Inclusive Housing and Housing Finance: Key Lessons and Challenges

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“Inclusive” Defined

• policies that do not leave behind the bottom 20% of the income distribution

• but is 20-25% a meaningful target for housing?

• Great tension when seen narrowly as access to homeownership
  o Case of US mortgage credit leading up to crisis
  o Case of current Mexico debacle in the low income ownership sector

• Housing finance and housing standards can only go down market so far in urban areas

• Subsidies can help and must be designed sensibly

• But inclusive housing means different strategies altogether for the real bottom end of the income distribution
  o Focus on rental
  o Are progressive S&S feasible? Or ownership in slum redevelopment? Priorities of the people or short term cashing in?
Scale of Indian Urban Housing Requirements is Daunting

- At least 23 million urban households in substandard housing of which 17 million in slum areas – out of total of 81 mill urban hh
- 54 million new urban households over next 20 years
  - 2.5 to 3 million new urban homes needed per year just for new households
  - if this number cannot be reached informal housing/slums will continue to grow
- Current new annual supply a fraction of this number - although precise figures are lacking
- Urgency of new construction even for EWS – filtering limited
- Upgrading is necessary but ultimate goal is not to have growth in households in slum/informal areas
Incomes are Increasing

• Per Capita Incomes are growing (5% to 8% GDP growth annually - well over population growth)

• Household indebtedness is relatively low

However:

• Large part of urban growth driven by urbanization; swells urban low income ranks disproportionally

• Growing income inequality within urban, between regions

→ Low growth elasticity of poverty – bottom end

→ Modest growth elasticity of inclusiveness (lowest 20%) in India

• Possible Reasons for growing inequality:
  • Low health and education spending
  • Low spending on housing/services
  • Modest financial sector development/ access to finance
  • Labor market issues

• Added challenge for inclusive housing strategies

Restricted by low levels of tax and transfers
Urban Growth Fastest in Least Urbanized Countries, Africa, China, India

But Inequality is Growing too
Reversal from pre-1990s

• Growing income and spatial inequality (regionally, rural-urban, within urban), plus increased poverty in urban areas

Past rises in inequality are likely to reduce the future impact of income growth on poverty and inclusiveness of growth

Source: Balakrishnan, Steinberg, Syed “The Elusive Quest for Inclusive Growth: Growth, Poverty and Inequality in Asia, IMF WP June 2013
Which Affects Positive Impact of Growth on the Lower Income Groups

Impact on poverty headcount

Impact on Inclusiveness

Source: Balakrishnan, Steinberg, Syed “The Elusive Quest for Inclusive Growth: Growth, Poverty and Inequality in Asia, IMF WP June 2013
Change in Debt in Selected countries 2007-12 in percentage points of GDP

Sources: IMF, World Economic Outlook; OECD; BIS; national data.
Positive Developments on the Supply Side

Real supply side
- New models for low cost housing production utilized by vibrant private developer sector to scale; excellent studies by Monitor and others; as low as $7000 houses?
- Current focus on land policies
- Draft Real Estate Regulation and Development Bill to bring transparency to the RE sector
- Pending establishment of regulatory authority to review construction of residential projects (avoid Mexico debacle)
- Rules that clarify foreign investment in RE sector

Housing Finance Sector
- Well developed rapidly growing mortgage sector; different types of financial institutions; well performing loan books; MFH expanding
- But extremely small in scale relative to housing requirements; GDP
- NHB focused on LIG loans; 60% of refis is for loans <5lakhs or US$10,000
- Special loan guarantees for targeted populations; mortgage insurance
- Initial house price index; appraisal guidelines etc.
- Housing loans to EWS and LIG part of required credit allocation rules
## Total Home Mortgages Outstanding are Increasing but Lack Behind Economic Growth

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</thead>
<tbody>
<tr>
<td>RBI</td>
<td>Total amount of home mortgage loans outstanding</td>
<td>₹6,736.17</td>
<td>₹6,188.22</td>
<td>₹5,724.41</td>
<td>₹5,058.40</td>
<td>₹4,604.04</td>
<td>₹4,365.75</td>
</tr>
<tr>
<td>RBI</td>
<td>GDP (current prices)</td>
<td>N/A</td>
<td>₹88,557.97</td>
<td>₹76,741.48</td>
<td>₹64,573.52</td>
<td>₹56,300.63</td>
<td>₹49,870.90</td>
</tr>
<tr>
<td>RBI</td>
<td>Total amount of home mortgage loans outstanding at the end of year - as % of GDP (current)</td>
<td>N/A</td>
<td>6.99%</td>
<td>7.46%</td>
<td>7.83%</td>
<td>8.18%</td>
<td>8.75%</td>
</tr>
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</table>

Mortgage Markets Grow with GDP and Financial Sector Development but Policies Play Major Role

Source: www.hofinet.org
How Can These Positive Trends Be Brought to Scale: Policies Matter

- Lessons from other emerging market countries: Chile, Columbia, Brazil, Mexico, South Africa, Egypt, Thailand, Indonesia
- **Review Taxes, Levies and Subsidies** pertaining to housing - adjust
- Distinguish segments of the population which can enter into formal housing market and those who cannot –
- Develop complementary housing strategies for each
  - Expand market and credit based approach for LIG, MIG, stably employed, using credit linked subsidies
  - Create rental or community based ownership approaches for EWS, unstable/informal employed, using incentives for private rental investors and demand side subsidies
  - Just focusing on MIG/LIG won’t ever create enough units to filter down to EWS
  - Just focus on EWS will encourage take over by LIG/EWS
- Combine subsidies for households with incentives for lenders, developers
  - Housing supply is fairly inelastic in most emerging markets ➔ supply side support needed if growing demand will not translate in poor urban environments and price increases. E.g. Chile, Mexico, Brazil
- Develop packages for both rental and ownership market/choice
Taxes and Levies on Housing Sector are High in India

• McKinsey estimated in 2010 that Taxes and Levies may be as high as 27 percent of end-user cost of housing–

• Review before new subsidies are considered

Source: McKinsey India’s Urban Awakening 2010
Indian Government Spending on Housing Has Been Low Compared to Other countries

Source: McKinsey India’s Urban Awakening 2010
Three Component for LIG/MIG Package

1. Efficient and transparent credit linked household subsidy that
   - Maximizes beneficiaries’ own inputs by requiring a maximum affordable loan (at 30-35% DtI?)
   - Savings for the downpayment
   - Upfront subsidy in the form of
     - Down payment support (for savings constrained)
     - Defray upfront costs or pay for mortgage insurance
     - Flexible interest buy down; phased out over several years

2. Lender incentives to serve targeted groups

3. Supply side support to developers or “sticks” if needed
1. Is Household Subsidy Package for this Segment Effective?

• Would current ISHUP subsidy scheme need adjustment? Does it focus on households at the margin of the market?

• Some suggestions from Q&D review
  o Create more flexible targeting system /criteria for different submarkets than RBI /MoHUPA definitions – frontier of the current market
  o Coordinate targeting with NHB guarantee schemes
  o Scale the subsidy to be lower with higher incomes and therefore allowing a broader group to participate and minimize subsidy amount – also avoid cliff effect
  o Allow use of subsidy for new developer built and on own land; existing housing/mobility
  o Flexible design; use subsidy for downpayment, upfront costs and mortgage insurance or interest buy-down
  o Establish mechanisms for regular adjustments and to move gradually down-market
2. What Incentives Do Lenders Need?

What is needed in India?

• Banks have a high Loan-to-Deposit ratio – 78%
• Close to 50% of bank’s retail loans is in longer term mortgage loans
• NHB only refinances small % of total mortgage loans - need to scale up
• Lift NHB’s concentration restrictions – limits the growth of large HFCs mortgage books for lower income segment
• Increase access to funds for NHB – Securitization? Other incentives?
• NHB to open special refi window for loans to rental investors?
• Mortgage insurance operational - include premium payment in possible subsidy scheme for lower income borrowers (risk and reserve requirements)?
• Support high transaction cost for informally employed customers?
• Sticks? Is preferred credit for low income lending sufficient?
3. What Incentives/ Sticks for Developers to Move Down-Market?

- Ease density restrictions by local governments FRA, FSI; increases profitability (different densities for different locations)?
- Stimulate mixed developments – already done?
- Speedy processes of approval, permitting for priority projects? One stop shop for low-income developments
- Provision of speedy off site infrastructure !! Or grant to developers
- PPPs on land, particularly for rental developments
- Exemption of developer charges?
- Other?

Sticks
- Demand affordable houses to be built as pre-agreed proportion of each development?
- Watch out for simple stock creation that leads to locational disfunction such as in South Africa and Mexico
What About a Push for Rental Strategies for both EWS and LIG?

- Few countries with effective rental strategies outside of Europe, but many countries are changing
- Public rental model has been discarded as disastrous
- Most rental in emerging markets is informal

Development of Rental Sector Requires that:
- Policies recognize rental is an important sector
- Perform an assessment of the rental sector
- Review the legal framework (rent control and tenant protection)
- Review the tax system (dis-incentives to rental investors?)
- Provide access to long-term capital
- Provide targeted, effective subsidies to investors and renters - often both are required
Proportion of Home Ownership is Not Related to Income....
• Compare household characteristics and housing conditions of tenants and owners.
• Discover tenants’ reasons for renting and the type of landlord.
• Evaluate the balance between supply and demand.
• Evaluate conflicts and the conflict resolution process.
• Compare the costs of renting and owning (including obstacles to access to credit).
• Compare rental return and risk with alternative investments (after and before tax).
Ensure that the rights of landlords and tenants are balanced.

Balance between stability for tenant and flexibility for owner
- Duration & termination of the contract
- Rent setting & rent increase.

Solving conflicts: Fair dispute resolution and alternatives to the judicial process (Regie du Logement in Quebec).

Balance between core legislation (stable) and other rules (flexible), between national and sub-national legislations.

Consolidation in a single law (hard to change the civil code).
Tax issues

• Level the playing field between rental and other investment / ownership.

• Rental income & capital gains often unfairly treated.

• Consequences: negative impact on the rate of return; disinvestment or informal renting.

• A good tax model should include:
  - Main expenses deductible (maintenance work and interest paid)
  - Economic depreciation
  - Losses to offset taxes on other income and/or carried forward for a few years.

• Egypt case: find a balance between a tax level that does not foster informality and allows significant incentives to maintain and renovate.
Financing for different classes of owner (individual, small, corporate).

Small owner incentives, such as capital for renovation, improvement or expansion.

Medium to long term capital, both debt (loans or bonds) and equity (investment funds, including REITs when tax structure makes them feasible).

Guarantees:

- Insurance products to insure rental income
- Credit enhancements: mortgage insurance, public guarantees for social housing finance.
Ownership and management

Private rental

- Individual owners is the most numerous category in all countries.
- Rental risk and taxation highly sensitive issues
  - Tax incentives can be used to guide investment (ex: small units).
- Countries with large well-functioning rental sectors (Germany, Switzerland, USA) have large scale owners (institutional)
  - Are long-term investors, ensure proper maintenance (economy of scale) and professional management.
Subsidies

• Demand-side subsidies most effective, but
  - Entail heavy fiscal commitments,
  - Require the collection and update of information on beneficiaries,
  - Have less effect on housing supply than supply-side subsidies
⇒ Both to be used in parallel whenever housing needs remain important.

• Supply-side subsidies may be given in several forms, including tax rebates, soft loans, and guarantees.
  - Soft loans most efficient (leverage effect),
  - Avoid long-term non-capped commitments,
  - Governments should require social commitments in return and control landlords.
Concluding Remarks

- We do not advise governments to put the emphasis on rental instead of ownership; rather to add a rental component to their housing policy; both sectors to be complementary.

- The priority policy goal for governments should consist in facilitating an environment for rental residential markets to develop, rather than directly financing, building and managing rental housing.
Total Home Mortgages Outstanding Relative to GDP

- GDP (Market Prices, Rupees Bn)
- Outstanding Home Mortgage Loans (% of GDP)
Bank Provisioning and Non-Performing Loans

percentage of total loans

Provisioning for non-performing loans (NPLs), latest
NPLs, latest
NPLs, 2006–08

GR = Argentina; AU = Australia; BR = Brazil; CA = Canada; CH = Switzerland; CZ = Czech Republic; DE = Germany; ES = Spain; FR = France; GB = United Kingdom; GR = Greece; HU = Hungary; ID = Indonesia; IE = Ireland; IT = Italy; JP = Japan; KR = Korea; MX = Mexico; MY = Malaysia; PL = Poland; RU = Russia; TH = Thailand; TR = Turkey; US = United States; ZA = South Africa.

For Germany, Italy, Japan, Korea and Switzerland, 2010; for all others, 2011.

Sources: IMF, Financial Soundness Indicators; BIS calculations.
Which Problems to Address First?

• Critical first step is reform of subsidized mortgage systems that create segregated markets; commercialize/privatize

• Second, reform of legal framework for lending and credit risk management; comprehensive credit information systems, standardization of underwriting, foreclosure law and legal enforcement – Central Banks+ Judiciary

• Third, implementation of measures to facilitate lending to the middle/lower income groups; appropriate lending instruments, collateral strengthening, selective mortgage insurance if feasible – South Africa, Morocco

• These measures will lower costs of mortgages

• Funding side support if necessary; but banks are liquid
Thailand Example of 1980/90s

• In 1990s actions to reform access to mass housing—(since reversal):
  - Reduced urban housing standards and permitting systems
  - Expanded mortgage lending
    - introducing competition in segregated market; rates came down
    - reducing risks to lenders: legal enforcement, credit information, standardization of underwriting
    - savings mechanism for informally employed
  - Result: developers built formal mass housing (accessible to 20th percentile with mortgage loan in 2001) and reduced # in slums (only 400,000 units left in 2001)
  - Strong model b/c minimal subsidies were used
  - But expanded access to finance linked to price increases; same as recent trends in Korea, China, Brazil etc.
  - Sequence of policy actions critical
Positive Trends in Micro-Finance for Housing Sector

• Consolidation, downscaling, up-scaling
• Improved regulation; e.g. Philippines, India
• More focus on savings – daily basis – to support credit
• Improvements in core banking systems and MIS allows greater use of Branchless Banking
• Increasingly sophisticated financial structuring – combining equity investments, DFI loans at concessionary terms, and savings to make loans at “feasible” terms – critical for longer-term loans
• Smarter use of subsidies to support capacity-building along with equity, e.g. Shorecap, SDI; but see issues in Mexico, Brazil
• Specialized rating agencies reduce risk for domestic and international investors
# Housing Finance Institutions and Commercial Banks: Not all are Effective

<table>
<thead>
<tr>
<th>Institution</th>
<th>Country</th>
<th>Product</th>
<th>Interest rate</th>
<th>Max term (to end-users)</th>
<th>Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>SIF</td>
<td>Mexico</td>
<td>Home improvement loans</td>
<td>3.6%-5.8% (to end-users)</td>
<td>24 months</td>
<td>$1.4b MXP</td>
</tr>
<tr>
<td>Land Bank</td>
<td>Philippines</td>
<td>General loans to MFIs via PCFC</td>
<td>10.5% or 91 day T-bill + 4% (higher of)</td>
<td>5 Years</td>
<td>NA</td>
</tr>
<tr>
<td>National Housing Bank</td>
<td>India</td>
<td>Wholesale financing</td>
<td>5 years</td>
<td>$25 million</td>
<td></td>
</tr>
</tbody>
</table>

Source: James Hokan
The massive scale of India’s urbanization will create a huge surge in demand

<table>
<thead>
<tr>
<th>Description</th>
<th>Metric</th>
<th>Demand forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Water supply</strong></td>
<td>Million liters per day</td>
<td>2007: 83, 2030: 189</td>
</tr>
<tr>
<td>Water demand will increase 2.3 times</td>
<td></td>
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</tr>
<tr>
<td><strong>Sewage</strong></td>
<td>Million liters per day</td>
<td>2007: 66, 2030: 151</td>
</tr>
<tr>
<td>Sewage generated will increase 2.3 times</td>
<td></td>
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<tr>
<td><strong>Solid waste</strong></td>
<td>Million tons per annum</td>
<td>2007: 71, 2030: 377</td>
</tr>
<tr>
<td>Solid-waste generation will rise 5 times</td>
<td></td>
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<tr>
<td><strong>Cars</strong></td>
<td>Urban stock of cars, million</td>
<td>2007: 10, 2030: 58</td>
</tr>
<tr>
<td>Total number of cars will rise 5.8 times</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Public transport</strong></td>
<td>Public trips per day, million</td>
<td>2007: 120, 2030: 328</td>
</tr>
<tr>
<td>Number of public trips per year will increase 2.7 times</td>
<td></td>
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<tr>
<td><strong>Affordable housing</strong></td>
<td>Affordable housing demand, million</td>
<td>2007: 25, 2030: 38</td>
</tr>
<tr>
<td>Demand will reach 38 million housing units</td>
<td></td>
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</table>

1 Assuming constant rate for unaccounted for water (UFW).
2 Net of existing supply.

• Mentioned of saturation in some narrow lower middle income market segments targeted by subsidies
• Given demand context this indicates suboptimal design relative to finance and supply market frontiers
Lessons

• Cannot be achieved by construction of middle income housing and filtering down of used units, even with current econ growth > pop growth

• Neither can problem be solved by focus on lowest income alone

• Requires massive investments in all segments, lower middle and low income, rental and ownership

Familiar Challenges:

- incomes low relative to cost of housing— land planning & building standards critical - FAR relative to location
- low level of infrastructure investment
- large (growing) proportion of workers in informal employment
- lack of access to construction finance and small scale of end-user finance
- lack of formal sector rental investors / finance
### Private Sector Debt Servicing Ratios (in per cent)

<table>
<thead>
<tr>
<th>Country</th>
<th>Graph</th>
<th>Year</th>
<th>Debt Servicing Ratio (% of Income)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ireland</strong></td>
<td><img src="#" alt="Graph" /></td>
<td>2011</td>
<td>32</td>
</tr>
<tr>
<td><strong>Spain</strong></td>
<td><img src="#" alt="Graph" /></td>
<td>2011</td>
<td>30</td>
</tr>
<tr>
<td><strong>United Kingdom</strong></td>
<td><img src="#" alt="Graph" /></td>
<td>2011</td>
<td>25</td>
</tr>
<tr>
<td><strong>United States</strong></td>
<td><img src="#" alt="Graph" /></td>
<td>2011</td>
<td>24</td>
</tr>
</tbody>
</table>

1. The debt service ratio (DSR) is the sum of interest payments and debt repayments, divided by income. An increase in the ratio implies a lowered capacity of debtors to withstand a negative income shock.  
2. Actual debt level and 75% quantile of the interest rate distribution since Q1 2000.

Sources: National data; BIS calculations.

Source: BIS Annual Report 2012
Credit Growth to Private Non-financial Sector, GDP Growth-and Credit Gaps: India Compared – 2011-2008

Credit growth and GDP growth

Credit gaps

AR = Argentina; AU = Australia; BR = Brazil; CA = Canada; CH = Switzerland; CN = China; CZ = Czech Republic; DE = Germany; ES = Spain; FR = France; GB = United Kingdom; HU = Hungary; ID = Indonesia; IE = Ireland; IN = India; IT = Italy; JP = Japan; KR = Korea; MX = Mexico; MY = Malaysia; PL = Poland; RU = Russia; TH = Thailand; TR = Turkey; US = United States; ZA = South Africa.

1 Compounded three-year growth rate, latest figures. 2 Total credit to the private non-financial sector. 3 Difference between the credit/GDP ratio and the trend of the credit/GDP ratio; latest figures.

Sources: Central banks; OECD, Economic Outlook; national data; BIS calculations.
Crisil Inclusix- India’s Financial Inclusion Index

- Score of 40 out of 100 in 2011 (up from 35.4 in 2009)
- 624 million savings accounts
- 160 million loan accounts
- Great regional disparities
Values Decline with distance from Central Business District

SOURCE: Alain Bertaud; McKinsey Global Institute analysis
Income Targeting of Housing Subsidies May not be Flexible enough

• RBI establishes the breakdown of the population by income:
  o EWS, LIG, LIG+, MIG and HIG monthly income brackets
  o EWS – LIG+ together < Rs.15,000 per month – or $340 per month
  o Drives subsidy allocation and targets for institutional goals
  o E.g. Interest subsidy scheme for Housing the Urban Poor (ISHUP) targets households with annual incomes < Rs2,00,000
  o E.g Credit Risk Guarantee Fund covers loans < Rs 5 lakhs w/o collateral at 90% - 85% cover
  o NHB targets 60% of their refinancing to loans of Rs5 lakhs
Examples of Other Countries’ Approaches

Most countries struggle through many falls starts:

- Chile: focus on deepening middle income access to mortgage finance; lacked adequate approach for low income until recently – includes rental strategies and subsidies
- South Africa: focus on 100% subsidized ownership housing for low income households on outskirt of cities with negative social outcomes; destroyed lower middle income owner market; rigid national income targeting lacked flexibility to work with markets; did not expand finance for lower middle income groups; very small rental programs; indebtedness prevents expansion of housing finance to target groups
- Brazil: focus traditionally on finance subsidies for middle and lower middle households; million houses program subsidized ownership deeper for below 3MW; stress on financial sector to expand credit further; government takes most credit risk; high indebtedness
- Mexico: see case study; deep finance subsidies for formal workers through provident funds; wanted to reach too deep down at the cost of location/services == vacancies and disastrous effect on construction sector when policies changed; unlevel playing field and weak liquidity facility and crisis destroyed MFC sector
- Egypt: highly subsidized expensive units with unsustainable finance subsidies fro commercial banks
- Indonesia