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February 14, 1979

I N T E R I M R E P O R T

to

Mario Pita, Chief,
RHUDO/PSA, Panama City, Panama

from

Marlo J. Schram, Consultant

for

Latin American Development Corporation

Contract No. AID/otr-C-1655

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I N T E R I M R E P O R T

TO: Mario Pita, Chief,
RHUDO/Panama & South America

FROM: Marlo J. Schram, Consultant



This report is made as required by Article V of our Indefinite Quantity Contract No. AID/otr-C-1655, Work Order No. 1, at the end of my first one-week trip to Panama as the consultant for the Contractor. I am including herein the analysis I have made of the operations of the National Mortgage Bank of Panama, a resumé of the recommendations I made to that institution (hereinafter referred to as "BHN" or "the bank"), the additional information I obtained which could influence the future relationship between AID and the BHN and the recommendations I wish to make to AID with regard to that relationship and the successful development of a secondary mortgage market in Panama.

Inasmuch as the current situation of the BHN reveals serious problems which could affect its survival as a financial institution, it is obviously unwise to comply literally with Article V and send just one report, produced for both AID and the BHN in English and Spanish respectively. Therefore, as the report in Spanish, I am enclosing five copies of a simple review of the recommendations I made to the BHN to guide it in its activities in developing the secondary mortgage market during the six week period that will transpire until I return to Panama to provide additional assistance to the bank. I will appreciate your kind cooperation in delivering the five copies of the report in Spanish to the BHN so that we will be in compliance with the 21 day time limit set in Article V.

In view of AID's well established commitments to the BHN as the financial arm of the Ministry of Housing (MI-VI) and as the central agency controlling Panama's savings and loan system, I think it important to provide for the record my opinion as to the condition of the BHN, why it is in the plight in which we now find it, what could be done to save it and why it would be disastrous for Panama and unwise for AID to abandon its long standing efforts to develop financial independence and institutional autonomy for the bank. The fact that I have been involved intermittently in the matter of developing facilities for the financing of housing in Panama since writing its first savings and loan law in 1962 enables me to view its present situation in the light of 16 years of AID's effort to create a viable system of housing finance in that country. I also bring to this analysis my most recent close involvement in the matter, having worked since September of 1977 in developing secondary mortgage market techniques for the BHN.

I

BHN'S EFFORTS TO COMPLY WITH AID'S REQUIREMENTS

For the past year, the BHN has been aware of the nature of the AID requirements which would be conditions precedent to obtaining the financing involved in the so-called URBE Loan. The specific conditions were stated in a letter to the bank from Chief of RHUDO/PSA, John Kilgore, dated May 5, 1978, and this was confirmed in the project paper sent on June 27, 1978, to the then general manager of the BHN from the Office of Housing in AID/Washington. Page 92 of that document contains the following statement:

"Conditions Precedent to Signing the HIG Agreement (\$5.4 million)

The National Housing Bank (BHN) shall provide, in form and substance satisfactory to AID, evidence that it has the necessary administrative authority and responsibility to carry out its role in the Project and that it has adequately planned for its future financial development. This evidence shall consist, inter alia, of duly approved internal regulations, an external audit of BHN's financial position, and a plan for development of the Bank as a self sustaining financial institution."

The management of the BHN has made every possible effort to comply with these conditions, seeking to obtain the right to operate with the degree of autonomy to handle its own affairs, plan and budget its own operations and become self-sustaining. AID has known for at least a year that the Ministry of Housing has refused to relinquish the absolute control it exercises over the activities of the BHN. The former general manager of the bank had been trying diligently to develop sound fiscal management and new sources of income and working capital for the BHN. The only result of these efforts was the removal of the manager in October, 1978, soon after the national elections in Panama. However, the newly named general manager is also trying to establish orderly administrative methods and sound fiscal policies for the BHN. As a result, he has also incurred the ire of the Ministry of Housing and has appealed to the president and vice president of Panama for support in his efforts to comply with the conditions precedent to the AID loan guaranty.

AID's persistence has finally obtained the external audit called for in the conditions precedent. That audit for the calendar year 1977 confirms with facts and figures the information which was already known in general terms, namely that the BHN is used by the Ministry of Housing to pay for a large part of its operating expenses and all of the cost of the projects the MI-VI decides to build. All of the payments are ordered by the MI-VI without any relationship established between the money spent and the limited income the MI-VI permits the BHN to obtain. This is a foreseeable result any time a governmental institution designed to produce subsidized housing is permitted to control the income and outgo of a financial institution which is basically a private enterprise organization in nature. The financial institution is used to accumulate the financing deficits until it is either destroyed by its debts or reorganized to begin the process anew. In either case, the public housing

institution or branch of the government is able to produce more housing than its limited finances would permit, it retains its prestige at a level which satisfies the personalities involved and its destroyed financial puppet is buried along with the blame for the financial incontinence for which it was in no way responsible.

Briefly stated, the audit confirms that:

- 1) The BHN's loss during the calendar year 1977 was \$4,051,861 and the cumulative loss at the end of the year was \$6,533,009. I can add that the loss for 1978 was undoubtedly larger than that for 1977 (the books for 1978 have not yet been closed) and January of 1979 was also a losing month. This situation will continue as long as the MI-VI is permitted to force the BHN to issue the checks the MI-VI wants it to issue.
- 2) The BHN is being forced to operate with no budget of future obligations, no certainty or schedule of future income and with no control over new borrowings or financial commitments.
- 3) The BHN owed approximately \$180,000,000 at the end of 1977. I can add that by the end of 1978 it owed at least \$220,000,000.
- 4) The titles to the property formerly owned by the now-defunct public housing institution (IVU) which, by a law, were declared to be assets of the BHN, have never been legally transferred to the bank.
- 5) There is no way to determine if the complete income from the rents and the so-called mortgages of the now non-existent IVU is being collected by the MI-VI and deposited into the bank accounts of the BHN. It is known that the MI-VI, as a matter of policy, does not foreclose or dispossess delinquent occupants of the housing which is supposed to be the property and a source of income of the BHN. Therefore, it is obvious that there must be a relatively high amount of housing which is in arrears in payments. I can add that the BHN has endeavored to obtain the mortgages and the information needed to establish its real assets but the Ministry of Housing can not or will not disclose this information.
- 6) Although the BHN has never received the legal ownership of the land and housing to which it is entitled, it has been required by the MI-VI to transfer more than \$5,500,000 in land and project costs and advances to contractors.
- 7) It is known that over \$60,000,000 in IVU-built housing is occupied by owners who have never signed mortgages. The BHN thus has no mortgage rights to protect its interest in these properties.
- 8) For various reasons, usually involved in poor financial planning of projects by the MI-VI, the sales prices of housing built by the Ministry in many projects are less than the real cost of the units. In the cases where this can be verified, the advances made by the BHN exceed the sales prices by approximately \$4,800,000 and the deficit cannot be recovered because the sales had already been consummated.

- 9) As of 1977, loans had been made by the BHN to savings and loan associations, for projects in which AID was involved in the financing, in the amount of \$6,776,082. The BHN is responsible for the debt service and, while the S&Ls credit the savings accounts of the BHN in the associations with the amortizations and interest collected, \$2,840,000 in mortgage payment were in arrears. The BHN and the S&Ls have never had adequate technical assistance in the development of a sound S&L system, all S&Ls have liquidity problems and the BHN has no reserve for the possible losses it may sustain.

We can be sure that this unsatisfactory condition will continue to be shown by the BHN until the absolute control which the MI-VI exercises over the income and expenditures of the bank is terminated. Neither the BHN nor the MI-VI seems to be able to prepare a budget which establishes projected income and expenditures for any given period of time. The bank's inability to do so is understandable because the information must come from the MI-VI which does not have it. Why the MI-VI does not have this information is obviously the result of the operating methods used by the Ministry. As long as this type of control over the financial institution which must serve the MI-VI is continued, no institution which might take the place of the BHN after that institution is destroyed can ever hope to survive.

Perhaps the most significant information we can glean from the recent change in the management of the BHN and the events which took place almost at once in the relationship between the Minister of Housing and the new general manager of the BHN is this:

- a) The relationship will always deteriorate as soon as any manager of the BHN disagrees with the way the MI-VI forces the bank to operate; and
- b) Unless the general manager of the BHN, whoever he is, refuses to run the bank in the way the MI-VI wishes it to operate, the bank cannot ever be a viable financial institution.

With regard to the other conditions precedent to the URBE Loan, the BHN has encountered the same roadblocks from the same source. The management of the bank has prepared its internal regulations. But the president and legal representative of the BHN are the same personage -- the Minister of Housing. The so-called board of the BHN is made up of the Minister of Housing, the Minister of Planning, the Minister of Labor and the head of the Banco Nacional of Panama (the equivalent of the Central Bank of Panama). All are very busy, they rarely meet and the delay in getting approvals from the board is long term and unpredictable. As for developing financial autonomy for the BHN, the general manager who tried to do so lost his job and the one who is now carrying on the effort may well suffer the same fate.

II

RECOMMENDATIONS

- 1) Based on the foregoing observations, it seems clear that the most effective recommendation for making the BHN a sound and respected financial institution is for AID to devote its maximum efforts to obtain administrative freedom for the bank. The new general manager is a knowledgeable banker and he is trying to surround himself with capable assistance. He appears to have more powerful political backing than the deposed manager had. With strong backing from AID, directed to the highest level in the Panamanian government, the new administration in the BHN can be put in the position of truly running the affairs of the bank so as to develop the institution into a respected financial arm of the Ministry of Housing. The BHN would then also be able to build the S&L system into the effective financier of low and middle cost housing it was intended to be.

In my opinion, the only way in which the BHN can be relieved of the unbearable financial position in which the MI-VI continually places it would be for the U. S. ambassador and the director of USAID/Panama to make a joint appeal to the president and vice president of Panama to give the BHN the status of an autonomous institution. Until an amendment to the organic law of the BHN can be passed, giving the legal representation of the bank to its general manager, the same change can be made by a simple delegation of that authority to the manager by the Executive Committee of the bank, a procedure which is contained in the law as it now stands but which the Minister of Housing refuses to permit.

With this simple change, the BHN would have the ability to work as a bank should work, it would be able to keep its expenditures in line with its income and it would be able to seek additional sources of working capital while it develops new methods of obtaining income from its operations.

- 2) The most convenient and immediate source of both new working capital and additional income for the BHN is through the development of a secondary mortgage market. AID and I have been working toward this goal for the past 18 months. The method has been established, the documents printed, the personnel of the bank has been trained, contacts have been made with interested prospective investors and the management of the bank, past and present, were and are anxious to sell their mortgage-based securities as soon as they are permitted to do so with the continuity and efficiency that such a market needs.

The need for AID's help in developing autonomy for the BHN is emphasized by information which I received while in Panama last week. I had been informed that, after a year of effort by AID and by me through advice to the BHN and the MI-VI, the BHN had obtained a resolution from the bank's board of directors, signed by the Minister of Housing as president of that board, authorizing the bank to sell mortgages in the secondary mortgage market. It also authorized the S&Ls to make such sales under the control and direction of the BHN. This resolution was dated August 28, 1978,

was received by the BHN in September and I saw it on February 7, 1979. We could not find it in AID's files but I obtained a copy and RHUDO/PSA now has it. While it is technically such an authorization, it still denies the bank the means of developing an agile and effective market in that the Minister of Housing expressly retains the authority to sign each and every document, transfer, check, agreement, etc., involved in the administration of such a market. In addition, the wording of the resolution appears to require that the manager of the BHN must give to the board, as a condition precedent to making any transactions, a prior detailed statement of what will be sold, for how much, under what terms, for how long and to whom . . . an obvious impossibility. No investor will wait, money in hand, until the market gets such permission to accept the investment. And the S&Ls will not put themselves in the position of negotiating sales and then being delayed by the lack of a signature (as they now are in all transactions with the BHN because the manager cannot sign anything) or rejected because the market has no continuity.

Therefore, the BHN has been waiting since the new manager was named last October for me to guide it in this new situation. I have been ready and waiting to do so but AID did not authorize the assistance until four months later. I have now informed the manager and the new officials of the BHN as to the methods by which the sales can be arranged for the contacts we had previously made for the marketing of BHN securities. However, a new complication has arisen. The BHN has been informed that the United Nations has obtained the GOP's approval to send a consultant to advise the BHN on secondary mortgage markets but the time of arrival, length of services, past experience and all other details are still unknown. The BHN does not want to wait and I have advised it as to how and with whom it can begin to negotiate mortgage sales. I have also offered my cooperation to the U. N. office in Panama in providing full information and background on the work done to date whenever their consultant is ready to come to Panama. But waiting for another round of investigations which will cover the same ground already covered by many committees and technical advisers will only add to the BHN's problems. I recommend that AID support the position of the bank and the advice I have given it to begin selling its securities with the techniques it now has.

- 3) The fastest way for the BHN to develop the secondary mortgage market and obtain new capital and income is to exploit the willingness of commercial banks to invest in BHN securities as the most convenient way to comply with the law which requires them to invest 50% of their deposits in housing loans. The contacts were made last year and the only reason why this market was not already opened was the lack of permission to make the sales. The bank will renew these contacts and the offers previously made and I will help them on my next trip to Panama. I have also advised the BHN to obtain the approval of the banking commission to allow the commercial banks to use the FHA-approved mortgages as government insured assets which can be deposited in custody of the Banco Nacional as part of the legal reserves of the commercial banks. This would give them an income from what is now a deposit which bears no interest at all. The bankers have told

us of their desire to support this request by the BHN which would greatly increase the productivity of the secondary mortgage market.

Proper development of the secondary mortgage market would make the S&Ls in Panama as dynamic a factor in the long term financing of low and middle cost housing as S&L systems have proven to be when well organized in other developing countries of Latin America. In addition, it must be recognized that the construction industry and the production of building materials are the largest source of employment for the unskilled and semi-skilled labor which forms the major part of Panama's work force. With the decline of the construction industry due to overbuilding of high-rise types of expensive housing for which there is no ready market in Panama, the resultant unemployment has created a serious social problem for the nation. Once again, AID's support of proper development of the BHN will provide benefits for many phases of the Panamanian economy.

- 4) Imitation is a form of flattery and the BHN can be flattered by the recognition of the method it will use in developing its mortgage market which has now come from an unexpected source. The Caja de Ahorros was one of the opposition to the idea of generating a secondary mortgage market by seeking the investing capacity of middle income people. To remove this opposition to our method of selling mortgage rights in FHA insured mortgages in small denominations on sight redemption terms with an upward moving scale of interest rates as an incentive for the permanence of the investments, I met with the manager and assistant manager of the Caja de Ahorros and explained in detail the value of the techniques which had proved so successful in Costa Rica and the Dominican Republic. On February 7, 1979, the Caja de Ahorros announced in newspaper ads and news items that it is now offering "Savings Certificates" to the public, redeemable at sight, offered in \$25, \$50 and \$100 denominations, with a scale of interest rates payable that increases with the length of the investment period. No better confirmation of the validity and viability of the methods I have developed for the BHN could be obtained and, while it would have been better for the BHN to have had the permission to be the first to use the technique when it was established for the bank a year ago, the offerings the bank can make now have additional advantages for the investor that will make it possible for the BHN to obtain the share of the market it needs even in the face of this prestigious competition.
- 5) At the request of the BHN, I am arranging to send its new assistant manager and general manager to Costa Rica for a few days each to study the efficiency and effectiveness of DECAP's secondary mortgage market and its performance as the central controlling institution of the Costa Rican S&L system. Both of these officials are convinced of the need for a secondary mortgage market and the BHN's ability to create it and a viable S&L system. I am arranging to let them see such an institution and activity in operation, particularly so that they can know how few people it takes to do an effective development job.
- 6) For the past 18 months, the BHN, AID and I have been trying to

obtain for the bank documentary evidence of the large portfolio of land titles, leases and mortgages which the BHN owns but has never seen. We have been told repeatedly that considerable progress was being made in developing the documentation, locating titles and curing defects which prevented recording of mortgages, etc. It is now clear that no material progress is being made by the MI-VI in these tasks and it is my opinion that the work will not be done until the BHN is given the authority to do it. I am mentioning this and other matters which show the difficulty of getting things done by the MI-VI as a way of providing background information to USAID officials who came on duty in recent months and may find it difficult to believe that what they hear from the Ministry of Housing with regard to financial matters and assets cannot be substantiated as factual.

- 7) I strongly recommend that AID be very cautious in permitting the MI-VI to obtain the use of committed and future AID-controlled funds for housing. The retention of financing is the only leverage which can put the MI-VI in a position where it has to act logically and perform in accordance with its commitments. This leverage, in my opinion, should be spent only after AID obtains a result which is desired. It should never be expended for an agreement to do something in the future.

I have already stressed the fact that the BHN is given no opportunity to guide its own affairs. I could provide many examples to amaze those who believe that logical things are done logically by capable people. Let me limit myself to just two more examples of how the MI-VI operates with regard to the BHN:

- a) A \$30,000,000 loan was negotiated with a foreign bank last year. The BHN was the borrower. The BHN learned about the loan for the first time two days before the loan was to be signed. The information came from a casual phone conversation from someone in the government, asking if the BHN was all prepared for the signing. Neither the manager or assistant manager knew that a loan was being negotiated, for what purposes, terms, time frame, etc.
- b) While I was in the BHN last week, I saw a recent notice from the Banco Nacional of Panama which informed the BHN that the bank account of the latter would be permitted a \$10,000,000 overdraft. Knowing nothing of the matter, the BHN made inquiries and learned that the Ministry had obtained an agreement from AID to permit an advance in that amount against future AID financing, the MI-VI had informed the Banco Nacional and arranged to be able to draw on that promise by charging the obligation to the BHN which, without knowing why, when, where and for what, will incur this liability which becomes a debt to be repaid by the BHN. However, the BHN has no assurance that a corresponding asset in the form of \$10,000,000 in cash will ever be given to the bank.

I share the BHN's concern about this matter but I, as a consultant for AID and the bank, am forced to wonder if the MI-VI's need for \$10,000,000 can still be used as leverage to obtain for the BHN enough autonomy to enable it to comply with the

"Conditions Precedent to Signing the HIG Agreement" for the \$5.4 million Shelter Component of the URBE Loan which I have already mentioned in this report. I do not know the answer but the question is certainly an interesting one which I do suggest merits investigation by AID at this time.

- 8) I strongly recommend to AID that it lend its support to the development of a dynamic and viable savings and loan system through the BHN. The bank has expressed the desire to make the changes necessary in the present system to build a sound operating method for the five S&Ls now under its control. The effort to create a good system of this type dates back to 1962 but the one essential factor which is needed for success in that undertaking is capable and experienced technical assistance. . . . and that has never been provided by AID in Panama, even though the principle of encouraging S&L development has been AID policy for the past two decades. The following is a quote from a report I made to AID on December 9, 1977, shortly after I began work under my previous contract with the BHN at AID's request:

"To convince anyone of the potential value of a well run S&L system to a developing country of approximately the same population size as Panama, it is only necessary to look at the S&L statistics of neighboring Costa Rica and compare them with those of the S&L system of Panama. The system in Panama has existed for approximately 15 years; that of Costa Rica began only 6 years ago. According to the latest statistics available, the whole S&L system in Panama financed an average of less than 8 housing units per month during the year 1976 and averaged only 12 housing units per month during the first half of 1977. Costa Rica's S&L system has been financing approximately 250 houses per month in 1977. Panama's S&Ls lent only \$934,000 in 1976 and \$734,000 during the first half of 1977. Costa Rica's system is lending more than \$30,000,000 per year for housing for low and middle income families. Approximately half of that capital is obtained through sales in its dynamic secondary mortgage market."

I can now tell you that Panama's S&Ls are doing less lending now than they did when that report was written and Costa Rica's system, with the same number of entities, is now lending at the rate of 350 units per month, with approximately \$20,000,000 per year in secondary mortgage market sales. Even though a substantial part of those sales are redeemable at sight, the rate of redemption has remained well under 5%.

The record will show that the Costa Rican system was built by me, from the writing of its organic law, through the development of its member units and operating methods and including the creation of its secondary mortgage market and marketing techniques. I can do the same for Panama. I therefore recommend that a small part of future financing through AID and/or the HIG Loan Program be designated for AID-approved technical assistance which I am ready and qualified to provide on an intermittent basis to build the S&L system into a financially powerful and independent factor for the long term financing of low and middle cost housing, under the control of a BHN with administrative autonomy.

- 9) The new management of the BHN is preparing a complete restructurization of the organization of the bank and substantial changes in its personnel, all of which is sorely needed. I have not yet had the opportunity to examine in detail the proposed organizational chart but that is one of the tasks scheduled for my next visit to Panama under the current contract. The schedule established for the remaining two weeks of my services in Panama is the 19th through 23rd of March and the 16th through 20th of April. I recommend that AID approve this schedule so that I may make the travel plans and business arrangements necessary to enable me to fulfill that schedule. To simplify the communications problem, I shall consider that schedule as operative, since it was made with the approval of the BHN, and I shall abide by it unless I receive different instructions from AID.

However, I must request more consideration from AID in this matter than I received in the scheduling of this contract. I have been kept in readiness to perform since September of 1978, with numerous changes of plans by AID at the last moment. This has meant that I was kept "unemployed" by AID, for all practical purposes, for almost five months, just to comply with my agreement to supply three weeks of services. There is no way that I can recover the financial loss this treatment by AID has caused, a loss which was unnecessary inasmuch as I can find no concurrent benefit that the Agency obtained from those delays. In fact, I believe a bad situation became worse because of the time lost. Therefore, I would appreciate the acceptance of the proposed schedule, keeping in mind the fact that the completion date for my contract is set by AID at April 30, 1979.