

# en breve



WORLD BANK

A regular series of notes highlighting recent lessons emerging from the operational and analytical program of the World Bank's Latin America and Caribbean Region.

## Low-income Housing in Latin America and the Caribbean

Abhas K. Jha

Housing is one of the most important sectors of the economy—in developing countries as in richer ones—with large positive externalities in terms of economic growth, public health and societal stability. It is the primary form of asset accumulation for the poor—often representing more than 50 percent of the assets of households. However, housing systems in developing countries are dominated by badly designed, poorly targeted, and inefficient government subsidies, market failures in land markets, overwhelming informality, a predominance of powerful vested interests and a growing slum population. Indeed Bertrand Renaud (formerly of the World Bank) has stated that “very few major sectors of the economy have been so much plagued by unjustifiable amateurism in public policy as housing in developing countries.”

Yet there is hope. More than three decades of experience in low-income housing has led the World Bank to adopt an “enabling plus” approach to housing policy, which moves beyond simple housing provision to an approach that combines a healthy respect for markets with intelligent subsidy design. It attempts to establish functioning land markets and uses a holistic and integrated approach to home improvement that incorporates tenure security, hazard mitigation and access to finance. In parallel, the focus of the World Bank’s strategy for housing in Latin America has evolved from sites and services (in the 1970s and 80s) to enabling housing markets (in the 1990s) to the current enabling plus model. This note focuses on the strategy to provide formal housing for low-income families in LAC. The Bank also has rich experience in urban upgrading and regularization of informal settlements in Brazil, Venezuela, Ecuador and Peru that would need to be dealt with in a separate note.

### The Housing Sector in LAC

Latin America has a higher urbanization level (76 percent)

and a higher level of home ownership (73 percent) than most other regions of the world. The housing sector in LAC has been driven by four powerful global trends of the past two decades: urbanization, democratization, decentralization and globalization. These trends have led to greater depth of financial systems, a wider range of housing financial instruments, and a transformation in the role of governments from a housing provider to an enabler. The availability of housing finance has increased dramatically in the region over the past decade, facilitated in particular by macroeconomic stability and the growth of mortgage securitization.

Despite these positive trends, there remains a huge housing deficit within the region. According to the United Nations ,26 million housing units are currently inadequate and an additional 28 million units are urgently required to relieve crowding and substandard conditions. The price of serviced land in Latin America is amongst the highest in the world, relative to income. Informal tenure is common, accounting for about one third of home ownership. The failure of formal housing markets to accommodate swelling urban populations has led to 128 million people living in slums in Latin America. Most housing in the major cities is self-made, a percentage that has risen steadily. For instance, in Mexico City an estimated 60 percent of the population lived in self-constructed homes in 1990 compared to 14 percent in 1952. Less than a quarter of all housing in Latin America is financed through formal mechanisms, and mortgages still accounts for a small fraction of total credit.

Housing finance systems in the region are still overwhelmingly dominated by inefficient government subsidies and public institutions. In Mexico the main actors are INFONAVIT and FOVISSSTE, which are pension funds that also provide below-market interest rate subsidies and originate mortgage loans. The latter in particular has a very high level of default on its loans. In Argentina the

National Mortgage Bank obtains high interest, inflation-adjusted rediscounts from the Central Bank. Its portfolio also shows a high level of delinquency. In Uruguay, the housing mortgage market has long been dominated by the state-owned Uruguay Mortgage Bank (BHU), which even until very recently accounted for 80 percent of all housing mortgage credits. The one significant and positive outlier in this regard is Chile where the government moved to a market enabling approach -in 1977- almost a decade before multilateral institutions such as the World Bank and IADB did. In 2002, Chile's Ministry of Housing and Planning (MINVU) stopped giving mortgage loans and gave up the direct construction of houses. In 2004, 96 percent of resources were targeted to subsidy programs and only 4 percent to building programs.

## The World Bank Group Housing Strategy in LAC

The huge housing deficits and the obvious inadequacies of the government-dominated housing finance system in LAC have led the World Bank to gradually but radically alter the way it approaches housing. The current "enabling-plus" approach is embodied in ongoing shelter projects in Mexico (the three Housing Development Policy Loans-DPLs- series and parallel Technical Assistance) and Brazil (two housing DPLs and a Sector Wide Approach-SWAp for urban upgrading) and a project under preparation in Peru (a proposed Adaptable Program Loan-APL).

Central elements of this approach include:

- Support for developing a policy and institutional framework for housing and urban development that draws together the disparate stakeholders
- A greater role for the private sector and community providers
- Support for widening and deepening housing finance systems through a variety of products like mortgage insurance, standardizing mortgage securitization
- A shift away from implicit interest rate subsidies to upfront demand-side subsidies
- Increasing the supply of serviced land for low-income housing
- Mainstreaming hazard mitigation into urban planning
- Mainstreaming and up-scaling urban upgrading into the overall city planning and financing process
- Capacity building for local governments in areas such as land-use planning, regulation and zoning.

This strategy has been complemented by the IFC's work in the housing sector in LAC, which has focused on building viable primary and secondary mortgage markets in the region through a combination of investments and technical assistance.

## Housing Reform in Mexico and Brazil

The housing sector in Mexico has been the stage for the country's "overlooked revolution." A combination of macroeconomic stability, after many years of turmoil, and good policy has led to a boom in middle and high income housing demand among Mexico's young and urbanizing population. In 2000 the incoming Fox administration made housing one of its top priorities. This led to the 2001 National Housing and Urban Development Policies and a number of subsequent reform measures which are discussed in detail in Box 1. As a result, Mexico has the highest volume of mortgage-backed securitization transactions in Latin America, while the government is on track to meet its target of providing 750,000 housing solutions this year.

The World Bank has been an important catalyst and partner in Mexico's housing reform. Through the now-closed FOVI loan the Bank (along with the IADB) financed the creation of *Sociedad Hipotecaria Federal (SHF)* in 2001, to spur development of the secondary mortgage market. Through the three-loan DPL and HUTAL series the Bank has worked with the Government of Mexico in formulating its national housing and urban policies. In addition the Bank has supported Mexico's comprehensive property registry modernization program and the development of comprehensive risk atlases for Mexican cities. Current work in progress includes technical assistance on housing subsidy reform, as well as a comprehensive assessment of urban land market microstructure and dynamics that will culminate in selected pilot programs for increasing the supply of land for low-income housing. IFC, in turn, has helped develop mortgage markets through local currency debt facilities to major originators in the sector, including *Su Casita*, *Hipotecaria Nacional*, and *Hipotecaria Crédito y Casa* and is focusing on providing warehouse credit lines to support mortgage securitizations, and other capital market securities, and is also supporting the development of a viable secondary mortgage market.

Brazil, like Mexico, has been pursuing market-based reforms to address the enormous deficit in its housing stock, particularly for low and moderate income households. Official estimates of the total housing deficit vary from 5.4 to 6.3 million households. The country also faced the challenge of a financial system ravaged by years of high real interest rates and volatile inflation. The Government of Brazil has undertaken a number of reform measures starting from the 1997 Law 9514 that established a comprehensive legal framework for mortgage securitization.

## Box 1: Recent Housing Reform in Mexico and Brazil

*Mexico:* In 2000, bankruptcy reform improved contract enforcement and creditor rights by clarifying and streamlining the process and strengthening lenders' ability to repossess assets. (The collateral provisions were further strengthened in 2003.) In January 2002, Mexico introduced a revised legal framework for credit bureau operations. This law, coupled with supporting bank regulation, improved the timeliness of credit bureau data on the creditworthiness of potential borrowers, increased lenders' use of credit bureau information and strengthened privacy protections. Mexico's first mortgage-backed securities were issued in December 2003, following years of improvements to the associated information systems. Other structural changes supporting securitization include the application of uniform underwriting standards, consistent loan valuation standards and transparent foreclosure rules. As a result of these efforts, Mexico's mortgage-backed securities market now compares favorably in terms of volume and number of transactions with those of comparable countries like Malaysia and South Africa. Sociedad Hipotecaria Federal (SHF) was created in 2001 to spur development of the secondary mortgage market by guaranteeing credits and creating a central database on borrowers, loans and mortgage-backed securitizations. Through partial guarantees, SHF has assumed a significant amount of the credit risk in securitized mortgage pools, lowering issuers' transaction costs and reducing the credit enhancement needed to meet a particular rating standard. The Mexican government, in turn, has explicitly guaranteed SHF's obligations through 2009. In addition to originating mortgages, SHF has been a major funding source for Mexico's mortgage finance companies (SOFOLs). Overall, 35 percent of SOFOL direct funding comes from government sources.

*Brazil:* The Brazilian Housing Finance System relies on two basic funding sources: savings deposits held by the public with financial institutions authorized by the Central Bank of Brazil; and mandatory deposits made by employers in accounts held in the names of their employees in the Fundo de Garantia do Tempo de Serviço or FGTS. However, many potential borrowers have been deemed ineligible to receive loans from these sources of financing due to concerns over the difficulty and expense involved in foreclosing on property. This ineligibility led to the creation of a new source of funding. Law 9514 of 1997 changed the face of the Brazilian mortgage industry, principally through the introduction of a new securitization vehicle (CIBRASEC- Companhia Brasileira Securitização or the Securitization Company) that will improve liquidity in the mortgage marketing and a new type of real estate investment instrument—the CRI (Certificado de Recebíveis Imobiliários or Certificates of Real Estate Receivables), which is a note issued exclusively by securitization companies. In February 2001, Brazil's Congress passed a constitutional amendment that guarantees the right to adequate housing for all Brazilians. In addition the Government of Brazil has been trying to enhance the role and impact of the market-based housing finance system (SFI) and to improve the existing the savings-linked Sistema Brasileiro de Poupança e Empréstimo (SBPE) and the higher-end market based mortgage system, known as the SFI (Sistema Financeiro Imobiliário). As regards SBPE, key efforts have been focus on the orderly and phased expansion and deregulation of the SBPE and broadening its reach through changes to the targeting and weighting of loans eligible for financing. For the broader SFI, the Government aims to set the stage for a gradual expansion of market-based finance as market conditions evolve. The Government has created the Programa Social de Habitação (PSH), which combines an upfront down-payment subsidy to households with an upfront subsidy to lenders to compensate them for the extra risks and costs in lending to lower income households, and a well conceptualized auction system for participating financial agents.

The Bank is supporting the efforts of the Government of Brazil through the Housing DPL and TAL as well as the upcoming SWAp that focuses on areas such as institutional development, better targeting of subsidies, establishing a credible regulatory and legal framework for housing finance. In addition, the Bank is undertaking a technical review of the issues related to the development of a functioning credit insurance market; a strategic study of the medium-term future of FGTS, the Federal Pension Severance Guarantee Fund, which has established a program for upfront housing subsidies for the poor; and providing support to the federal urban upgrading program. In parallel, IFC's housing finance strategy in Brazil aims to increase market liquidity by supporting the business activities of securitization companies, mobilizing funding from capital markets investors, and helping standardize residential real estate origination and securitization practices along international lines. For example, in June 2006 IFC provided a credit-linked guarantee to Banco ABN AMRO Real S.A., which

would make local currency funding available to support Rio Bravo Securitizadora, a leading real estate securitization company in Brazil.

### The Challenges Ahead

The Bank's recent housing work in LAC has highlighted a number of emerging issues and gaps in our analytical knowledge. Main issues that require further attention include:

*How do we make land markets work for low-income housing?* The supply of serviced land is the greatest bottleneck to increasing the supply of low-income housing. Yet there are very few empirical, data-driven studies of urban land markets in the region. In finding a solution, much of the problem is aligning the incentives of local governments (who often control the supply of land) with federal and state governments, who are responsible for providing low-income housing. One interesting model is

the Metrovivienda land banking/poverty alleviation program in Bogota, Colombia. However, each country in LAC needs its own form of a sustainable model for the supply of land for low-income housing that addresses land market rigidities and failures.

**How do we build a robust system of housing indicators?** Very few countries in the region have a housing information system that is comprehensive, reliable and up-to-date, and is of use to all stakeholders including the private sector, federal, state and local governments, and regulators. Mexico, a sophisticated middle-income country, does not have a system for tracking new housing starts and one often has to wait for the national income accounts for data on the subject. Similarly, very few governments or central banks track the systemic risk posed by housing finance, along the lines of the systemic risk review conducted by the US Office of Federal Housing Enterprise Oversight-OFHEO). There are a number of private housing databases (e.g. SOFTEC in Mexico), but there is a need for an initiative to pull together disparate sources of information into one comprehensive source and also build regional and local affordability and hedonic price indices.

**How do we make rental housing work for the poor?** Rental housing is the Achilles heel of the Bank's housing practice. For many years the unspoken assumption by both governments and the Bank has been that home ownership is a universal aspiration. This is not true. There are many people (including highly vulnerable groups) who cannot or do not want to own, and would therefore rather rent. Similarly, in developed economies young people generally rent as they move between jobs and cities and find rental housing the most cost effective way of allowing them to move to better opportunities. Government policies, on the other hand, have been hostile to renting through tax treatment, rent control laws etc. There is a need to better understand this market, in terms of its actual size (at least in the main urban centers), social composition of tenants, rents actually charged for different submarkets, estimated vacancy rates, and the undeclared/informal market share. In addition, clearer information is needed on the detailed tax treatment, non-payment and other main risks, as well as on the formal and informal gross and net yields received by investors. Similarly, innovative financial instruments like rent-to-own (as in the UK) and lease-to-own (Austria) may be useful in this regard as would promoting non-profit management of rental housing.

**How do we tap the full potential of housing microfinance and remittances?** Housing microfinance is a growing but

still niche area of housing finance. The poor typically build their homes incrementally and microfinance instruments offer a good match for their cash-flows. Financial and non-financial institutions across the region are piloting new housing microfinance loan products. For example, Patrimonio Hoy run by CEMEX in Mexico allows poor consumers to lock in building material prices, while making small regular repayments and receiving advice on home building. A credit card based payment system that is widely accepted by building material suppliers and contractors is one way of addressing high operating costs, which represent a key constraint in scaling up housing microfinance. Remittances sent to Latin America and the Caribbean from all parts of the world are expected to total more than \$60 billion in 2006, surpassing both the amount of official development assistance and foreign direct investment to the region. Housing is a priority area of usage for remittance finance. One of the most promising areas of housing finance is how to design innovative instruments that could leverage this enormous flow of capital. For example, using the remittance history of a recipient to serve as collateral for a home mortgage or a home construction loan, or creating vehicles by which some of these funds could be invested in more liquid mortgage-backed securities.

**How do we create a new class of medium and small developers?** Experience in other countries has shown us that small and medium developer capacity is key to addressing the supply of low-income housing. Large developers are most often uninterested in the small profit margins of low-income housing. However, small and medium developers are handicapped by a lack of access to construction finance. Guarantee schemes and bridge loans are good ways to address this gap (as shown by the success of NURCHA in South Africa ) as is the provision of some form of guarantees/ refinancing of long term mortgages which would go a long way to increasing banks' willingness to provide construction loans. Costa Rica, where NGOs have developed relatively sophisticated capabilities to deliver low-income housing, offers another useful model. There is a clear need for an analysis of small and medium developer capacities and needs, as well as for greater efforts to design financial instruments that best address these needs.

#### About the Author

Abhas K. Jha is a Senior Infrastructure Specialist with the Water & Sanitation Cluster (LCSFW) of the Latin America and the Caribbean Region of the World Bank, based in Washington D.C.