Public/Private Partnerships for Housing Finance

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One could say that most of housing finance is a public/private partnership. Certainly the public sector has to create an environment supportive of the rule of law, where voluntary contracts can be enforced. In the case of the financial system, it has to provide a system of governance that creates trust in the intermediaries between the savers and the borrowers, like the banks or insurance companies.

The big question is whether housing finance involves an extra set of issues that require further governmental intrusion and institutions that are actually jointly owned, governed and/or operated by the public and private sectors. Such institutions are pretty common. In the US, we have a significant number of them, including broadly FHA, GNMA, FNMA, FHLMC, and the Federal Home Loan Banks. Some are actually government entities, but working closely with the private sector, while others are what we call, Government-sponsored enterprises or GSEs. The HFC here in Ghana would be considered a GSE.

What is the proper role of a public/private enterprise in housing finance. How well do they tend to work? Are they are good things on net? To jump ahead for a moment, let me say that the answer is probably yes, no, and maybe, depending on the exact circumstances. The hard question is recognizing the circumstances under which each answer applies.

Let me start from the beginning. I think that 40 years ago, as many countries began to emerge from colonialism, the feeling was that the private sector would not be able to make all of the complex arrangements and connections needed to provide funding for housing and so the government needed to do the job, usually directly out of the government s funds. I think after 20 years or so, it was recognized that, whether or not the private sector could or would provide housing finance, the public sector was not much of an option either, mostly because of the high costs and losses it created.

In the worst cases, the government itself made the loans at a subsidized rate and did not enforce repayment. In that case, not only did people borrow more than they needed, but they learned that loans do not need to be repaid, thus undermining the development of a credit culture where private lenders can trust borrowers to make every effort to repay.

This is sort of where things stood in the old days of public provision of housing finance.

And this sort of government-run lending has just about disappeared.

This is progress. The focus has shifted to what the public sector can do to harness the funding and efficiency of the private sector for the purpose of meeting the public commitment to the existence of housing finance.

As noted, there are plenty of things that the public sector can do along these lines, starting with providing the strong legal infrastructure needed to support private housing finance. The government can also do such things as offer deposit insurance to build trust in the banks, it can offer mortgage insurance to build trust in the borrower, it can offer pool insurance (pools of mortgages, not swimming pools!) to build trust in a secondary market, or it can set up its own secondary market directly. One key question is whether these things are better than the old-style direct intervention in the market. Another question is whether pursuing these objectives through a public-private enterprise is better than through a completely public one.

In fact, all of these actions and even more have been undertaken in the US, so we have first-hand experience with them. But there is also a good bit of experience elsewhere, so there is a lot to learn in general.

Before looking at specific instances of public intervention, let s for a moment consider the general pros and cons. The pros:

P1. Interjects a social policy objective into the process.

P2. Captures additional economies of scale.

P3. Overcomes other failures of an atomistic marketplace.

These last two are the usual arguments for special intervention in the housing finance market.

The cons include:

C1. Introduces political considerations in the allocation of benefits.

C2. Introduces political considerations in staffing and operation.

C3. Encourages excessive risk-taking.

C4. Shifts flows of capital to less valuable investments.

All of these can be illustrated by reference to the Federal Housing Administration (FHA) mortgage insurance programs in the US.

Pro 1. Created confidence in mortgage lending after the ravages of the Great Depression.

Pro 2. Permitted pooling of risk across the whole country, thereby reducing the premium needed to keep the program actuarially sound.

Pro 3. Created experience with long-term, self-amortizing mortgages (before had been generally 5 years at a time and non-amortizing).

Con 1. Apartment developers wanted part of this benefit, so lobbied hard for very risky programs.

Con 2. Fortunately, the US civil service is pretty immune to this. But still affects the top administrative staff.

Con 3. As a market becomes overbuilt or over-priced, private mortgage insurers often become more cautious, but FHA still absorbs new business. Also, FHA took the risky step of tacking on the premium up-front and insuring it. But it was required to be self supporting and thus loss-generating activities were self-limiting.

Con 4. Too many apartments in the 1950s, too little saving in general because of low requirements for a downpayment?

On net, I think that most people count the creation of FHA as a big positive for housing finance in the US, even while some argue that it no longer is appropriate.

But the FHA was and is a public enterprise entirely. Would it have been even better as a public/private partnerships or a GSE? In general, what are there advantages and disadvantages relative to purely public or private entities?

This question is important, because there s a new model floating around developing countries and donor organizations. That s one where governments lend their money and prestige to private sector entities that are designed to close one or another apparent flaw in the system. Examples include the HFC, Cagamas in Malaysia, the Caisse de Refinancement de Hypothecaire in France, and the National Housing Finance Corporation in South Africa.

The intent is primarily to plug holes in the system, where arguably the private market has failed, usually for specific reasons that are identified before moving ahead. And it is trying to do it in a way that minimizes the burdens of being a public effort and approximates the incentives faced by a truly private entity.

How well does it work? I look forward to hearing what Mrs. Ansah has to say about the difficulties of wearing both a private and public hat. I don t think it s as easy as wearing only one or the other. But there are a lot of short-run success stories, so it is an intriguing model.

Let s go back to the pro s and con s listed above. Are they better or worse with a public/private structure rather than a purely public or private endeavor?

Pros:

P1. *Interjects a social policy objective into the process.*

This is possibly weaker than for a public/private entity, because of private investors risk aversion and profit motivation. The solution is generally to start off with primarily public control and establish the course before becoming more private.

In the case of FHA, it is not seen today as solving imperfections in the marketplace, but primarily as a tool of a policy directed at encouraging homeownership. In this regard, it must remain basically public.

P2. *Captures economies of scale*.

This appeals to the private sector, especially if the private investors are from the housing finance industry and benefit from the entity s activities. When this is the main purpose, it seems appropriate to have private participation.

P3. *Overcomes other failures of an atomistic marketplace*.

The same perspective as P2.

Cons:

C1. *Introduces political considerations in the allocation of benefits (redistribution).*

Interjecting a private element reduces the potential for redistribution or any substantive subsidy. In fact, benefits generally go first to industry and only through competition end up with the public.

C2. *Introduces political considerations in staffing and operation.*

Private interests being involved severely limits the scope for inefficient, politicized operation; it usually also removes the pay scale from civil servant constraints. There is one downside, however. By their nature, public/private partnerships in housing finance are usually monopolies. This undermines the pressures on the entity to operate as efficiently as possible or with the most benefits flowing to the public.

C3. *Encourages excessive risk-taking*.

In general, a private sector voice would discourage risk-taking. But if the private voice represents interests such as lenders who are shifting risk away from themselves, it is possible that having a private ownership element would expand risk taking. The key concern is the degree to which the private sector interests have such inherent conflicts of interest. This is a good reason why any entity that is taking on significant risks from the private sector, such as FHA, should not be a P/P partnership.

C4. *Shifts flows of capital to less valuable investments.*

This negative depends on the degree to which the services of the entity are underpriced and to what degree the goal is to specifically cause more housing. As in the case of C3, private interests will push underpricing only if they are the beneficiaries of it.

This analysis seems to confirm the potential for public/private partnerships to achieve the best of both worlds, preserving the social objectives of the entity and bringing to bear the private incentives to pursue such objectives more efficiently and effectively. It also highlights the downside, whereby letting the housing finance industry have a say in operation can permit to use the resources, prestige, and potentially the credit rating of the Government for the narrow private interests of lenders, homebuilders and other potential investors.

A good example of these considerations are secondary market institutions. These are not intended primarily to redistribute wealth, but rather to deal with what are perceived to be extra difficulties that housing finance faces because of the longer terms and illiquidity. They are claimed to require government intervention because of the uncertainties and economies of the scale (but that does not always seem to be the case). However, there is no reason why the secondary market should not be operated on a commercial basis and with a large amount of input and control by the private sector, especially the housing finance sector itself.

A couple of examples of P/P partnerships that are secondary market institutions are the Federal Home Loan Banks (FHLB) and Fannie Mae. The FHLBs are liquidity facilities that were started by the government, but gradually sold to the lenders themselves. Today they function as sort of cooperatives for efficient access to wholesale funds, allowing economies of scale of bond issuance and also some remaining benefit from an implicit government guarantee.

Fannie Mae also started off as a government entity, but is today even more private than the FHLBs. Because of that, it acts an aggressive entrepreneur, but in doing so passes on most of its benefits to the public, while operating as efficient a secondary market as possible.

I think, however, that there is more to be learned in this regard over time, and the ideal roles for public and private entities actually depends a lot on the specific goals of a project and the specific cultural and institutional strengths and weaknesses in a country. I would be glad to discuss what I know about a number of specific public/private partnerships elsewhere as it is useful to the discussion.

I hope that this has raised the key issues that need to be examined in this session and I look forward to learning from the perspectives and experiences of all of the participants.