TDY FINAL REPORT

TECHNICAL ASSISTANCE TO THE NATIONAL HOUSING FINANCE CORPORATION (NHFC) AND SECONDARY MORTGAGE MARKETS

NOVEMBER 1998

This publication was produced for review by the United States Agency for International Development. It was prepared by Chemonics International.

TECHNICAL ASSISTANCE TO THE NATIONAL HOUSING FINANCE CORPORATION (NHFC) AND SECONDARY MORTGAGE MARKETS

A TASK ORDER UNDER THE EUP ENVIRONMENTAL AND URBAN PROGRAMS SUPPORT IQC
CONTRACT NO. PCE-1008-I-00-6006-00, DELIVERY ORDER NO. 805

TDY REPORT

For: USAID/RUDO/South Africa
From: Claude J.J. Bovet
Date: November 1998

Consulting activities were conducted in South Africa between November 15 and 22, 1998. These involved furthering USAID's program of assistance in the housing finance area through a series of individual and general meetings and talks with local counterparts. Pursuant to the corresponding Scope of Work and to additional requests received from the local counterparts, the consultancy covered the following subjects:

- Advice on the National Housing Finance Corporation (NHFC)'s Project Gateway
- Promotion of the Secondary Market Concept
- Proposals for incremental shelter lending for low-income groups
- Encouragement and facilitation of community savings groups
- Linking governmental home subsidies to a formal savings scheme
- Use of vouchers for subsidies and for slum relocation programs

The agenda in Cape Town consisted of a series of individual meetings and subject matter discussions with members of parliament and other housing related persons. These meetings were assisted by Dr. Angela Tait, advisor to Parliament's Housing Portfolio Committee.

The agenda in Johannesburg included: (a) a round-table discussion with members of the African Union for Housing Finance (AUHF) and the Banking Council; (b) individual meetings with NHFC staff and financial advisors; and (c) a formal presentation and question-and-answers session at a workshop convened by NHFC for the benefit of public and private sector entities involved in its Project Gateway.

Overall, it was felt that the various subjects treated were well understood by the parties concerned and that, political will obtaining, progress can be made in furthering the twin goals of secondary home loan market development and of low-income housing promotion.

The low-income lending and related proposals covered with local counterparts are included in the attached aide-memoire prepared at the request of MP Ben Turok of Parliament's Finance Portfolio Committee.

Project Gateway

As developed by NHFC, Project Gateway is well structured and very professionally researched. Assuming the validity of its underlying market assumptions, it is to be expected that it will reach its objective of successfully securitizing the mortgage loans originated by it. But, none the less, it must be emphasized that, as a first market opening effort, Project Gateway is targeting a more financially viable—but small—segment of the population in need of housing finance. Ant that, in consequence, it is limited to serving those families and individuals that are and have been in regular employment over a period of years and who, in addition, can muster own funds equal to at least fifty percent of the purchase price of their home.

Thus, Project Gateway—for the time being at least—will not reach out to those families and individuals unable to meet the above conditions. For these, and especially for those in slums and in the informal sector, the suggestions contained in the attached aide-memoire were reviewed and discussed with local counterparts at my various meetings and workshop presentations.

List of Entities and Persons Contacted
South Africa - November 1998

Parliament	
MP Nomatyala Hangana	Chairperson, Housing Portfolio Committee
MP Mary Turok	Member, Housing Portfolio Committee
MP Ben Turok	Member, Finance Portfolio Committee
Dr. Angela Tait	Advisor, Housing Portfolio Committee
Credit and Savings Help Bank (CASHBANK)	
Ms. Christine Glover	Managing Director
African Harvest Capital	
Mr. Michael Leeman	Director, and also a director of NHFC's Project Gateway
Mr. Reyburn Hendricks	Director
The Banking Council	
Mr. Robert Tucker	Managing Director
Ms. Mary Tomlinson	General Manager, Housing
Mr. Brian Leveson	Counsel
African Union for Housing Finance (AUHF)	
Ms. Sharon Trail	Secretary General
Ms. Felicity Cawley	Assistant Secretary General
Mr. Cas Coovadia	Director
Mr. Denis Creighton	SERVCON
NURCHA	
Mr. Cedric de Beer	Managing Director
National Housing Finance Corporation	
Dr. David Porteous	Senior General Manager
Mr. Morgan Pillay	General Manager, Niche Market Lending
Other senior staff	
Standard Corporate and Merchant Bank – NHFC's capital placement advisors	
Mr. Fred Teeling-Smith	Departmental Manager, Corporate Finance Division
Mr. Paul Hewatt	
Abt Associates South Africa	
Ms. Teresa Hillary Clarke	Managing Director
USAID/RUDO/South Africa	
Ms. Carleene Dei	Director
Mr. Joel Kolker	

Entities represented at the NHFC workshop

Ministry of Finance
Banking Council
Home Loan Guarantee Corporation (HLGC)
Several banks and housing related institutions
USAID/RUDO
Media

NOTES FOR CONSIDERATION
ON HOUSING FINANCE FOR LOW-INCOME HOUSEHOLDS
IN THE REPUBLIC OF SOUTH AFRICA

DEVELOPING A SECONDARY MARKET FOR LOW-INCOME HOME LOANS

Main Features for a Proposed Solution

- Bulk-up credit demands of low-income borrowers through the intervention of "demand organizers". Organizing borrowers into community level groups with a high degree of group cohesion and identification will result in a strengthening of their members financial discipline, an enhanced collective and individual credit-worthiness and an ensueing reduction in underwriting and servicing costs; all items conducive to a greater borrowing capacity.
- Require prior savings from potential borrowers before qualifying for a loan, both to prove their financial discipline, to contribute to their own financing needs and to provide security for outside borrowings.
- Restructure the government's subsidy schemes to further encourage and strengthen the savings and borrowing capacity of lower income groups.

Low-income borrowings

Slum and other low-income community borrowings for infrastructure purposes (water, sewerage and sanitation, as well as roads, storm drainage and other community facilities) can be structured to meet both the needs of the borrowers and the requirements of lenders.

Key elements for low-income infrastructure lending are:
- A bottom-up solution (where interested borrowers provide new and appropriate incentives to encourage lenders and investors to understand and meet their borrowing objectives and repayment abilities), instead of the usual top-down solution (where governments try to direct bank credit to meet their own perception of how lower income credit needs are to be met).
- An active community participation within a properly structured and functioning communal or group organization.
- That a parallel contribution be forthcoming from the borrowers themselves, whether from a savings program as described below, or by a combination of such savings and an in-kind labor participation
- That they be restricted to amounts that can be properly serviced by the borrowers under current market conditions, including a gradual and incremental phasing of both the loans and the improvements they are designed to finance in those cases where borrowers lack the capacity to service a more comprehensive development.
- Governmental subsidies presently available can be redesigned to help reduce the size of these loans, while also stimulating a more profound and widespread savings effort by the borrowers themselves (as described below in greater detail)

A system of successive incremental loans is particularly appropriate to loans in upgradeable slum areas. And it is similarly appropriate for low-income households with insufficient savings and earnings capacity to justify the purchase of finished homes in fully developed neighbourhoods.

An incremental loan facility favors both the borrower and the lender. For the borrower, it allows individual loans to be kept within more manageable amounts and repayment terms, while gradually building a credit history and a consequently enhanced borrowing capacity. For the lender, it allows quicker recovery periods, thus affording basic rate protection, as well as avoiding the usual "borrow short, lend long" mismatch between their assets and liabilities which normally appears in long-term mortgage lending. It also provides an opportunity to confirm repayment history before each renewal. In essence, this is no different from credit card credits where borrowing limits are periodically reviewed and increased subject to performance.

Savings Groups

Under the principle that outside financial assistance, to be effective and adequately secured, can only proceed as a complement and not as a substitute to the borrowers' own efforts, the establishment of an appropriate savings program becomes essential in the case of slums and low-income communities. An essential characteristic of these savings groups designed to support outside financial borrowings is that they serve to accumulate the down-payments required for the project, as well as to demonstrate the group's capacity to save on a regular basis over a relatively extended period of time. And it is this demonstrated capacity that will help provide outside lenders with the necessary confidence to make these, hitherto unaccustomed, loans.

The exact nature, extent and management of these savings programs must be left to the members of the slum and community groups themselves. But here also, demand organizers (as described below) can play a constructive role in helping to set-up and provide initial guidance to them. Government's role, for its part, is to encourage the formation and operation of such community savings (and loan) groups, relieving them from those formalities, requirements and restrictions that are more suitable and applicable to full fledged financial institutions. Stokvels provide a good precedent.

Demand Organizers

The goal of bringing low-income households into the formal financial sector necessitates their being organized and grouped into credible (i.e. creditworthy) and profitable borrowing units that are also large enough to support the fixed operating costs of the system. To this end, help by "Demand Organizers" can make all the difference.

Typical demand organizers include most of the entities and individuals, such as micro-finance companies, savings groups and NGOs, already working within the lower-income population, as well as new entrepreneurs discovering business opportunities in the informal sector..

The role of demand organizers is to prepare low-income borrowing groups to structure and submit their credit requirements in form and substance to overcome the main objections currently raised by formal financial institutions when considering (if at all) the lower-income groups. These objections and their overcoming measures are:

- Credit risk - Evaluating credit risk is a principal area where a demand organizer can considerably help to reduce a lender's misgivings and lack of familiarity with low-income lending. First, by selecting, evaluating, organizing and managing the borrowing pool, a demand organizer is well placed to secure timely fulfillment of all borrower obligations. And secondly, to the extent that a lender's experience of working with a given demand organizer develops with few or nil defaults, it will come to place a growing reliance on the demand organizer's underwriting with a corresponding reduction of its own underwriting requirements and costs.
- Yield - Formal lenders' perception that small denomination loans to low-income groups must inevitably carry a lower interest rate than conventional loans, is not borne out by the facts. Lower interest rates are expected by prospective borrowers only when governments directly sponsor these, usually through indirect subsidy schemes. It is a proven fact that when low-income borrowers incur debts other than on government sponsored borrowings, they do so at market and even higher rates. The proposal for demand-organizer sponsored loans as suggested herein is very definitely based on market rates and terms.
- Transaction costs - Banks and financial institutions in general are reluctant to consider loan applications for relatively small amounts. Their reluctance is based on the grounds that it is just as costly (if not more so) to evaluate a small denomination loan as it is a larger one, with the inevitable consequence of an increase in their origination costs for a given investment. Demand organizers can play an important role in overcoming this constraint. To the extent that they can effectively evaluate potential borrowers and suitably document their loan applications, they relieve the lender from these costs. Also, inasmuch as demand organizers are much closer to and knowledgeable of the prospective borrowers, their costs are expected to be considerably lower than those of a formal financial institution.
- Collection costs - The same applies to collection costs as to transaction costs. Where the service and recovery of small denomination loans can be expensive for a formal financial institution, a demand organizer dealing directly with the savings/borrower group can ensure that these tasks are performed more efficiently and at greatly reduced costs, to the corresponding relief of the lender.
- Follow-on relationships – Formal financial institutions do not normally see low-income lending as generating follow-on business relationships. But this is not necessariliy the case. Initially, repeat business will naturally flow from incremental type lending. Also, new business originating from established demand organizers can clearly be expected. And who can deny that this low-income population represents the future majority market?

REWARD-BASED HOUSING SUBSIDIES

Current System

Housing subsidies are given by government as an "entitlement" based on beneficiaries' low income levels. As such, recipients take them as a "right" not subject to any prior effort on their part and, in most cases, even without acknowledging their nature as an "aid" to them.

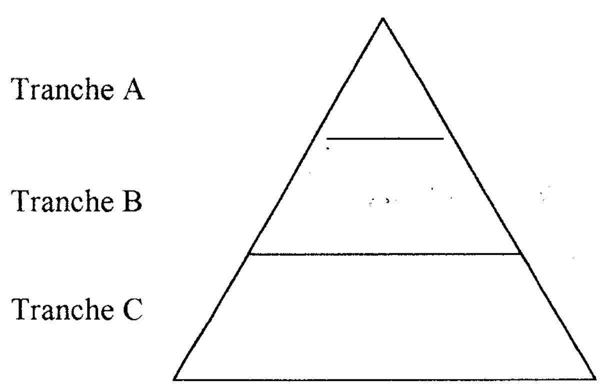
Recommended Improvement

Link the subsidies program to a prior savings effort by intended beneficiaries and deliver subsidies: (a) on a "reward" basis; and (b) through a properly focused and fully transparent points system.

The advantages of this system are many:

- Individual savings, aside from helping to qualify applicants, aggregate a new and growing deposit base for mortgage financing.
- They provide government with improved tools for targeting the population sectors to be helped, both as to income levels, geographic distribution and urban or rural requirements.
- They can be made "progressive", i.e. increasingly loaded in favour of progressively lower income groups.

The following triangle and chart provide an example of progressivity. They illustrate, for each of the three tranches shown: the level of home prices considered; the proportion of government funding applied to each tranche; the savings component required of subsidy applicants at each level of home prices applied for; and the subsidy and loan components applicable to each level.



Tranche	Home Price	Funding	Savings	Subsidy	Loan
A	Upper	1/9 of total	35%	15%	50%
B	Middle	3/9 of total	25%	25%	50%
C	Lower	4/9 of total	15%	35%	50%

SUBSIDY AND RELOCATION VOUCHERS

The use of vouchers in the case of home subsidies has many advantages. Typically, these vouchers can have a duration of several months (e.g. 18 or 24). During this period, the beneficiary has an opportunity to shop around for the home of his choice. This has the first consequence of placing on him the responsibility (and therefore acceptance) of his choice, eliminating the eventual rejection normally found in government provided solutions. But perhaps even more importantly, it also sends a message to potential developers that here are buyers with an immediate purchasing power (based on their qualifying savings, the subsidy voucher and enhanced loan potential). This stimulates competition among developers and home builders, both as to quality and price, resulting in an expanded diversity of choice and in lowered costs overall. In other countries, such a system has contributed greatly to increased housing production, with its attendant jobs creation, industrial development and commercial stimulation.

A voucher system would also be an improvement, in the case of slum relocations, over the traditional system of relocating dwellers in government provided stands. Again, the choice provided to relocating households by the voucher system would go a long way to obviating the drama, personal losses and eventual complaints usually accompanying forced relocations.
