Shelter*, dated July 15, 1994, by the same author.

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Sri Lanka HG Program Summary

The Sri Lankan HG program dates back to 1979. At that time a total of $100 million in housing guaranty loans were planned over approximately a 10 year period. As a result of one deauthorization and a new authorization made for infrastructure finance, the total program is now $90 million. This concept paper deals with HG-004, a $25 million authorization which began implementation in October 1992. To date, $10 million in eligible expenditures have been realized under the program as covered in the Program Delivery Plan (PDP). The GSL wishes to proceed forward with the balance of the $15 million remaining, however a recent program evaluation disclosed that certain important objectives of the program were not being realized. The evaluation made recommendations for changes to the program. This paper lays out the framework for an amended PDP within the scope of the evaluation recommendations.

Goals, Purpose and Objectives

The goal of the project is to improve shelter and services provided to the urban and rural poor. The purpose of the project is to assist the GSL to develop policies, programs and solutions which, through coordination with the private sector, will increase the effectiveness of limited government resources and provide maximum benefit to lower income households.

The objectives of the project are to:

1. Develop policies and programs for market-oriented housing finance within the context of both structural reform in financial and capital markets and overall shelter policies in Sri Lanka.
2. Rationalize the public sector role in financing shelter.
3. Develop instruments and procedures to facilitate the growth of the housing finance market and remove barriers and disincentives to market growth.

No changes to the goal, purpose or objectives will be made. Likewise, no amendment to the project paper or implementation agreement is needed.

Structure and Implementation of Current Program

The current structure envisaged the creation of a sustainable housing finance system whereby an "apex" lender (the Central Bank of Sri Lanka) refinanced low-income housing loans[1] originated by numerous "sub-apex" lenders comprised of commercial banks, the

[1] Low-income loan is one made to a family whose income is at or below the national median for urban and rural areas.

State Mortgage and Investment Bank (SMIB), the Housing Development Finance Corporation (HDFC) and other entities qualifying as an "approved credit institution" under the Monetary Act. The program allows no loan subsidies and stresses high recovery rates. Market interest rates are determined based on a margin over average bank deposit rates in Sri Lanka. Currently, the market rate is 20.5%; refinance loans from the CBSL carry a 12.5% interest rate giving sub-apex lenders a minimum 800 basis point spread.

Sub-apex lenders may also wholesale loans to other institutions which do not qualify for refinance borrowing from the CBSL. This element was introduced to integrate informal sector lending (primarily coops and NGOs) with the formal sector as a way of targeting more beneficiaries. The only instance of wholesale lending has been the Bank of Ceylon making loans to the National Housing Development Authority, a large, inefficient GSL institution.

The program also calls for a grant element administered by the NHDA. Grants are made available to low-income families unable to qualify for loans. Generally, these families have incomes falling below the 25th percentile in the income distribution. The PDP called for approximately 40%(about $4 million) in HG resources to be used for grants, thus leaving approximately $6 million for loans.

The Housing Finance Steering Committee (HFSC) was formed as a policy formulation and referral unit for housing matters. The HFSC is comprised of high-level representatives from public and private sector housing-related institutions. It has not met in over 2.5 years.

Evaluation Findings and Recommendations

In July/August 1994, an evaluation of the HG-004 (First Tranche) was conducted by a PADCO consultant. The findings of the evaluation were:

◊ Financial achievements: the CBSL approved 42,200 loans for a total of Rs. 420 million ($8.6 million). Loans averaged Rs. 10,000 ($204) with an average term of about 10 years. Interest rates were at 20.5%.

◊ Policy Objectives Achieved: the loans have been made at market rates of interest, a notable achievement in a country accustomed to subsidies for the poor. Additionally, loan recovery rates generally remain high.

◊ Policy Objective Shortfalls: the NHDA continues consuming the vast majority of the HG *loan* resources.[2] The private sector is not playing a major role in the loan program. Most importantly, *no progress has been made in developing instruments and procedures which would insure program sustainability* once the HG program terminated.

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[2]We would prefer the NHDA to concentrate on grants and policy development.

The key finding, however, appears to be the inability of the current housing finance system to tap a sustainable source of long-term funds for housing. Traditionally, housing finance systems were born and maintained with capital provided through household savings deposits. In Sri Lanka, the largest mobilizer of these deposits is the National Savings Bank (NSB) yet their involvement in housing is minimal due to GSL directed investment policies (the NSB is a principal funding source for the GSL budget deficit).

The evaluation thus concluded on the following recommendations:

◊ A new PDP should be prepared for the use of the remaining HG loan and new technical assistance funds. The focus of the PDP must be on sustainability.

◊ The PDP should seek to strengthen existing home *mortgage* lenders' ability to originate a steady supply of *mortgages* which can be used by primary lenders as collateral for funds mobilization in the capital markets. A natural evolution toward a secondary market in mortgages should be encouraged and supported by USAID.

◊ The ratio of loans to grants should be increased from 60:40. The NHDA should be weaned slowly out of the lending program and other lending institution should be allocated approximate proportionate shares of the loan funds.

◊ Find a method to include the informal sector in the program.

◊ Reconstitute and convene the HFSC as a public/private sector policy body for housing finance.

◊ The PDP should include assistance to the GSL to develop a regulatory and supervisory environment conducive to the development of primary and secondary mortgage markets.

Description of a Sustainable Housing Finance System

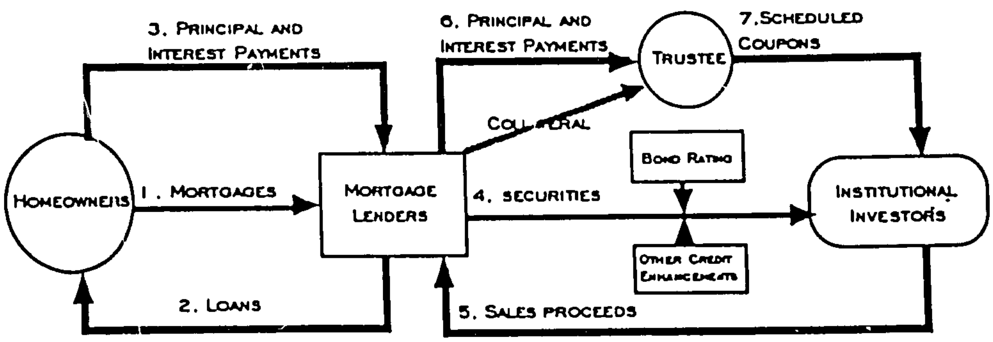
Efficiency Equates with Sustainability

Sri Lanka's financial system is fairly institutionally diverse. In addition to commercial banks and housing institutions, there exist life and hazard insurance companies, pension (provident) funds, investment bankers and brokers/dealers in a variety of financial instruments-- stocks, debentures, commercial paper, unit trusts, etc. For a developing country, a good deal of Sri Lanka's financial system is "efficient" or "integrated" in that credit flows are based on market forces rather than government allocation. Efficient systems are self-perpetuating, or sustainable, because financial instrument prices and yields accurately reflect the elements of risk, liquidity and uncertainty:

> **"At any given moment or over an extended period of time, a surplus of funds may exist in one or more sectors of the economy. The cause of general economic efficiency will be served if the means exist to allocate the surplus funds under the control of one financial specialist to the customers of another type of financial specialist who have demand for credit."[3]**

In many countries, housing finance mobilizes surplus funds from households in the form of savings deposits. But in Sri Lanka, the government allocates and directs credit for the nation's largest savings bank. Housing finance institutions are government owned and dependant on a diminishing supply of government resources or high-cost/short-term debentures as sources of funds.

If one were to point to one of the principal shortcomings of the current program, it would have to be the low level of participation of private sector commercial banks. Although a very large 800 basis point spread was offered them as a financial incentive, these institutions pointed to *interest rate and liquidity risk* as the primary reason for their lack of interest. In Sri Lanka, commercial banks are almost exclusively short-term lenders, matching their asset maturities with their short-term liabilities. In short, the program did not *create the means to allocate surplus funds efficiently*. The risk factors mitigated this.



<u>New Fund Sources</u>
This example shows a mortgage lender selling loans to the capital markets by issuing its own mortgage-backed securities.

Faced with the prospect of privatization in the near future, what can Sri Lanka's housing finance institutions do to access long-term funds for housing, especially if traditional savings deposits are unavailable?

One solution is the mortgage banking model that has been used in the United States and elsewhere very successfully. The diagram above depicts how a mortgage lender originates loans. When the lender needs new capital to maintain lending operations, it "packages" the loans into a type of debt known as a "mortgage-backed security" or MBS. The securities are sold, often through an investment banker, to institutional investors such as pension funds,

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[3]James W. Christian, *Integrating Housing Finance into the National Finance Systems of Developing Countries*(New York: United Nations Centre for Human Settlements (Habitat), 1991), p. 36.

insurance companies, banks and unit trusts (even other mortgage lenders). Credit enhancements such as insurance, overcollateralization of the mortgage pool and bond ratings lessen the risks institutional investors perceived in a pure mortgage instrument. In essence, the *means is created* to allocate surplus funds efficiently.

In Sri Lanka, enough interest has been expressed by institutional investors, housing finance agencies and investment bankers to indicate that this type of system is not only feasible, but sustainable.

Using HG funds for Sustainable Low-Income Shelter

The system described above works because it converts a financial instrument that many investors perceive as risky into one where risk is mitigated. In particular, these MBSs are generally tradeable in a secondary market, thus reducing liquidity risk. The risk is shared amongst the loan originators, credit enhancers (e.g., insurance) and speculators; the basis for an efficient allocation of funds has been set.

Conceptually, this system can be applied to low-income shelter provided certain credit enhancements are added to the process. Under the current framework, the HG program would support primary mortgage lenders such as the SMIB and the HDFC. They and other lenders willing to make low-income home mortgages could refinance the loans through the CBSL window. Working with the investment community, and in coordination with the Financial Markets program, USAID will provide these institutions with TA&T necessary for them to issue mortgage-backed securities to capital market investors.

An important element of the program will be the capitalization, with HG funds, of a low-income mortgage insurance fund. This fund may be split to insure lenders (and owners thereof) against default by homeowners and to insure investors against default on the securities issued against the low-income loans. *If the fund is managed by a GSL-owned insurance company, this framework could assist in rationalizing the public sector's role in housing finance.*

As the system grows and the efficacy of MBSs is proven, the need for a conduit organization (such as Fannie Mae in the U.S.) may arise. Likewise, a bond rating agency may prove useful to further development of this market. These are natural progressions in the evolution of the market which USAID will encourage.

This program is compatible with the Mission's current strategic objective #1:

> **Broad-based economic growth--increased opportunity for people to participate in, and benefit from, a growing market-oriented economy.**

The following table summarizes the elements of the low-income housing program under a new PDP:

Function	Name of Organization	HG Loan	Responsibilities
GSL Counterpart	Secretary to the HFSC and Director of Dept. of Natl. Planning, MPPI		Oversight; monitoring policy reforms.
Borrower	Ministry of Finance		Onlender of funds; guaranty to the USG.
Lenders	SMIB, HDFC and other credit institutions making *mortgage* loans.	$10 million for low-income housing mortgage loans.	Lending to homeowners; selling mortgages as MBSs.
Grantor	NHDA	$2 million for grants to families below 25th percentile	Beneficiary selection; reporting.
Mortgage Insurance/pool insurance	Either a new firm or an existing Sri Lankan insurance company.	$3 million in capitalization	Insure owners of mortgages against default by homeowner/ insure investors against loss on default of securities.
Conduit	To be formed as need and market forces dictate in future		Purchase loans from many originators; issue securities; set standards.
Debt rating agency	To be formed or imported as market forces dictate		Credit enhancement for debt issues.
Trustee	Commercial Bank or qualified law firm		Fiduciary for investors.

It is important to note that the first phase of the HG-004 program saw over 31% of all loans made go to women-headed households (well known as superior credit risks). The new PDP planned for the second phase should build on the gains made under the first phase in terms of reaching women borrowers.

There will be certain policy agenda items that will need to be negotiated with the GSL. These items will become conditions precedent to further borrowings and are deemed important to create an investment environment conducive to the issuance of long-term mortgage-backed securities and the development of a sustainable housing finance system:

Policy Agenda for HG-004 (Second Tranche)	
Policy Item	Action Needed
Land title registration	Commit to delivering clear title to low-income families currently on occupancy permits.
Taxes on Mortgage sales and securities issues	Exemption for low-income mortgages and securities backed with low-income mortgages.
Disincentives to investments in mortgages and real estate.	Report by the HFSC on findings and recommendations for removal.
Regulation and supervision of housing finance system	Report by the HFSC on recommendations for establishing regulations and supervision.

Technical assistance and training under this program will be funded through existing Mission programs and RHUDO contributions. TA&T breaks down as follows:

TA&T	LOE	FY'95	FY'96	Total
USPSC Technical Advisor	8 pm	$82,000	$82,000	$164,000
Research and develop new PDP	1 pm	32,000	0	32,000
HFSC Staffing	Funding	24,400	4,400	28,800
Assist HFSC develop regulation & super. recommend's	2 pm	64,000	0	64,000
Assistance to HFSC to promote title registration CP	2 pm	64,000	0	64,000
Assistance to make operational mortgage insurance funds	3 pm	64,000	32,000	96,000
Loan securitization: structuring and servicing TA&T	3 pm	64,000	32,000	96,000
Managing Interest rate risk training	1 pm	0	32,000	32,000
TOTALS		$394,400	$182,400	$576,800

Based on realistic assumptions on the time needed to negotiate the new PDP and the expected funding levels from lenders, the program should begin in April 1995 and complete funding by September 1996.