THE DUAL TRANSACTION NATURE OF HOUSING GUARANTY LOANS

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Summary

AID's Office of Housing and Urban Programs makes financial assistance available to developing countries for shelter and related activities which benefit lower income households. This assistance takes the form of a commercial U.S. dollar loan to the participating governments which is guaranteed by the U.S. Government under AID's Housing Guaranty (HG) Program. HG loan proceeds are disbursed to the host government based on the expenditure of local currency to carry out approved shelter activities. The dollars themselves, however, are not tied to the HG project since most low-cost housing schemes have minimal import requirements, and governments are able to use the dollars for other foreign exchange requirements.

Typically, a series of finance transactions are involved in HG projects. The participating government borrows the U.S. dollars which makes local funds available, usually in the form of a loan, to an intermediary or implementing agency. In turn, the intermediary on-lends to a project's beneficiaries, again in local currency.

The governments of developing countries have tended to want to attribute the terms of the HG loan to local currency transactions; that is, to pass on the HG's interest rate and amortization period to on-lending transactions. Making this link, however, ignores the fact that two fundamentally different financial transactions are involved: a foreign exchange transaction and a local currency transaction, with the latter usually involving a series of on-lending arrangements. This basic misunderstanding about the relationship between HG dollars and local currency has confused efforts to determine appropriate on-lending interest rates and repayment periods.

Since U.S. and the capital markets in developing countries operate independently, linking the HG loan to local transactions can alter local capital markets by distorting the way financial resources would flow in the absence of HG financing. The cost of borrowing HG funds is attributable to the purposes for which the dollars are used, and the cost of mobilizing local resources is attributable to the purposes for which local currency is used. Thus, on-lending rates should reflect prevailing market interest rates, since local currency is mobilized in the local capital market. Similarly, on-lending repayment terms should reflect prevailing loan terms for mortgages and similar types of transactions, again in order not to distort normal market conditions.

Potential borrowers may be looking to the HG Program as a source of relatively cheap capital to undertake domestic programs, but if this link between HG dollars and local activities is not valid, it becomes relevant to ask why a government would want to borrow HG funds. Presumably, potential borrowers are in need of foreign exchange, and the decision to borrow under the HG Program should be based on the competitiveness of HG loan terms to other sources of external financing. Moreover, the most appropriate borrower of HG funds is the public authority which normally handles the country's foreign accounts, such as the Central Bank or Ministry of Finance.

Lower income families in developing countries have not been well served by formal finance institutions, and governments have often adopted policies which isolate the housing finance sector from the balance of the finance sector. HG projects provide an opportunity to integrate housing finance with the larger finance sector, provided emphasis is placed on cost recovery at market interest rates. Additionally, HG projects can result in an increase in housing investment and reduction of public expenditures for housing, provided HG financing arrangements reflect market conditions.

Introduction to the Problem

The Office of Housing and Urban Programs administers AID's Housing Guaranty (HG) Program, under which financial assistance is made available to developing countries for shelter and related activities which benefit lower income households. This assistance is made available in the form of a U.S. dollar loan to the participating government for reimbursement of its expenditure of an equivalent amount in local currency for approved HG activities. In some instances, an advance in U.S. dollars is made for the generation of an equivalent amount in local currency to initiate the HG program. The U.S. Government guarantees these loans which are made by U.S. commercial lenders, and the presence of this loan guaranty enables lenders to extend this financing on favorable terms.

The government borrows the HG funds itself, either through the Central Bank or the Ministry of Finance. In all cases, governments are required to guarantee full repayment of the loan to the U.S. Government. Actual project implementation may be carried out by public agencies, parastatals or private institutions, or a combination thereof. The ultimate beneficiaries of HG funds are the households themselves which benefit from the project's activities. These households pay for services provided (e.g., new housing or urban services), and as such, they are considered private borrowers.

In effect, this process involves a series of loan transactions. The participating government borrows from the U.S. lender which in turn makes funds available, usually in the form of a loan, to an intermediary or implementing agency (e.g., the Central Bank borrows HG funds and on-lends to the national housing authority). In turn, the implementing agency on-lends to the project's beneficiaries; or in cases where the intermediary primarily acts as developer or project manager, private financial institutions may make credit available to beneficiaries. At each stage, transaction costs (including interest, administrative and overhead expenses) are incurred, and repayments must cover these expenses if full cost recovery is to be realized. As with most financing arrangements, these costs are covered by the interest rate charged on the loans.

A basic misunderstanding about the relationship between the HG loan in U.S. dollars and the local currency which is made available to carry out a HG project has confused efforts to determine appropriate on-lending rates and repayment terms. Borrowers - that is, the host governments - frequently want to attribute the terms of the HG loan to local currency transactions, but since U.S. and local capital markets operate independently, linking the HG loan to local transactions can alter capital markets by distorting the way financial resources would flow in the absence of HG financing.

The problem of setting appropriate interest rates largely centers on the first transaction involving local currency (that is, the rate at which the government makes funds available to the implementing agency). Determining an appropriate interest rate on subsequent local currency transactions (such as when the implementing agency or private banks on-lend to beneficiaries) has proven to be less elusive since the interest rate on these second tier transactions is generally set somewhat higher than the rate at which the intermediary has borrowed funds from the government to cover its administrative expenses, loan loss risk, and in some cases profit. As an example, if the implementing agency borrows from the Central Bank at 14%, it will on-lend to beneficiaries at a somewhat higher rate to cover its expenses, perhaps 16% or 17%.

This paper explores the relationship between the HG loan and the local currency transactions, particularly in the context of establishing on-lending interest rates. The Office of Housing's practices and AID's policies in this regard are reported and discussed. The question of who is the most appropriate borrower of HG funds and the reasons why a government might want to borrow HG funds are considered. Finally, the impact of HG borrowings on a developing country and the basis for establishing interest rates are discussed briefly, though it is not within the scope of this paper to dwell on these issues at any length.

Two Financial Transactions

HG loan funds are disbursed to the participating governments based on their expenditure of local currency to carry out an AID-approved project. Thus, a programmatic link exists between the HG loan funds and local currency, and it is this programmatic link which governments have perceived as extending to and defining a HG project's finance arrangements. Making this link, however, ignores the fact that two fundamentally different financial transactions are involved: a foreign exchange transaction and a local currency transaction, with the latter usually involving a series of on-lending arrangements.

HG loans are made in U.S. dollars which are not tied to any particular activity. In most countries, low-cost housing is built largely with local building materials and has only a small import component; thus, the lion's share of HG funds may be used by the participating governments for balance of payments, capital investments, budgetary support or other activities requiring foreign exchange. The cost of HG funds, therefore, becomes the cost of undertaking these foreign exchange activities.

By contrast, the cost of mobilizing local currency to implement HG projects is directly attributable to the projects. Governments acquire these resources in the local capital or finance markets through a number of mechanisms, including tapping existing savings, or mobilizing new savings through bond issues or other debt instruments. A cost can be attributed to mobilizing resources in the local capital market - typically the market interest paid to mobilize these resources plus administrative expenses - and this cost should become the basis for determining appropriate on-lending interest rates for the local currency transactions. In other words, prevailing local interest rates which reflect the cost of funds become the basis for establishing on-lending rates in the participating country.

Thus, the cost of borrowing HG funds is attributable to the purposes for which the dollars are used and the cost of mobilizing local resources is attributable to the purposes for which local currency is used, and these two transactions are not related in terms of setting interest rates. This dual nature of a HG's financial transactions is further evidenced by the fact that the assets generated locally (e.g., mortgages) do not serve as the basis for repayment of a HG loan, nor do they serve as any form of collateral to the U.S. lender. Repayment of the HG loan is not predicated on beneficiaries repaying their loans; rather, collecting from beneficiaries is a servicing issue for the lenders involved in the local currency transactions, whereas HG repayment is a servicing issue for the government which has guaranteed to repay the loan in dollars to the U.S. lender. This is not to say that HG project designers are not concerned with loan servicing and collateral issues, since these concerns are related to a project's successful implementation. But no connection is made between the government's obligations under its HG loan agreement and local collateral arrangements, beneficiary repayments or the ability of local lenders to convert local currency to dollars.

A couple of examples will be helpful in illustrating this dual transaction nature of the HG Program. In the first case, the Central Bank borrows HG dollars for 30 years at U.S. commercial rates, and the Central Bank retains these dollars to meet balance of payments obligations. At the same time, it makes available to the national housing authority an equivalent value in local currency. This local currency has been generated by selling government bonds, guaranteeing a rate of interest to investors which reflects current market rates. The Central Bank loans these funds to the housing authority, for 15 years at two percentage points above the bond interest rate in order to cover administrative costs. The housing authority proceeds to on-lend funds to the project's beneficiaries, also for 15 years so that the flow of beneficiary payments correspond to its own repayment obligations to the Central Bank, but it increases the interest rate by another two points to cover its servicing and projected loan loss expenses. The ultimate on-lending rate is now four points above the bond rate, which in this case is comparable to local long-term mortgage rates. What is significant in this example is that the terms of the HG loan have not been attributed to the local transactions; rather, interest rates reflect the cost of mobilizing funds locally, and loan repayment periods are based on local considerations.

The above example is typical of public sector arrangements, but it could also apply to HG projects involving the private sector. Instead of making funds available to the national housing authority, the Central Bank could on-lend to a housing bank, savings and loan associations, or commercial banks in the mortgage loan business. Such private finance institutions commonly borrow from central banks. In this case, the Central Bank on-lends at a rate which reflects its cost of funds, the private institutions on-lend at current mortgage rates, and the spread between the Central Bank rate and the mortgage rate is sufficient to cover expenses, bad debts and normal profit margins. Again, interest rates reflect local market conditions.

A tendency exists to attribute both the interest rate and repayment term of a HG loan to local transactions, but just as the on-lending interest rate should reflect prevailing rates, on-lending repayment periods should correspond to normal mortgage loan terms. HG loans are typically repaid over many more years (e.g., 30 years) than local loans, and to introduce a significantly different repayment period can also have a distorting affect on the local capital market. A number of factors influence the maturity or repayment periods on local investments, including economic conditions, rate of inflation, confidence in local institutions and political stability, and the combination of these factors defines the investment climate in each country. While U.S. investors may feel secure in extending HG credit over 30 years, local investors may be less comfortable on-lending for 30-year mortgages.

An objective of many HG projects is to mobilize a higher level of investment in low-cost housing, but attributing a HG's long amortization period to the loans made to ultimate beneficiaries can hinder a project's success in this regard. Investors simply may not want to tie up their funds for such extended periods, especially when other investment opportunities exist at comparable interest rates but shorter maturities.

This issue of breaking the link between a HG's repayment period and local transactions is more of a concern with respect to lending to ultimate beneficiaries than to intermediary institutions. In some instances, it is desirable to make longer term loans available to intermediaries as part of a process of institutional development, including providing them sufficient long-term capital with which to operate. This transaction normally occurs between the intermediary and the Central Bank or Ministry of Finance, and is less likely to have an impact on local capital markets. But the loans made by the intermediary to the beneficiaries take place within the context of the local market, and therefore should reflect market terms of interest and amortization. As an example, the Central Bank may make a 30-year loan to the Housing Authority, which on-lends to beneficiaries over 15 years - the same term offered by banks on mortgage loans. Such a situation has the two-fold advantages of not adversely affecting the local market while giving the intermediary essentially the double use of the funds by reinvesting reflows.

Appropriate Borrower of HG Loans

The foregoing discussion has emphasized the fact that HG projects embody dual transactions: a foreign exchange transaction, and a local currency transaction or series of transactions. In turn, it becomes relevant to ask who is the most appropriate borrower of HG funds. It follows that the foreign currency transaction is most appropriately handled by the public authority which normally manages a country's foreign exchange accounts, typically the Central Bank or Ministry of Finance. The Office of Housing's practice has been to encourage such public authorities to serve as the HG borrowers, in turn making local currency available through normal on-lending arrangements to an intermediary agency which will implement the HG project. In doing so, it is easier to break the link between the terms of the HG loan and on-lending loan terms.

Why Borrow HG Funds?

Potential borrowers may be looking to the HG Program as a source of relatively cheap capital to undertake domestic programs, but as the foregoing discussion has pointed out, linking HG loans to activities requiring local currency is based on a fundamental misunderstanding about the relationship between HG dollars and local transactions. Thus, the question needs to be asked as to why a government would want to borrow HG funds.

Presumably, countries desiring to participate in the HG Program are in need of foreign exchange, and the decision to enter into a loan agreement with a U.S. lender should be based on a favorable comparison of the terms of a HG loan to other sources of external financing. In turn, borrowing terms should be compared to the financial benefits of the proposed use of the dollars.

If a government is contemplating using HG funds for balance of payments purposes, presumably the HG loan will be replacing external debt which has been borrowed on less favorable terms, thus marginally reducing the country's external exposure. On the other hand, HG dollars may be sought for investments which will themselves generate foreign exchange, and the rate of return of these investments should compare favorably to the HG's repayment terms. In other words, the cost of borrowing HG funds is attributable to the purposes for which the dollars are used. Whatever use of the dollars is contemplated, the return on or benefits of the foreign exchange transaction should compare favorably to the cost of borrowing before a government borrows under the HG Program.

Setting Interest Rates in the Local Market

Lower income families in developing countries generally are not well served by formal finance institutions. Irregular or low incomes discourage formal institutions from trying to serve them, and often the costs of relying on these institutions is relatively high for lower income groups since the available methods of savings collection and loan origination are not adapted to their special needs.

Exacerbating these problems is the fact that many governments have established both deposit and mortgage lending rates which do not reflect market conditions and are considerably below market levels. In turn, savings are discouraged, a subsidy is provided to each borrower of a mortgage loan, and the ability of the housing finance system to expand is restricted. A major implication of these policies is that the housing finance sector is isolated from the balance of the financial sector.

HG projects can foster the integration of the housing finance sector with the larger finance sector, provided emphasis is placed on cost recovery at local market rates. More broadly, HG projects provide an opportunity to intervene in the general policies of governments and parastatals to align their interest rates with the overall market which will enhance their ability to mobilize resources and tap other parts of the capital market outside of the shelter system for funds. These opportunities exist, however, only if the local currency on-lending rates under the HG Program correspond to market conditions. By way of demonstration, let's look at examples of how this works.

U.S. lending rates are, in most instances, lower than interest rates for comparable purposes in developing countries. Thus, HG loans are made to governments at interest rates lower than the cost of mobilizing resources for mortgage loans locally. For a variety of reasons, including the notion that people need or deserve better housing than they can afford under market conditions, governments may want to pass on these lower rates to intermediaries and ultimate borrowers. In doing so, the following outcomes can be anticipated:

1. Investors place their funds where the return is the highest; thus, housing loans made at below market rates will restrict the shelter sector's ability to mobilize investment funds. Lower interest rates inhibit full cost recovery and limit profitability, and private institutions will find it preferable to invest in other sectors or projects which operate under normal market conditions. The ability of the housing finance system to expand will be dependent upon the willingness of the government to target resources to the sector, which may require costly budgetary support or special programs such as mandatory payroll contributions. As a result, shelter investments become a political decision which is not necessarily based on financial considerations.

2. The provision of low-cost housing will remain the domain of the public sector, and housing credit for lower income families will continue to be insulated from the rest of the finance sector. In turn, public sector inefficiencies will increase the per unit cost of shelter, making it more difficult to meet lower income housing needs.

In short, when local currency transactions are made at below market interest rates, market conditions are distorted and shelter finance remains insulated from the larger finance market. When HG rates are higher than local market rates, and the HG rate is passed through to local currency transactions, naturally different outcomes can be expected. Again, the flow of resources in the economy will be distorted, this time in favor of the shelter sector as investible funds seek the highest return. But this sudden shift of resources into housing can detrimentally affect other economic sectors.

The Office of Housing's policy that on-lending rates should be consistent with prevailing rates is intended to prevent such distorting influences from occurring. When local currency transactions reflect market conditions, the following results can be expected:

1. Investment in the shelter sector will increase since interest rates offered to mobilize resources will be competitive. Private resources will flow into housing, but not at levels which disrupt other economic sectors; and public sector costs will be reduced because the

government will no longer be subsidizing housing through budgetary support, special programs or artificially low interest rates.

2. The housing finance sector will be more fully integrated with the rest of the finance sector, thereby increasing the sector's efficiency.

While encouraging participating governments to adopt prevailing interest rates in donor-supported local transactions, it should not be overlooked that these rates themselves may not be based on sound economic policy. Indeed, in many countries interest rates are considerably below rates which would prevail in an unregulated market economy, but for political or other considerations they are kept artificially low. However, it is not within the scope of this paper to analyze how a government should set interest rates which accurately portray the cost of funds.

In some countries, low legal ceilings on interest rates, government interventions in the capital market, and inappropriate fiscal and credit policies have resulted in interest rates which do not reflect the opportunity cost of capital. In fact, interest rates may be set so low that they do not provide real rates of return on investments after inflation, thus decapitalizing finance institutions. Where these conditions are present, <u>it should be a broader concern of the overall AID program in the country to progressively remove the impediments to a free capital market, and the HG Program provides only one of many opportunities to enter into such a policy dialogue.</u>