Housing Finance Options for Low and Medium Income Families: Analysis of the Latin America Experience[1]

by Bruce Ferguson[2]

1. INTRODUCTION

65% of the population in Latin America cannot meet the payments of a mortgage credit for the acquisition of the cheapest of new homes. As a result of this reality, in many countries in the region -excluding Panama which is an exceptional case - families progressively construct their houses during five to fifteen years. Low-cost housing conditions basically consist of a plot of land with toilet, the improvement or extension of an existing house, or the replacement of a house in a state of deterioration.

Table 1 shows the low- and medium-cost housing solutions available in Mexico. The first point that should be emphasised is that many alternatives exist in this country for housing solutions, and this is the key for a housing strategy for low- and medium-income families. It should be noted that it is essential to stress the need for low-cost solutions in order to achieve sustainability in the financial credit of a program or product. For example, the cost of the acquisition of a new flat for a medium income family in Mexico City, Guadalajara or Monterrey, is equivalent to ten times the cost of extending a house. As such, it is vital to emphasise low-cost solutions as part of sustainable strategies for housing in low and medium income groups.

There is also another reason why emphasis should be placed on home extension and improvement solutions for low-income families. Surveys consistently demonstrate that low-income families notably prefer to improve their current home in their present neighbourhood instead of relocating to a new unit under social housing programs. A much greater level of satisfaction is registered with programs for the improvement and construction of a house in a plot that the family already owns, than buying new social housing. The reason behind this is that where the families live is, in many cases, also where they have their work, and have established social relationships etc. In addition, social housing is sometimes of poor quality. Low-cost solutions are clearly preferred by low-income families.

TABLE 1
Low and moderate cost housing solutions in Mexico
(in dollars)

HOUSING SOLUTION	COST IN US$
Simple improvement (new ceiling, floor and kitchen refurbishment	500 – 1,500
Expansion (for example, new room or lounge)	1,000 – 3,000
Replacement of a deteriorated house by a new basic house for the family group	4,000 – 6,000
Purchase of a low cost second-hand house	5,000 – 15,000
Purchase of a new 40 m^2 progressive house	10,000 – 20,000
Purchase of a new 45 m^2 flat in a multi-apartment building in Mexico, Guadalajara and Monterrey	20,000 – 30,000

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[2] Specialist in the Housing Sector of the Finance and Basic Infrastructure Division of the *Banco Interamericano de Desarrollo (BID)*. E-mail: bruce@iadb.org

2. MORTGAGE CREDIT IN LATIN AMERICA

In Latin America, traditional mortgages consist of mortgage loans over a fifteen to thirty year period for the acquisition of new housing for families from the formal sector, and in employment. This type of option is often recommended bearing in mind its success in countries such as the United States, European countries, and certain wealthy Asiatic countries; on the other hand statistics indicate that traditional mortgage credit fails to reach 50-70% of the population, including the majority of low- to medium- income families, due both to problems of supply and demand.

In the case of demand, low- to medium-income families cannot sustain the payment of a loan for the acquisition of a new, low-cost home produced by the formal sector, and frequently do not possess title deeds nor have formal income. As such, another type of low-cost solution is required. Moreover they do not want mortgages over long time periods as these do not correspond to their lifestyle, given that their incomes fluctuate greatly.

In the case of supply, the *modus operandi* of the mortgage institutions facilitates the financing of large housing subdivisions, but does not adapt itself well to low-cost solutions (improvement, extension, construction of a basic house on a plot of land, older housing). For some savings and lending entities which specialize in giving large-scale credit for the acquisition of new housing, very important scale economies exist. For example, *sociedades financieras de objeto limitado (sofoles)* [limited objective financial companies] in Mexico, have offices on the housing project site itself, for the granting of loans, collection of payments, etc. As for the property developers, they assist the savings and lending entities, the *sofoles* in this case, by taking the families' details. It is for this reason, in examples such as this, that there are many scale economies in the granting and administration of mortgage loans for the acquisition of new housing in very large subdivisions. By contrast, loans for low-cost housing in different housing developments are individualized loans, and as such, are more difficult to generate because they involve greater expense.

In principle, microfinancing is one solution to the aforementioned problems of supply and demand. Microfinancing of housing consists of small loans, generally from US $500 to US $5,000, for low-cost solutions such as improvement, extension, and construction of a house on a family's own plot of land. The interest rates vary depending on the entity (around 2-3% per month), and the loan amount varies according to the needs of low- to medium-income families. For obvious reasons, many entities that grant microfinancing use diverse kinds of guarantees. Small loans require only small payments, which are more easily met by the families.

Microfinancing is the type of financing that best suits the needs of low-income families. Microfinancing of housing has rapidly spread throughout Latin America over the last four years, principally through microfinancing entities, and not so much through savings and lending entities, although there are exceptions: for example Mutual La Primera in Bolivia, that performs these kinds of operations. Another exception is the Dominican Republic, where the *Banco Interamericano de Desarrollo (BID)* [Inter-American Development Bank] is preparing a project on microfinancing of housing with the *Banco Nacional de la Vivienda* [National Housing Bank].

For example, the Dominican Republic has a good institutional base for the development of microfinancing for housing, given that there are five sound microfinancing entities, two private development banks, and 13 rural savings and lending cooperatives, which are already performing microfinancing for housing on a modest scale. In addition, the savings and lending associations have created two foundations to work with these kinds of loans. As for the *BID*, it is supporting the *Banco Nacional de la Vivienda* [National Housing Bank] so that this becomes a second tier entity and in this manner may grant credit or liquidity to the aforementioned entities and other first tier entities, to increase the supply of low-cost, housing microcredit.

For the *BID* housing microcredit is the cornerstone of a housing policy directed towards helping low-income families in a sustainable fashion. The other alternative is to offer subsidies on a massive scale, but very few governments can support strategies to subsidise 50% of the population with this mechanism.

3. FAMILY SAVINGS IN LATIN AMERICA

In Latin America savings and lending systems created in the image of traditional Western European systems of mortgage financing- from France, Germany and Austria- were in operation, or are still in operation in various countries, which promote the use of family savings during a determined time period- for example from three to five years- as the basis for automatic qualification for a loan, the amount of which being a multiple of the amount saved, generally three or four times its value.

In many Latin American countries, savings continue to be the most important source of investment in housing. It should be noted that in the region, the percentage of homes that have a mortgage is extremely low: even with the advantages that Panama enjoys, in this country only 10% of homes are mortgaged, and in the Dominican Republic this amount is even lower (2%). As such, the majority of housing finance comes from family savings. Nevertheless, governments often fail to take full advantage of this saving capacity. In general the aid projects offered by government do not place any emphasis on saving, except in certain exceptions, such as the case of Chile, where the time and quantity of savings is rewarded; nevertheless, in other countries in the region the adoption of these types of mechanisms has advanced very slowly.

What is needed in order to increase family saving in Latin America is the creation of strong incentives and the programming of appropriate time periods - a minimum of 12 to 18 months - so that families can save significant sums to complement the subsidy and loan; an example of this is, as has already been mentioned, Chile. Another interesting example is the case of some *sofoles* in Mexico, which classify families according to their savings behaviour, and who, in general, pay their mortgage without any problems. This is achieved by requiring that the families deposit savings for one year or a year and a half, in order to qualify for the loan, it is very important to note that very few of these loans are non-performing.

4. DEMAND SUBSIDY IN LATIN AMERICA

4.1 Creation of the demand subsidies system

Over the last fifteen years the demand subsidies mechanism has often been recommended to allow people access to housing in Latin America. The pioneering country in the implementation of this mechanism was Chile and, based on this experience, the system has spread to the great majority of Latin American countries. Demand subsidies came about as an answer to the problems of the previous contractual savings systems, many of which still exist in various countries, channelled by interest rates below the market rates for the acquisition of social housing. These contractual savings systems were, or are, based upon tax or contribution on the earnings of employees in the formal sector, and using these resources the construction and acquisition of new housing was, or is, financed. On many occasions these funds had a double role, as they were also destined for retirement purposes for the contributors.

In the majority of the Latin American countries, contractual savings arose in the decade of the Seventies, and continue operating in some countries such as Brazil, Jamaica, Mexico and Venezuela. These funds, in general, have various drawbacks, but one very important problem is that when a significant part of a financial system for housing that relies on a contractual savings mechanism of this type does not function under market conditions, it is very difficult for the system to completely develop, in particular for the financing of low- and medium- income families. This is the problem that some countries are currently facing, for example Mexico. It should be emphasised that these funds have two advantages: one is that they permit the accumulation of a great amount of resources; and the other is their continuity over time.

The idea behind the implementation of the mechanism for demand subsidies was to replace the traditional method for financing social housing. In reality, the classic demand subsidies model, based upon the Chilean experience, contains four reforms. The first reform consisted in initially making the subsidy in question a transparent amount that may be budgeted for, instead of an interest rate that may not be budgeted for over the year, given that the rates are constantly fluctuating.

The second reform is that the subsidy attempts to stimulate housing loans at market rates (with the same applying for savings). The third reform consists in concentrating fiscal resources on low- and medium- income families, through a points system, that rewards the need for housing and saving effort. The fourth reform involved in this system is that demand subsidies are portable, so that families have the power to select their housing, in terms of type of property, location and other characteristics. This is important because when the subsidy is given to the family and they select the property then it really is the family who is receiving the subsidy; but when the subsidy is given to the developer or financial entity, the tendency exists for these offering agents to absorb an important part of the subsidy.

4.2 Lessons from the regional experience

The Chilean model of demand subsidies has extended to other countries in the region, including Colombia, Costa Rica, Ecuador, Guatemala and Venezuela. From the experience of these five countries and Chile, four important lessons have been learned. The first lesson, and perhaps the most important, is that the demand subsidies system has functioned very well in some countries in the region, having had rather significant impact in Chile, Colombia and Costa Rica, who to this end dedicate significant amounts- more than 1%- of the governmental budget, maintaining temporal continuity, during a period of more than 10 years. Similarly, in countries where there has been no commitment of this kind, in terms of the amount and continuity of resources, the system has not been successful.

For example, when the demand subsidies system was established in Ecuador, this functioned well while it was financially supported using resources from a BID loan; however, when these resources were exhausted, there was no effective commitment from the State to continue financing these subsidies, which produced a paralysis of the system with a huge negative impact on the main players. This has not only occurred in Ecuador, but also in various other countries. For this reason, without a minimum resource amount provided by the government and with no long term commitment, it is not very intelligent to apply this mechanism, because it will not be successful and, on the contrary, could even create many complications.

The second lesson refers to the focus of the demand subsidies system. The demand subsidies system has allowed considerable access to housing for the medium-low income group, that is, families with incomes of 3.5 to 6 times the minimum wage, depending, of course, on the country in question; but, generally they have not reached low-income families - that is, those who have incomes from 1.5 to 3.5 times the minimum wage- and, incidentally, nor have they reached “poor” people- with incomes less than the minimum wage, although partial exceptions do exist, such as the cases of Costa Rica and Colombia explained in part by *sui generic* reasons. For this reason, other types of interventions are necessary to reach these two other income groups.

The third lesson is related to portability (that is, the right of the family to choose their home). Reviewing the regional experience in the application of the demand subsidies system, one may reach the conclusion that portability is very important - as it is the families themselves and not the property developers who receive the subsidy-, but its implementation is very complicated without governmental commitment for significant amounts and continuity. Apart from Chile, only Colombia has portable demand subsidies in the classic sense in the sample of countries considered.

The fourth, and last, lesson is that the demand subsidies system has had a positive impact in stimulating credit for the medium-low income group, but not for low-income families and, as such, other kinds of credit incentives are needed. In this sense, it is important that the offer of credit be directly supported, for example, through microfinancing housing. The demand subsidies system has encouraged saving when strong incentives and the necessary time period have existed, but has had no impact on savings in the absence of these conditions.

5. EFFECTIVE HOUSING PROGRAMS FOR POOR FAMILIES

Below are some recommendations concerning the type of programs that have functioned well in the Latin American region. All of these programs share three basic elements - subsidy, credit and savings - in differing forms, and are divided according to level of income. For poor families, with incomes up to 1.5 times the minimum wage, three types of successful programs are suggested that combine subsidy with family savings, principally in the form of labour and materials: (a) Flats and roofs, which is applied, for example in Nicaragua; (b) Replacement and/or progressive construction of a basic house on a plot of land owned by the family, as seen, for example, in *PARVIS (Programa de Ayuda Rápida para Viviendas de Interés Social)* [Rapid Aid Program for Social Interest Housing] in Panama, or the case of Guatemala, and the collective subsidy in Nicaragua; and (c) Basic improvements in the neighbourhood, relating to the installation of services that may be lacking.

As for families with 1.5 to 3.5 times the minimum wage who are able to fulfil obligations resulting from small loans, there are two types of programs. The first is the improvement of the basic infrastructure of the neighbourhood, plus housing microcredit. As has already been mentioned, the *BID* is currently preparing a housing program in the Dominican Republic in order to implement this modality. In this case not all the families will receive a microcredit, but a significant percentage will do so. The second modality, which functions very well through the private sector, without any subsidy whatsoever, is the development of sub-divisions with a progressive infrastructure, plus housing micro-credit. This program has been applied in El Salvador since 1992, having stimulated the construction industry, principally that aimed at assisting low-income sectors.

Lastly, for families with medium-low incomes the implementation of demand subsidies is recommended, but with the condition that they are provided with a significant amount of resources with the possibility of continuity over time. Microcredit housing programs are also recommended in order to progressively extend houses resulting from the demand subsidy programs; as well as the improvement of older houses.