Scaling Up Housing Microfinance for Slum Upgrading[1]

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"Achieve a significant improvement in the lives of at least 100 million slum dwellers, by 2020." (UN Millennium Development Goals)

To achieve the U.N. Millennium Development Goals, it is essential to scale up slum improvement programs to a level commensurate with the rapid growth of slum populations. To eliminate slum conditions over the next 15 years will require a sustained effort on a global scale. This is a challenging proposition since it is clear that scaling up slum improvement will require very substantial financial resources. Central and local governments will never have enough money to do the job entirely by themselves. Only by mobilizing private capital and enabling slum dwellers to improve their own housing conditions on a financially sustainable basis will it be possible to achieve such large scale results.

This paper is organized in a series of questions concerning microfinance for housing in slum upgrading. This paper will examine cases where housing microfinance and other sources of private sector housing finance were leveraged to improve housing conditions in slum communities on a financially sustainable basis. The answers to these questions support our assertion that housing microfinance is potentially the most effective way for slum dwellers to improve their own housing and their livelihoods.

What is Slum Upgrading and why is it important?

Slum upgrading is a programmatic response to existing slum communities that focuses on keeping the community intact while improving the quality of housing, infrastructure and services in the slum. Slum upgrading minimizes physical and social dislocation of the urban poor compared to alternative programs of "slum clearance" or "slum eradication" that typically drive the urban poor from their homes, bulldoze their shacks (and their belongings), and make inadequate efforts to provide alternative housing that takes into account the economic and social realities of the slum dwellers themselves.

What are the main constraints that slum dwellers face to build or improve their homes?

Housing is not only a shelter for slum families – it is their social security. It is estimated that 75% - 90% of all new housing is built informally through incremental housing rather than new home construction. More than half of the population in the world is not served by mainstream housing finance. This is particularly true for those living in slum communities.

Furthermore, it is estimated that fewer than 25% of people in developing countries can afford to purchase the least expensive developer-built unit with traditional mortgage finance because of the entrenched factors in the developing world[2]. Some of these factors are:

1. High real interest rates
2. Lack of long term funding on domestic markets in developing economies which creates interest rate risks for mortgage lending and greatly limits the funding for mortgages.
3. Expensive and costly formal sector systems including those for property registration, land use development and property transfer taxes
4. Instability of household income especially from the informal sector, making long term debt risky for households
5. Many affordable housing projects often poorly fit the needs of low income families.

Due to the above constraints, most slum dwellers do not attempt to build homes and

[1] This paper is excerpted from a larger work by the authors entitled "Scaling up Slum Improvement", presented by the authors in an interactive session at the 2006 World Urban Forum in Vancouver. The full article is available upon request.

[2] Fergusson, Bruce. Scaling up Housing Microfinance: a guide to practice, Housing Finance International (feature),International Union for Housing Finance, Vol. 19, Issue 1, p3-13, September, 2004.

access finance from informal money lenders at rates of interest as high as 120% to 150% a year. These loans have the potential to keep slum dwellers permanently in debt, which may actually destroy whatever security they may have had.

What are the Benefits of Housing Microfinance for Slum Dwellers?

- **Flexibility and Outreach:** Housing microfinance can reach low income households in developing countries, including slum dwellers. HMF provides a flexible form of finance for a wide range of uses, including home improvement, construction of a small unit on a lot already owned by a family or provided by a low-income developer, the purchase of tenure regularization of a lot, expansion of the core unit provided by local governments or to fill the gap between a public subsidy and a household's down payment for a home.[3]
- **Incremental Financing:** As discussed above, incremental housing construction is the norm in most of the slums around the world, which is best served by incremental housing finance. As most slum dwellers have irregular incomes, they are averse to taking on loans with maturities over five years. Housing microfinance offers smaller, more accessible loans with shorter tenures. This type of financing helps the poor establish credit histories, thereby reducing the risk to lenders and ultimately lowering interest rates.
- **Formal title not required:** Another major hurdle for slum dwellers' access to finance is their lack of legal title to their properties. Housing microfinance accepts alternative forms of collateral, such as co-signers, forced savings, home appliances and other non-mortgage forms of guarantee. While housing microfinance providers do need some kind of assurance about right of occupancy, they accept tax receipts and other substitutes.

What are specific common themes among successful models to help practitioners glean lessons learned?

SBI (ShoreBank International Ltd.) conducted an inventory of sustainable models for channeling private sector finance to slumdwellers as part of its Global Financial Innovations Partnership, a Global Development Alliance with USAID. Below are summary lessons learned from the analysis of successful housing microfinance models[4].

- **Targeting the poor and having high repayment rates are compatible:** Microfinance providers have shown that a legitimate traditional system of small savings can be applied to provide access to credit to the poorest of the poor. The social capital inherent in the local traditional systems can be modified and leveraged for use in microfinance. These systems are easily adapted to the tools of microfinance as they are well suited to the existing structures of the local community.

INSTITUTIONAL PROFILE: THE KUYASA FUND

The Kuyasa Fund is a non-profit MFI in Cape Town specializing in the provision of housing loans for un-banked and under-banked low income households with secure occupational rights in Khayelitsha. South Africa's fastest growing township.

With an outstanding loan portfolio of $1.2 million and a repayment rate of 93%, Kuyasa targets low income households whose incomes are just below the poverty datum line for the average urban South African households (around $310 for a family of six).

Product Characteristics:

- Kuyasa uses collective peer group dynamics to mobilize savings and assess potential.
- Loan size from R1,000-R10,000 ($140-$1400). The maximum loan granted is limited to three times the savings or a maximum of R10,000. The average loan is R5,000 ($720).
- Loan Terms: repayable over 6 to 30 months.
- Conditions: 32% interest rate per year.
- Loan uses: (1) Purchasing houses on serviced sites; (2) Home and/or property improvements to existing housing, such as storage, roofing, etc; (3) Improving and extending developers houses; (4) Purchasing sectional title units in undeveloped land,
- Life insurance (fee based product): Non-repayment risk life insurance is included in the fee structure of the loan products.

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[3] Fergusson, 2003.

[4] SBI carried out a comparative analysis of existing slum upgrading financial models and financing strategies to find and analyze which of them could be most effectively brought to scale to broaden their impact. SBI had interviewed 19 practitioners that are experts in urban and slum upgrading, microfinance, housing and social investments; as well as collected and reviewed 29 case studies. This thoughtful research and analytical exercise was part of the Global Financial Innovations Partnership, a Global Development Alliance (GDA) with USAID.

- **A properly managed loan process, visibility of loan officers and peer pressure from community members can sustain high repayments:** Microfinance providers have also shown that the ability of the poorest of the poor to repay loans can be predicted through a strict analysis of saving patterns and past loan records.

- **Importance of savings groups as risk management strategy:** The risks of loans can be considerably decreased in a group lending method as clients are pressured by their peers to repay their loans. These groups also fulfil an important social function, as group savings are a form of security for emergencies for poor people. The savings group activities also give them the chance to prove their financial and organizational skills.[5]

- **Right of occupancy as permanence proof:** Formal title is only one of the ways to recognize the permanence of slum dwellers on their plots, probably not the most effective or suitable in many cases (titling registration is expensive and burdensome, no updated registration system, etc). It is more important to recognize permanence, than to recognize ownership. Thus, the home itself is often not the collateral and the lender relies on alternative forms as security (described below).

- **The best collateral for housing loans need not always be the mortgage:** Savings, co-signers and household articles as collateral can be as effective for housing micro finance.

- **Expansion and scaling up requires profitability:** the greatest priority is to ensure that operational scale and efficiency is developed to enable operations to be financially sustainable. Once the financial sustainability is achieved, alternative sources of sustainable wholesale financing (loans from banks, access to financial markets) can become available. In the case of micro enterprise MFIs, Principal Debt Outstanding growth is possible by deepening loan activities with existing clients. However, in housing microfinance growth requires expansion, because even though there may be some repeat borrowings, sustained growth means new clients, new areas of operation, and new products.

- **The private sector can play a crucial role in slum upgrading by recognizing low income families as clients** (*Approach from the Bottom of the Pyramid*[6]). In fact, a program developed by the Mexican cement company CEMEX called Patrimonio Hoy (PH), demonstrates that the low-income population can be indeed a reliable and profitable segment of the market. PH is a profitable initiative, and provides a comprehensive housing solution for poor people at market prices, with no subsidies, and exclusively relying on private funding. However, corporations need to invest heavily on the front end by understanding the low income segment of the market, and designing products and services tailored to their needs and cultural values (it took PH some seven years to design and roll-out the program).

- **Buy-in by stakeholders is a prerequisite of success:** Even though the program was designed as a win-win solution for all stakeholders, PH faced internal reluctance from CEMEX Corporation to serve low-income households, as well as initial distrust from this segment of the market. On one side, launching PH required CEMEX corporate funding for years, which clashed with the short-term business vision prevalent in many corporations. In fact, PH reached the break even point in October 2003 (after 42 months), and all the investment was paid back to CEMEX in April 2005 (nearly seven years from the initial concept). Top management's leadership and support to the program was crucial to overcome the internal reluctance. On the other side, PH invested in building trust among the community by fulfilling all of the program's promises, providing high consumer service standards, having local presence, and enrolling members of the community as promoters.

- **Knowing the borrower is essential:** Instead of strict credit evaluation and collateral, PH preferred to minimize risks by extending a minimum credit to people who sign up to be "members" in the first phase of the program and testing their commitment as the program progresses. This strategy ensures that business volume increases without exposing the company to big risks. This not only helped the company build a credit history of its own clients for future transactions, but also minimized administrative costs. It is also very easy for the new client to understand the rules, thereby lowering access to financial barriers for the low-income market.

- **Long term customer retention in this market segment is challenging:** Even though customer enrollment is growing at a rapid pace, many members in the PH program take a break from the rigors of repayment once one room is complete. In many cases people cannot afford to pay both the installments and the masonry fees, so they buy the materials at one time, and then after 70 weeks, start building houses. The customer retention problem could also spring from the cultural belief that fate determines outcomes, leading to the conclusion that long term planning is worthless. PH is working to overcome both problems, by creating a "club experience" that motivates productive behavior, and by establishing masonry training facilities for "self construction" for members.

[5] This point emphasizes the importance of a savings group as a risk mitigant and skills building vs. the way microfinance leverages these groups to provide financial services. I've reworded it slightly.

[6] Prahalad, C.K. (2005) *The Fortune at the Bottom of the Pyramid. Eradicating Poverty Through Profits.* Wharton School Publishing.

INSTITUTIONAL PROFILE: PATRIMONIA HOY

Patrimonio Hoy (PH) offers micro-credit for purchasing building materials based on solidarity of a group with no collateral. This supply lending program is 100% privately funded by CEMEX, the third largest multinational cement manufacturing company in the world, operating out of Mexico. Launched in 1998 to reach the informal or self-construction segment, PH targets low-income workers, whose households earn approximately 50-150 pesos ($5-$15) per day.

In 2005, PH had 48 offices in 23 Mexican cities, with more than 75,000 participating families, who have built the equivalent of 33,000 additional 110 sq. ft. rooms. The repayment rate was 99.2%.

Program features:

- Provides $4 of materials for each $1 saved.
- Membership: 15 pesos/per member ("socio")/per week,
- Fixed raw material prices for 70 week periods.
- CEMEX sells construction materials to participants at market prices.
- Technical advice for customized house growth project for each family provided on fee basis (one room at a time).
- Warehousing services to store materials according to their needs.

The first phase of the program lasts 10 weeks. Each member starts by paying PH 105 pesos (after taking 15 from a total of 120 pesos) for the first 5 weeks, totalling 525 pesos. At the end of the 5th week, PH delivers raw materials for construction worth 1,050 pesos, effectively providing the members with a credit worth 5 weeks payment. This phase helps to establish the credibility of PH in the community by delivering on the promises it made and also tests the commitments of the members.

The second phase of the program is 11 to 70 weeks, during which members receive raw materials worth ten weeks at the end of week two of the second phase, ie, materials advance of eight weeks if they remain committed beyond the first phase. Deliveries are made during weeks 12, 22, 32, 42, 52 and 62 if the members keep up their weekly payments and stay in the program.

- **Government also has a role:** Governments should adopt policies that can enhance competition in the housing micro finance sector as only heightened competition spurred by new entrants into the market is likely to lower the interest rates on a sustainable basis[7].

- **Diversify funding to capital markets:** on balance sheet corporate debt or corporate bonds are the most appropriate for housing micro finance providers because of the small amounts, relatively short term and diversity of housing micro loans[8].

What is the impact of financing on housing quality in slums?

Housing microfinance allows the poor people in slums to buy good quality construction materials. Without access to finance, slum dwellers often buy small quantities of construction materials often of low quality, which in turn will negatively impact their housing quality. Quality of housing in slums is an obvious advantage of housing microfinance.

Most housing microfinance providers want to ensure that their clients build good houses. This is in the interest of the housing microfinance provider, given that housing quality will have a direct effect on repayment rates, as well as on the provider's image among slum dwellers. Hence, most housing microfinance providers recommend or even require beneficiaries to purchase materials from a reputed supplier. Housing microfinance staff are trained to ensure that the slum dwellers get better quality materials than they could buy independently. Some housing microfinance institutions have contracts with material providers through which the borrowers get discounts, while the supplier gets a constant stream of business. Whatever the relationship between the housing microfinance institution and the supplier, it has a positive effect on the housing quality.

As new entrants like construction material suppliers and even cement companies are coming to the market to provide housing micro finance, the quality of housing should continue to improve in slums. The CEMEX/Patrimonio Hoy case places considerable emphasis on enhancing the technical skill of its borrowers. They do so by providing an architect or advisor for the borrowers for a small fee. It is found that good construction practices actually decrease the housing costs, while improving the quality at the same time.

7 Fergusson, 2003

8 Fergusson, 2003

Is housing microfinance financially sustainable?

Housing microfinance lies at the intersection of formal housing finance and micro-enterprise finance[9]. It can be sustainable with the necessary scale, on an institutional basis. At scale, several successful housing microfinance providers can be a good tool for national governments in solving the shelter and settlement problems. For example, the Ministry of Housing in Morocco, currently undertaking a large slum upgrading program (“Villes Sans Bidonvilles” or “Cities Without Slums”), estimates that 80% of slum dweller’s financing needs will be met by incremental housing microfinance loans as opposed to mortgage finance[10]. The involvement of mainstream financial institutions in housing microfinance is critical to leverage local capital necessary to scale up and make micro lending sustainable. This will help the housing finance institutions improve their market access by providing services to the low/moderate–income households, which constitutes the majority of the population of the developing world. Specifically, microfinance institutions require access to additional, commercial sources of financing, such as loans from commercial banks and bonds, which would provide liquidity, particularly in local currency, to the sector and thereby allow it to reach scale.

One of the major challenges for the sustainability of housing microfinance is the access to long term funds for the housing microfinance providers, who often experience a mismatch between the assets and liabilities. In developing countries, this mismatch is true even for mainstream financial organizations, due to institutional constraints on interest rates and access to capital markets.

There are many approaches to solve the problem of access to long term capital: international markets, warehouse lines of credit, secondary market approaches, etc. In the meantime, national governments can encourage the mainstream financial organizations to enter into partnerships with MFIs. However, in some countries, the regulatory environment is not conducive to such arrangements. A common circumstance is that central banks prohibit banks from lending to MFIs. Additionally, the collateral requirements imposed by central banks on national banks for lending to MFIs, where the ultimate sub-loans are not secured by traditional forms of collateral, effectively scuttles any possibility of accessing long term finance by housing MFIs.

The mainstream private sector financial institutions in housing microfinance often lack familiarity and tools to reach the target market. Commercial banks are learning the value of MFIs as a service linkage and are building bank capacity to develop policies that recognize irregular incomes of slum dwellers. Thus, credit policies should be adjusted to meet the needs of low income people. Indeed, a “one size fits all” set of guidelines and regulations for all segments of society will not encourage the mainstream financial institutions to reach out to low income populations.

Another critical aspect for sustainability of housing microfinance is profitability (linked to reaching scale). Profitability will eliminate the dependency on grants to sustain the operations. At present, the high administrative costs amounting to almost 20%[11], makes the interest rates very high. Even though these rates are low compared to the money lender rates, they deny access to many potential customers, and thus reduce the business for MFIs. Use of appropriate technologies can bring down the administrative costs to a certain level. There are instances where housing microfinance institutions have significantly increased the number of loans processed by one officer by improving the technology. These kinds of improvements will go a long way in making housing microfinance sustainable.

Cross selling other products can augment the coverage of these institutions, and hence subsequently increase the access to slum dwellers. Some examples of offerings include savings products, remittance services, and other types of credit by housing microfinance institutions. This kind of relationship banking with clients in slum dwellers can further contribute to sustainability for housing microfinance institutions. A diverse portfolio of products will increase the number of clients for the housing microfinance institution, as well as raise the repayment rates, contributing to the sustainability of operations.

What is needed to scale up slum dwellers’ access to housing micro-finance?

Low income communities are inherently considered risky, involving high transaction costs and small margins. Private sector involvement, crucial for scaling up any initiative, is limited mainly because of this risk perception. Hence, the main challenge for regulators is to reduce the risks associated with private sector participation, in order to mobilize additional capital.

In addition, it is important to avoid premature and inappropriate regulations, especially interest rate caps. Regulators should not compare housing microfinance interest rates to the mortgage lenders. They should be compared to the rates of informal providers.

1. Governments should replace interest rate subsidies with direct demand subsidies, preferably in the form of portable homeownership or downpayment vouchers. These

[9] Daphnis, 2004.

[10] From conversations between ShoreBank representatives and the Minister of Housing and other ministry representatives of the Kingdom of Marroco in November 2005.

[11] Ferguson, 2003.

subsidies can complement the housing micro finance for poor people and also will effectively avoid distorting the market.

2. Governments could further encourage select private financial institutions with a good track record in serving low income people with other products to demonstrate the feasibility and profitability of housing microfinance. This might require these institutions to develop specialized terms for underwriting, marketing, servicing and collateral guarantees. SBI is currently working with the Moroccan bank BMCE Bank, to pilot a lending for slum dwellers who are purchasing government-subsidized new homes. In this instance, SBI and the bank have created "Retail Platforms" to bring the bank directly to the slum dwellers. SBI worked with BMCE to adapt the lending methodology to account for informal and irregular incomes. Prior to launching the products with BMCE, SBI conducted demand surveys of income levels in the slums to segment the market and determined that many slum residents indeed qualified for these loans. BMCE is further leveraging a government-sponsored guarantee program, FOGARIM, which was created to encourage lending for low income housing needs among private commercial banks. While the pilot with BMCE is still in the early stages, BMCE has lent $23 million to the low income housing sector, including slum dwellers, since the pilot began in early 2006. In cases where long-term funding for on-lending to MFIs is limited, such funding could be mobilized through international equity investment or bond issues in the local capital markets.

3. Promote research and best practice dissemination in the field of housing microfinance to improve performance of individual institutions and encourage more entrants and competition in the field.

4. Housing microfinance providers can establish strategic business partnerships with a variety of building materials suppliers to market housing microfinance. This is the case of MiBanco in Peru, who established marketing arrangements with the largest cement producer in Peru, a roof manufacturer, an association of lumber suppliers and carpenters, and hardware stores. These alliances will probably evolve into financing partnerships, which will probably enhance the ability of MiBanco to reach a larger number of customers for its housing microfinance products.

5. Capital market developments such as secondary markets, bond issues, mortgage insurance, special purpose vehicles, and other such tools could expand housing microfinance.

6. Improvements in portfolio performance (credit underwriting and collections), efficiency, technology, and ultimately, profitability, will be the primary determinants of each institution's success and of the viability of the model.

Conclusion

The basic finding is that housing microfinance has the potential to become one of the most effective ways for slum dwellers to improve their own housing and their livelihoods. Housing microfinance has the following critical characteristics:

- It overcomes two main obstacles preventing the poor from accessing traditional housing finance: incremental building and the requirement of collateral.

  On one side, the small and sequential loan products that characterize housing microfinance suit the progressive building methods of the poor and is also affordable. This model not only fits the construction practices of the poor, but also reduces the risk for credit providers as the loan amounts are small. Some of the important benefits for the borrowers are the small repayment increments and flexible repayment terms that suit poor people whose income fluctuates unpredictably over the long term.

  On the other side, the use of alternative collateral arrangements is very effective in reducing the risk to the credit providers and thereby enabling the poor to access housing finance. Successful housing finance providers have developed a variety of innovative collateral arrangements for their loans so that they are better suited to poor borrowers.

- It could achieve the required large scale and be done on financially sustainable basis. The phenomenal growth and expansion of microfinance has proven that the low income population certainly offers a business opportunity for the private sector. The provision of quality housing for the poor in slums will be enhanced by involving the private sector in government slum upgrading efforts. But it is also evident from the cases that the involvement of the private sector may not occur automatically and certain conditions may be necessary for encouraging the private sector to enter this market. The key is to create an enabling environment in which the private sector can operate. This may look different in different countries. An equally important factor is the adoption of innovative financial models by the private sector so that they can provide the flexibility needed when targeting the poor while keeping their risk at a manageable level.

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