

Housing Policy: *Developing a Market-based Housing Finance System*

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Breaking away from the formula lending approach

Early on in the Estrada administration, the Housing and Urban Development Coordinating Council (HUDCC) crafted an innovative approach to housing finance. It was innovative because it broke away from the old approach to housing finance which past administrations had employed in an attempt to address the huge backlog in the shelter sector. The old approach was to use the funds of the Social Security System (SSS), Government Service Insurance System (GSIS) and Pag-Ibig to finance the Unified Home Lending Program (UHLP) of the government. Under the so-called "formula lending" of the old approach, developers or private housing contractors originated the housing loans from eligible borrowers and then submitted the mortgage papers to the National Home Mortgage Finance Corporation (NHMFC) for take out. As the public knows, this strategy led to the bankruptcy of the government's housing program in view of the inability to collect loan repayments.¹

Under former HUDCC Secretary-General Karina David's leadership, the HUDCC redefined the government's role in the housing market (Box 1). The major changes consisted of tapping the private mortgage market to finance the housing demand of low income groups and targeting housing subsidies to low income households. Thus, under the new approach, the government has chosen to pursue an enabling role where its main job is to provide the environment for private sector participation in the housing market. While subsidies will still be provided, they are, however, only targeted for poor households.

The rationale for this market-based housing finance approach adopted by HUDCC was to integrate socialized housing into the mainstream financial markets. This came about as government planners realized that there is no way that government would be able to finance all the requirements in the housing sector, especially given the

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¹*Draws heavily on Gilberto Llanto, Aniceto Orbeta, Jr., Christine Tang and Teresa Sanchez, "A Study of Housing Subsidies in the Philippines," PIDS Discussion Paper No. 98-42, 1998. The original report was submitted to HUDCC in 1997. It suggested a number of reforms in housing finance. For an earlier critique of government's policy framework in the housing sector, see Gilberto M. Llanto, "Housing Subsidies: A Closer Look at the Issues," PIDS Policy Notes No. 96-02, September 1996.*

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Box 1. The Housing Finance Program of the Estrada Administration*

Objectives

- * Formulate a comprehensive shelter program in accord with a defined *national urban policy framework* that will regard the sector as a critical component of both social and economic policy
- * Develop a sustainable, market-oriented housing finance system that will encourage maximum private sector participation
- * Design a system that will focus and effectively address the need of the bottom 30 percent of the society
- * Facilitate a decentralized shelter delivery system that will bolster valuable community support, thus making it demand-responsive

Strategies

- * Initiate reforms in the housing finance system to enable private sector participation in housing finance and production improvement of institutional infrastructures in the primary mortgage market as well as the development of a secondary mortgage market through securitization review and rationalization of the shelter agencies' operations
- * Institute the Housing Assistance Fund (HAF), an "on-budget" subsidy fund, and a corresponding transparent targeting mechanism
- * Provide an unambiguous support to the low-end sector via explicit, nominal grants as against distortive interest and tax subsidies to mortgage loans
- * Encourage involvement of private institutions in socialized housing finance by allowing the sector to operate within the market interest rates
- * Enable efficient rental market to augment shelter provision for less affluent and more mobile households
- * Render accessibility to developmental, cooperative-led and community-based lending through decentralized housing delivery via the local government units (LGUs)

Role of the government

- * Strengthen and define legal regulatory framework that will govern the housing finance system

*Under former Sec. Karina David's HUDCC helmsmanship.

- * Provide adequate fund to the HAF and identify other welfare-enhancing programs
- * Extend technical assistance to the LGUs in formulating proactive local planning

Role of the key housing agencies

- * Rationalize management and implementation of the housing programs
 - HUDCC – undertake effective supervision and coordination of all agencies
 - NHMFC – improve collection efficiency
 - HIGC – enhance risk management capability
 - HDMF – develop asset-liability management

Role of the private sector

- * Private developers and lending institutions – handle origination and channeling of funds to homebuyers
- * Banks – engage in enhanced investment in mortgage-lending especially in socialized housing; undertake financial advising and intermediation in the securitization program
- * NGOs – facilitate community-organizing
- * Private investors – provide liquidity through investments in asset-backed securities

The primary mortgage market

- * The proposed *Plan for Shelter and Urban Development Sector* principally adopts the framework of previous primary mortgage programs of the National Shelter Program, e.g., resettlement, community-based lending, retail lending, guarantees, and others except the ailing and structurally-flawed programs which will be discontinued.
- * There will be an explicit prioritization in socialized housing, e.g., 80%-20% allocation of aggregate public resources in favor of low-cost housing programs; specified target share of developmental lending including guarantee provisions.
- * An innovative "on-budget" subsidy (Housing Assistance Fund) will be established to complement the regular low-cost programs under the housing agencies and promote greater room for private bank low-cost lending. Banks and other lending institutions are unable to compete under the former strategy because of the distortive interest subsidies of government loan offers.
- * Moreover, under the HAF, the subsidization period of loan amortization of qualified borrowers will be reduced from

Box 1 (cont'd)

25 years to 10 years. This is due to the consideration of the rising capability of the borrowers to service their loans over time. That is, while amortization remains constant in nominal terms, nominal income increases due to inflation and income improvements. The problem of loan affordability then is re-assumed to exist only for a maximum of ten years.

- * Effective implementation, e.g., adequate fund releases and collection efficiency should, however, be installed to avoid the pitfalls of the previous programs.
- * Development of auxiliary infrastructure should also be achieved to help ensure the programs' success.

Implementation strategy

- * Private developers would continue to assume their usual roles as loans originators and channels of funds. On the other hand, banks are expected to take greater roles in mortgage financing including low-cost housing, with the trend towards minimization of distortive interest subsidies, particularly in retail lending.

The secondary mortgage market

The other important component of the *Plan for Shelter and Urban Development Sector* is the development of the secondary mortgage market through securitization of assets.

huge losses under the formula lending approach and the inappropriate incentives that misdirected housing subsidies could create.² Subsidies as a whole create distortions in the financial markets and discourage the participation of private lenders who obviously cannot compete with the government's subsidized programs. The social costs of subsidizing housing loans and misdirecting subsidies to nonpoor borrowers are quite high (Table 1).

Abandoning an innovative approach

Unfortunately, however, the government had a recent change of heart when it decided to abandon this innovative, market-based approach adopted by HUDCC in favor of a formula lending and subsidized approach. With this shift, there is a possible repetition of the sad results experienced under past administrations where:³

- * the National Shelter Program that relied on formula lending led to a heavy fiscal burden for the economy,
- * pension fund members and low-income taxpayers bore not only the funding responsibility but also the

²The incompatibility of incentives under formula lending was explained in Gilberto M. Llanto and others (1997).

³The empirical support is found in the study by Llanto and others (1997, 1998).

⁴This draws on Gilberto Llanto and Leilanie Basilio (1999), "Housing Policy, Strategy and Recent Developments in Market-Based Housing Finance," PIDS Discussion Paper Series No. 99-20, July 1999.

credit risk of nonperforming housing loan programs of the government,

- * credit incentives led to various disincentives that distorted the financial market and discouraged real private participation in the housing finance market, and
- * the housing subsidies under the UHLP and formula lending were regressive, benefiting nonpoor members of society instead of the real target beneficiaries—the poor.

Is there light at the end of the tunnel?⁴

In order to prevent these distortions and inequities in the housing market to happen again, what options are thus open to the government to address the housing problem? One option is to deregulate the rental market that has constricted the supply of dwelling units for rent. Another is to reinstitute the market-based housing finance approach earlier adopted by the present administration to enable low-income borrowers to finance their purchase of houses through loans.

Developing the rental housing market. It should be noted that the prevailing bias for *all* households to own houses regardless of their economic capacity rests on a wrong assumption. Not everyone in society can afford to buy and own a house. The real problem is *not* how to provide everyone a house to own but how to provide access to affordable and decent shelter. This objective can be achieved through several mechanisms:

Table 1. Cost and Incidence of Subsidies under the UHLP, 1993-95



Subsidy Incidence	Income Group		
	Low	Middle	High
% of Beneficiaries	38	33	29
% of Loan Value	26	33	41
% of Delinquent Loans	11	36	53

Definition of Income groups:

- Low - households with monthly income below P5,000
- Middle - households with monthly income P5,000 - below P7,500
- High - households with monthly income above P7,500

Source: Gilberto Llanto et al. (1998), "A Study of Housing Subsidies in the Philippines," PIDS Discussion Paper Series No. 98-42.

- * renting,
- * ownership through purchase or private transfer (e.g., through inheritance, donation), and
- * public housing for certain sectors of society (e.g., the poorest of the poor).

For this to happen, housing markets, including housing finance, should work efficiently. Thus, the rental market should be freed in order to encourage greater supply of dwelling units for rent.

The problem with the prevailing bias for homeownership and control of the rental market is that these invariably raise the cost of the government's housing program. The desire to provide housing to the majority of the population raises expectations that the government should provide access to homeownership at all cost. At the same time, this also motivates private economic agents who benefit from the subsidies to lobby for more funding for an unsustainable housing program.

Developing market-based housing finance. Several developments in the housing finance markets indicate that it is possible to have a low-cost housing program

that relies on the market for financing. Before we discuss these recent innovations, however, it is important to understand why banks seem reluctant to venture into low-cost housing finance.

The banking system constitutes more than three-quarters of the total assets of the financial system. Nonetheless, except for their limited participation in the National Shelter Program's UHLP which used formula lending, banks have not taken an active role in low-cost housing finance.⁵ This can be partly explained by the negative effect of government-subsidized programs which have discouraged the development of the primary

market for housing, and by the short-term orientation of bank assets where the banks' short-term liabilities do not match the long-term nature of households' housing loans. This mismatch of borrowing short and lending long produces risks of term intermediation. These term risks are inherently associated with the relative illiquidity of the housing good, the opportunity costs of unadjustable interest rates, and exposure to currency risks, if housing loan programs are financed by foreign loans.

In the low-cost housing sector, banks face not only high transaction costs but also information asymmetry. The lack of information on creditworthiness, relative credit risks and other risks can discourage bank lending to low-income households. The offset could be high interest rates that will cover risks and generate some profit for the lender. However, adverse selection and moral hazard problems arise, making this approach untenable. Thus, in the absence of information, collateral and substantial equity from the low-income borrower, and the lack of long-

⁵They are understandably active in the middle- and high-income mortgage market.

term funds, banks rarely take on mortgage loans of low-income households.

What then are some recent innovations in market-based housing finance that seem to offer a way out?

Below are three areas which may be considered, namely, (a) contract savings for housing, (b) role of contractual savings, and (c) mortgage-backed securitization.

* **Contract Savings for Housing Scheme.** Contract savings for housing (CSH) system is essentially a contract between a household and a financial institution concerning the granting of a loan, provided that the household meets the minimum savings commitment over a specified period of time at a prescribed rate. The accumulated savings can be the household's equity to the loan. They can also be used as security for their mortgages with banks.

This system integrates the households into the banking system. That is, in the absence of sufficient sources of long-term deposits for banks, CSH offers a disciplined, regular saving pattern from households. From the perspective of the financial institution, the saving period provides monitoring of the creditworthiness of the contingent borrowers. Hence, the CSH reduces information asymmetries that are prevalent in credit markets. Furthermore, accumulated savings minimize the maturity gap of short-term borrowing and long-term financing within the financial institution. Since the deposits are kept for a specified purpose, they are not easily called off and can form part of long-term loan funds of the bank.

A variation of the CSH can include a one-time capital grant from the government to targeted households. Under this scheme, the households will be required to put up a minimum savings of five percent of the total cost of a low-cost housing unit in a bank of their choice. Eligible households will then be provided directly with a one-time, lumpsum capital grant in the form of a voucher. The voucher, together with the five percent savings, will constitute a 25 percent equity for a low-cost housing unit.

The households will assign the voucher to the private developer or seller. The voucher, which can only be used for home acquisition, is redeemable from the government. The voucher plus the savings will be the downpayment for a housing unit and the balance of the cost of the unit will be paid to the developer by the mortgage bank. The mortgage bank, which can be a government or private bank, will provide a mortgage loan at market rates of interest.

Under the proposed alternative subsidy scheme, those who are creditworthy can take a housing loan. The direct capital grant to well-targeted low-income group will resolve the inability of the low-income group to put up the required equity or downpayment for a housing unit. With this form of subsidy, the low-income group will be able to borrow from the financial institutions at competitive terms. This will enable the government to direct its resources to housing programs such as community housing and resettlement programs that clearly benefit the very poor.⁶

The CSH, albeit laudable, cannot however stand alone as a financing scheme. The financial institutions still have to find substantial long-term funds to meet the demand in the primary loan market. This requires the development of stable, long-term financing sources. Still, what should be stressed here is that the CSH brings into the open the importance of linking it with banks.

* **Contractual Savings Institutions.** Contractual savings institutions, e.g., social security, pension funds, insurance companies and mutual funds, are showing how important they are in the country's financial system. In 1995, all nonbank financial intermediaries (NBFIs) accounted for 20 percent of the total assets of the financial system. Of this, the share of government NBFIs, primarily the social security programs, was 64 percent, an 88 percentage increase from its share of 34 percent in 1980. As such, these institutions have the potential to

⁶Gilberto Llanto et al. (1998), "A Study of Housing Subsidies in the Philippines." PIDS Discussion Paper Series No. 98-42.

accumulate vast amounts of resources which could become an integral part of the capital market system. They also normally have greater coverage and guaranteed contributions in case of occupationally-based mandatory security schemes.

Contractual savings institutions have long-term contracts with saving members. This helps solve the term intermediation problems inherent to the housing sector. Pension funds have a longer investment horizon and are less concerned with liquidity than other financial intermediaries because their liabilities are typically long-term obligations set by actuarially-based contracts (Guérard and Jenkins 1993).⁷ Thus, they can extend long-term mortgage loans without being exposed to liquidity risks.

In the process of development, pension funds can also play a major role in integrating housing finance into the capital market system. This means that the pension institutions do not have to limit mortgage extension only to their members but may also channel resources through the secondary mortgage markets. Mortgage bonds are relatively fixed investments that provide more modest returns but connote lower risks for the investors. The catch, however, is that subsidization of interest rates in the primary mortgage market reduces the attractiveness of this market to pension funds since the latter look for the highest possible net yield for their members.

The success of these institutions depends on the stability of contributions, proper regulatory framework and efficient investment management. Their growth is largely anchored on their proper design which consequently leads to consumer confidence. Mandatory contribution schemes are often tempting because they minimize the cost of savings mobilization for the government. Through this, the state can also exercise central control over the allocation of resources.⁸ However, established credibility of the institutions rather than mandatory schemes encourages contributions better. Although the system can often meet the minimum limit of contributions, it does not generate further resources from individuals outside the establishments if they are not perceived to gain from the

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establishments' investments. Since contributions are automatic salary deductions, employees do not have the option to invest in other intermediaries who may better manage funds and generate higher returns. Hence, a poorly designed and managed social security system simply crowds out efficient private participants.

Fitting reforms in the regulatory policies and institutional design that specifically govern the contractual savings institutions and social security systems should therefore be effected to maximize their potential in mobilizing long-term sources of funds and making them available for long-term investments such as housing.

* **Mortgage-backed Securities.** An important innovation in the financial market is the securitization of assets. Asset securitization is the process of pooling assets and using the pool formed as collateral for a security. The securities created are referred to as asset-backed securities.⁹

Securitization can improve access to mortgage financing by separating origination from funding. As a con-

⁷Yves Guérard and Glenn Jenkins, *Building Private Pension Systems: A Handbook*. International Center for Economic Growth and the Harvard Institute for International Development, 1993.

⁸Bertrand Renaud, "Housing and Financial Institutions." *World Bank Staff Working Papers, WPS 658, Washington D.C., August 1984.*

⁹Frank Fabozzi, *Overview of Mortgage-Backed and Asset-Backed Securities.*

sequence, home mortgage finance will be integrated into the overall capital market.¹⁰ It will provide liquidity through a *recycling mechanism* at interest rates that are often more profitable than what the issuer of the assets would get under more conventional financing given its creditworthiness.¹¹

Mortgage-backed securities is a vehicle for linking the primary market with access to long-term funds that are critical for long-term investments such as housing. The modern model of housing finance uses the secondary mortgage market where loans are securitized and issued to investors. Traditional mortgage lenders in the primary mortgage market originate and service mortgage assets. Mortgage companies, on the other hand, buy loans from the primary market, package them and securitize them.

For the primary and secondary mortgage markets to develop, however, there is a need to develop the legal, institutional and regulatory infrastructure that will minimize risks in origination of primary mortgage loans and securitization, ensure market pricing of mortgage

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assets and provide credit enhancement mechanisms. Again, subsidization of interest rates in the primary market negates the development of a strong secondary market.

The need for a comprehensive view and understanding of the housing problem

The housing problem is not simply a funding issue. Some quarters make the erroneous assertion that throwing money to the problem solves it. In the first place, under a distorted system, no amount of money can make

a dent to the problem. What is needed is to make the housing market, including housing finance, work efficiently. For this to happen, the present administration should pursue the housing program proposed under the stewardship of former Secretary Karina David and undertake a number of reforms, to wit:

- * Rationalize the government's housing programs and institutions.
- * Promote a market-based housing finance system as a mechanism for financing low-cost housing.
- * Target subsidies, e.g., one-time capital allowance, to well-identified low-income households.
- * Require targeted households to mobilize savings as equity contribution in the low-cost housing program of government.
- * Stimulate the private rental housing market by lifting rent control and providing on-site (upgrading) and off-site (new developments) services to localities outside the major metropolises.
- * Provide infrastructure that will lead to the opening of new lands for low-cost housing.
- * Review zoning regulations, building codes and other regulations, e.g., development permits, land conversion, and others, to eliminate high transaction cost.
- * Introduce reforms in the pension funds to make more long-term funds available for housing.
- * Review/amend the Comprehensive Shelter and Finance Act and the Urban Development and Housing Act to make them more consistent with a market-based housing finance system.
- * Provide a legal, institutional and regulatory infrastructure for the efficient functioning of the primary and secondary mortgage markets.
- * Maintain a stable macroeconomic condition characterized by low inflation and low interest rates.

¹⁰Simon Kwan, "Innovations and Recent Developments in Mortgage-Backed Securities." FRBSF Weekly Letter, Federal Reserve Bank of San Francisco, Number 96-01, January 5, 1996.

¹¹Lynn Soukup, "When Assets Become Securities Financing: The ABC's of Asset Securitization," online version (www.shawpittman.com/soukup.html), Shaw Pittman Potts & Trowbridge, 1996.

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