

Chapter 1: Housing Finance

1.A Overview of Housing Finance

Housing finance is an important aspect of the development of the housing sector in any country. There are a number of housing finance instruments, such as: housing microfinance; middle-market housing finance, e.g. construction savings banks known as *Bausparkassen*; primary mortgage lending; and secondary mortgage markets (mortgage backed securities).

**Chapter 1.
Housing Finance**

This chapter covers:

- Housing microfinance
- Construction savings banks, or *Bausparkassen*
- Mortgage lending instruments

For detailed information on housing finance mechanisms, see: Pfeiffer, Herbert, *Guidelines on Housing Finance Systems for Countries in Transition*. Bratislava, Slovakia: Pending Production by UNECE (November 2003).

Across each country the enabling environment for these housing finance instruments may be very different. For instance, while the US housing market is well familiar with the mortgage-backed securities, in areas such as Southeastern Europe where the housing market and overall economic and regulatory environment are suffering, the macro-conditions would not be able to viably support such types of instruments. Alternatively, microfinance can be an appropriate housing finance alternative for low-income clients with no credit history, or in situations where other forms of long-term credit (such as through private banking institutions) are unavailable. Construction savings

banks can serve as an intermediary solution as governments and financial institutions pursue larger reform agendas, although for construction and savings strategies to function, legal preconditions such as an operable land registration system and collateralization are necessary. The following sections describe these different types of housing finance instruments in greater detail.

1.A.1 Housing Microfinance³

Housing microfinance programs can address one of the primary constraints to housing sector development, limited access to affordable housing finance, by establishing alternatives to commercially available mortgages and traditional supply-driven housing provision approaches. When designed to take local economies and household financial realities into consideration, housing microfinance loans can provide low- and mid-income families with the resources necessary to undertake a variety of modest projects that substantially improve their quality of life, such as incremental improvements to their homes, reconstruction of housing damaged during conflict or natural disasters, or in exceptional instances, construction of new homes.

Basic Principles to Housing Microfinance

Housing microfinance loans differ from traditional microenterprise loans in a number of ways. Typical microenterprise loans are usually very small and affect the borrower's income, and

³ This information on housing microfinance is based on a presentation written by Franck Daphnis of CHF International and delivered by David Strine, Director of CHF International's Office of Development Finance, at the Sarajevo conference *Towards Social Stability and Economic Development*. It also draws heavily upon CHF International's microfinance program experiences in over 100 countries, encapsulated in its guide to housing microfinance, *So, You Want to Do Housing Microfinance?*, published in 2001.

repayment capacity is based on the generation of future income. In contrast, housing microfinance loans are larger and affect the borrower’s asset base, and repayment capacity is based on current household income.

Key attributes of housing microfinance

- An alternative to traditional long-term mortgages that targets the needs of low-income households
- Preliminary feasibility assessments aid in the design of contextually appropriate loan products
- The terms of individual household or group loans can offer clients affordability and options best suited to their housing priorities
- Typical characteristics of housing microfinance loans:
 - Large loan principle amounts based on household repayment capacity
 - Short lending periods
 - Securitization through co-signers or guarantors

Housing microfinance providers

In different parts of the world, there are a variety of institutions offering housing microfinance, including MFIs, home lenders, NGOs, and commercial banks. Although housing microfinance programs in Southeast Europe are generally limited to MFIs and NGOs, it is conceivable that a wider array of institutions could offer housing microfinance products in the future.

Housing microfinance clients

Housing microfinance products typically target low- to mid-income clientele who do not qualify for traditional housing finance and also possess an adequate capacity for monthly repayment. Describe the proportion of income that housing microfinance loan repayments should represent, in addition to whatever other debt burden the household may already carry.

Housing microfinance design parameters and loan terms

Main factors to consider in designing housing microfinance products to target the poor include the potential purpose of loans, the repayment capacity of the target population, the length of the lending period, the size and pricing of loans, means of assuring loan security, the potential need for technical assistance to accompany loans, and appropriate property ownership and tenure security requirements.

In general, housing microfinance programs most effectively address the credit needs of poor communities by providing loan products that:

- Extend relatively small loan amounts, based on household income and estimated repayment capacity
- Carry a short repayment period
- Are usually guaranteed through co-signers rather than collateral
- Are priced to ensure both long term financial viability of the provider and affordability
- Incorporate systematic monitoring procedures



This woman in Romania receives a microfinance loan to make improvements to her home.

Although the terms of housing microfinance products vary somewhat to reflect local economic conditions, the housing loans that institutions throughout the world offer have been designed according to the same general guidelines. Below is a brief description of the terms of housing microfinance loans that institutions have offered in various countries.

Typical Terms of Housing Microfinance Loans

| Loan Characteristic | Linked Housing Microfinance | Stand-alone Housing Microfinance |
|---------------------------------------|---|---|
| <i>Purpose</i> | For construction of a complete new core home or improvement of existing home | Typically for home improvement or repairs |
| <i>Maturity</i> | Ranges from 12 to 120 months | Ranges from 12 to 36 months |
| <i>Amount</i> | Ranges from \$100 to \$600 | Ranges from \$3,000 to \$5,000 |
| <i>Interest Rate</i> | Priced to include: Administrative Expenses (AE); Loan Losses (LL); Cost of Funds (CF); Desired Capitalization Rate (K); and Investment Income (II). $R = [(AE+LL+CF+K)/(1-LL)] - II^{\dagger}$ or priced using the <i>Microfin Loan Projection Model</i> | |
| <i>Repayment Capacity Estimation</i> | Based on prior client savings history with the institution | Periodic payment no more than 25% of household income, total debt burden no more than 40% |
| <i>Security</i> | 2-5 co-signers with institution guarantee or one year savings as lien; 1-2 years of history with institution | Guaranteed through two or more co-signers or collateral for larger loans; may introduce a savings requirement if repayment capacity is borderline, no prior history with institution required |
| <i>Technical Assistance Provision</i> | Generally no technical assistance provided | Technical assistance provided as appropriate |

1.A.2 **Bausparkassen: Construction Savings Banks**

General description of Construction Savings Banks

Construction Savings Banks, also referred to by their German name, *Bausparkassen*, are similar to a community-based cooperative microfinance institution, in joining a construction savings bank, members agree to deposit a constant amount of funds for a set period of time. After an initial contribution period of one to two years, members are eligible to take out a loan from the collected funds, which function as the necessary source of refinancing.

Development of the Construction Savings Bank Model. The current Bausparkassen model, or contractual saving for housing construction, is derived from models used in post-World War I and World War II Germany. During the inception of this model, the transitional economy and government infrastructure was unable to provide for the housing market demand. The Bauspar system successfully filled the supply void left by the struggling economy. Currently, the German market boasts 28 Bausparkassen, managing more than 32 million contracts.

Application of the Construction Savings Bank model – when it’s appropriate. Construction savings banks can serve as an intermediary solution as governments and financial institutions pursue larger reform agendas, although for construction and savings strategies to function, legal preconditions such as an operable land registration system and collateralization are necessary.

Benefits of construction savings banks

A Deposit Taking Housing Finance System like Construction Savings is in the developing phase of a national economy the most effective technique and offers benefits to the Customer, the Construction Industry and the State.



Construction Savings:

[†] Rosenberg. CGAP, 1998

- Was invented in the times of economic depression and is so tailored to the needs of a developing economy.
- Is a lifetime saving concept for renovation construction and repair, which works at stable conditions independent from the capital market, based on the initiative of the individuals.
- Increases the savings ratio and supports building up equity of the individual, without raising the interest rates.
- Shifts short term savings to long term loans at stable conditions and at interest rates below or maximum 6%.
- Carry a low default rate, 0,56 % in SK, because regular savers are paying back regularly and punctually.
- Generates abundant qualitative and quantitative effects to the state budget, which exceed the expenses by far, because the investment of the state encourages the saving process by a limited state premium.

For additional information on how Construction Savings works, see section 1.C, “Additional Resources for Housing Finance”

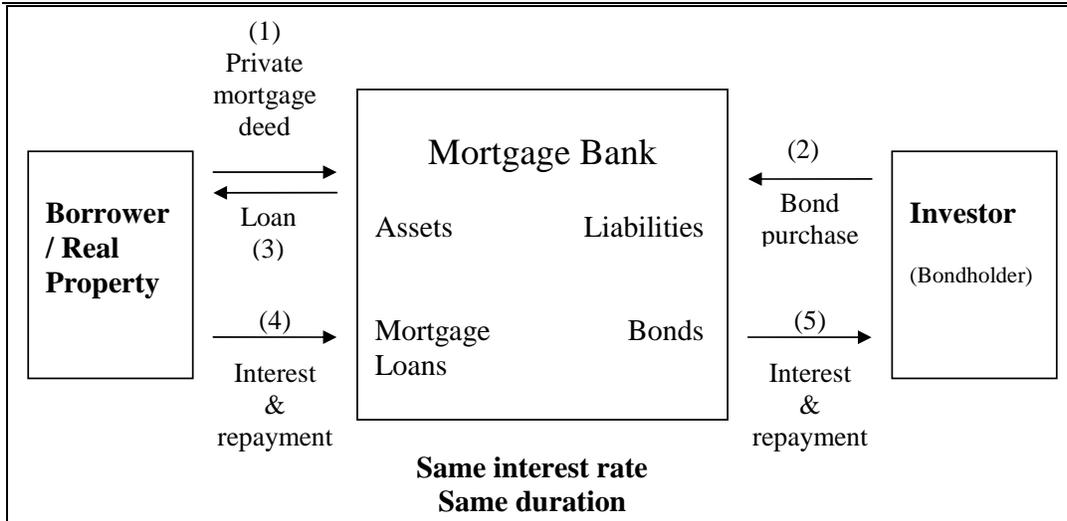
1.A.3 Mortgage Lending Instruments

Mortgage bonds and mortgage-backed securities are appropriate housing financial instruments in countries where there is a strong legal and regulatory environment that can adequately regulate the activities of financial intermediaries such as private banking institutions and securities trading firms. The following graph on the right illustrates the different models for mortgage bonds and secondary mortgages. (Lamoreaux, P.)

| Bonds | Mortgage-Backed Securities | Other |
|---|--|--|
| European Mortgage Model - Bond financed - On balance sheet - Specialized portfolio lenders | Off balance-sheet – bankruptcy remote | Unsecured corporate debt – not directly related to mortgages |
| Mortgage-backed bonds with various structures | Pass through (GSE's in US) vs. Structured (branches, enhancements) | Contract savings – deposit financed, specialized institutions offering loan-linked savings contracts |
| Federal Home Loan Bank Model – bond financed for member institutions | Credit Enhancements may include senior/subordinated, guarantees, mortgage default insurance, pool insurance, monocline insurance, reserve pool | Federal Home Loan Bank Model – loans to member institutions using mortgages as pledged collateral, but not taken off balance sheet |

Mortgage Bonds

Mortgage bond markets are common in a number of European countries and are being developed in Eastern European countries such as Hungary, Slovakia, the Czech Republic, and Poland. In Europe, mortgage banks are portfolio lenders that issue bonds that are backed indirectly by the mortgage loan assets of the lender. Mortgage bonds can also be issued by banks and other depository institutions that use their loans as collateral for the securities. The following diagram illustrates the basic principle of how the mortgage bond works. (Pfeiffer, H.)



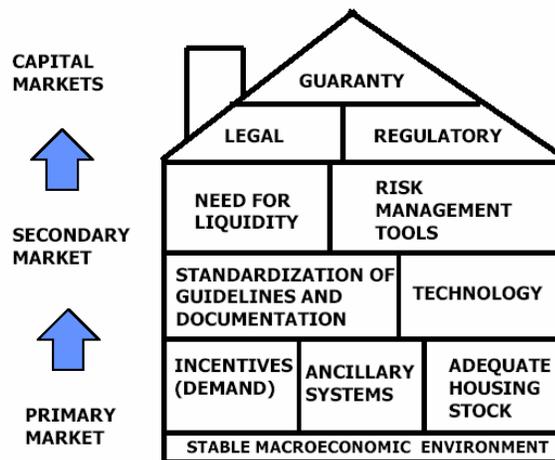
Secondary Mortgage Markets⁴

A relatively new development in housing finance is the secondary mortgage market, which involves pooling and sale of mortgage loans. A strict definition of a secondary mortgage market is a market in which mortgages trade; i.e., one that involves the sale and purchase of the mortgage asset. Although this activity has been around for a long time, it has greatly expanded in recent years, reflecting the creation of new and specialized institutions and innovations in technology and security design.

Secondary markets are not exclusive to developed countries: there are several examples of successful secondary markets in developing countries, and with prospects for many more. Nevertheless, there are a number of preconditions for a successful secondary market. The most critical factors to support the viability and sustainability of a secondary mortgage market are:

- Stable or improving macroeconomic environment;
- Sufficient legal, tax and regulatory framework;
- Robust primary market operations and standardization;
- Capital market preparedness and appetite for mortgage-backed securities;
- Economic incentives for secondary market participation.

BUILDING BLOCKS OF SUCCESSFUL SYSTEM



For more information on secondary mortgage markets, see a number of resources are available on the internet (see following sections).

⁴ Source: Lamoreaux, Pamela. IFC.

1.B Housing Finance List of Supplementary Materials (Part II of Handbook)

To view these supplementary materials, please refer to **Part II** of this handbook.

Pfeiffer, Herbert. Handbook on Housing Finance Strategies. November 2003 Draft. (In development, to be published by the Housing and Urban Management Advisory Network to the UNECE.)

CHF International. *Housing Microfinance: An Alternative to Traditional Housing Finance Mechanisms*. Presentation delivered in Sarajevo, Bosnia and Herzegovina (May 2004).

Pfeiffer, Herbert G. *Savings Models, Managed by Deposit Taking Banks, in which Housing Finance Techniques are Available*. Presentation delivered in Sarajevo, May 20, 2004.

Merrill, Sally. *Regional Conference on Housing Finance: Building Housing Finance in Central and Eastern Europe: Sharing and Comparing*. Prepared for USAID Contract No. PCE-I-00-97-00052; Warsaw (December 10, 1999).

International Finance Corporation: “Overview of Housing Finance: Government Housing Policy/ Legal Structure”. From presentation prepared by Lamoureaux, Pamela.

<http://law.hku.hk/aiifl/ABMF/Lamoureaux%20Securitisation.pdf>.

Home Mortgages Training Manual. Available at:

<http://www.dec.org/default.cfm?CFID=302725&CFTOKEN=53033388>

Construction Lending Training Manual. Available at:

<http://www.dec.org/default.cfm?CFID=302725&CFTOKEN=53033388>

Mikelsons, Maris. *Why Not Borrow to Buy a Home? A Guide for Future Homeowners (A Public Education Brochure)*. Prepared for USAID Contract No. EPE-C-00-95-001100-00, RFS No. 555. (June 1999)

Housing Microfinance Case Study: REZ-FOND Home Improvement Loan Program in Bosnia and Herzegovina

Housing Microfinance Case Study: *HILP and Condominium Loans in Romania*

To view these supplementary materials, please refer to **Part II** of this handbook.

1.C Additional Resources for Housing Finance

Useful Websites

ADEMI - The Association for the Development of Microenterprise: <http://www.ademi.org.do>

CGAP - The Consultative Group to Assist the Poor: <http://www.cgap.org/>

CARD - Center for Agriculture and Rural Development: <http://www.cardbankph.com/>

CHF International : http://www.chfinternational.org/about_what_microfinance.htm

SEWA Bank: <http://www.sewabank.org>

FUNHAVI - Fundación Habitat y Vivienda, A.C. :

[http://www.citiesalliance.org/citiesalliancehomepage.nsf/Attachments/funhavi/\\$File/funhavi_final_DMW.pdf](http://www.citiesalliance.org/citiesalliancehomepage.nsf/Attachments/funhavi/$File/funhavi_final_DMW.pdf)

Grameen Bank: <http://www.grameen-info.org/> or

<http://archnet.org/library/pubdownloader/pdf/6111/doc/DPT0071.pdf>

Cities Alliance: <http://www.citiesalliance.org/citiesalliancehomepage.nsf>
Parivartan Slum Upgrading Project, Ahmedabad, India. <http://www.sewabank.org/activities/parivartan.htm>
or http://www.ucl.ac.uk/dpu-projects/Global_Report/pdfs/Ahmedabad_bw.pdf
Central and Eastern Europe Mortgage Finance. *Developing Secondary Mortgage Markets in Southeast Europe* (February 2003) <http://www.ceemortgagefinance.org/conferences/seeconference/agenda.cfm>
Central and Eastern Europe Mortgage Finance. <http://www.polandhousingfinance.org>
European Association of Cooperative Banks. <http://www.gebc.org>.
European Banking Federation, <http://www.fbe.be>.
European Federation of Building Societies, <http://www.efbs.org>.
International Union for Housing Finance, <http://www.housingfinance.org>.
World Savings Banks Institute and European Savings Banks Group, <http://www.savings-banks.com>.
World Bank: <http://www.worldbank.org/wbi/banking/capmarkets/housing/readings.html>

Publications & Presentations

Housing Microfinance: A Guide to Practice. Edited by Franck Daphnis and Bruce Ferguson. Bloomfield, Connecticut, USA: Kumarian Press, January 2004. Available: www.chfhq.org or communications@chfhq.org.

So, You Want to do Housing Microfinance: A Guide to Incorporating a Home Improvement Loan Program into a Microfinance Institution. Silver Spring, Maryland, USA: CHF International, January 2004. Available: www.chfinternational.org or communications@chfhq.org

UNECE Housing Profile for Romania (2001). <http://www.unece.org/env/hs/cph/romania/welcome.htm>

The Current Operation of the Bauspar systems in the Czech Republic, Hungary, and Slovakia. Prepared for USAID by Douglas B. Diamond, The Urban Institute, September 1998. http://www.dec.org/pdf_docs/PNACJ148.pdf

The Efficiency of the Bauspar-System in Eastern Europe. Presentation by Rainer Hager, Fundamenta-Lakáskassza. The Eastern European Workshop on Housing Finance and Housing Affordability. Metropolitan Research Institute, Bucharest, 24-25 May 2004. http://www.mri.hu/downloads/hfin_ws_p/Hager.pdf

Homeownership and Housing Finance Policy in the Former Soviet Bloc: Costly Populism. Edited by Raymond J. Struyk, The Urban Institute, October 2000. <http://www.urban.org/UploadedPDF/costly-populism.pdf>

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The Implementation of Contract Savings Schemes for Housing (Bausparen) in Transition Economies: Features, Recommendations and Examples. Presentation by Andreas Zehnder, European Federation of Building Societies, IUHF Congress, Brussels, 24 June 2004. <http://www.housingfinance.org/WorldCongress/Presentations/41%20-%20Andreas%20Zehnder%20Presentati.pdf>

The Transition in Housing Finance in Central Europe and Russia: 1989-1999. Prepared for USAID by Douglas B. Diamond, The Urban Institute, November 1999. <http://www.polandhousingfinance.org/Poland/PDF/HFTransition.PDF>

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