

KEY ISSUES, FINDINGS AND MESSAGES

Financing shelter is an important component within development policy frameworks intended to secure environmental sustainability, economic prosperity, cultural diversity and social equality. *Financing Urban Shelter: Global Report on Human Settlements 2005* examines recent shelter finance trends and driving forces. It also explores policies and strategies that hold the promise of making shelter development truly sustainable, in the process filling the gap between the two extreme outcomes of current shelter systems that are being witnessed today: affordable shelter that is inadequate, and adequate shelter that is unaffordable.

In the next 20 years, there is little likelihood that in many developing countries conventional sources of funds will be available for investment on the scale needed to meet the projected demand for urban infrastructure and housing. Many countries around the world continue to face deficits in public budgets and weak financial sectors. Local governments have started to seek finance in national and global markets, but this is only in its initial phase. Countries and cities, therefore, will have to rely on the savings of their citizens.

With the exception of East Asia, most developing country regions have not experienced sustained, positive growth over the past two decades. Africa has continued to suffer the most, with at best uneven growth in a few countries. Most sub-Saharan states have continued to deteriorate, thus failing to provide needed urban employment and incomes. Latin America has also been quite disappointing, as the promised neo-liberal reforms have failed to deliver the promised patterns of sustained growth. In general, the upper end of the income distribution has benefited from the new patterns of economic growth in the age of globalization. While in some countries there is evidence of a new middle class, particularly in China and India, the middle class has actually disappeared in other countries, joining the poor in the absence of 'living wages'.

Despite considerable effort to encourage urban and infrastructure policy reform and capacity-building in the developing countries, there is little evidence of any sustained large-scale impact. In general, national economic authorities have been preoccupied with macrostability, debt and trade and have tended to neglect implementation of needed policy and institutional reforms in the urban sector, with a few exceptions such as India, China, and richer developing countries such as the Republic of Korea, Thailand and Mexico.

Against this background, the key issues and messages emerging from this report are presented below, starting with broader contextual issues, followed by those issues more specific to shelter finance, including: conventional mortgage finance; subsidies and financing of social housing; shelter microfinance; and shelter community funds.

BROADER CONTEXTUAL ISSUES

The problem in many developing and even in some developed countries is not that housing is too expensive, but that incomes are too low. It is clear that an efficient housing finance system is a necessary but not a sufficient condition for the development of sustainable urban shelter and that improving the access of poor households to adequate shelter has two further requirements: reducing housing production and delivery costs and increasing income levels. The locus of attention should therefore be on both the cost of housing and the level of payment received by workers. This demand-side focus is in line with current trends in subsidies and concentrates attention on the systemic problem of poverty, which is the underlying source of poor shelter conditions.

In processing housing loans, lenders should take into account future income generated, directly and indirectly, from house improvement. There is a well-documented link between finance for income generation and improvements in housing. Many homeowners operate one or more home-based enterprises from the structure on which they raise housing finance. The same goes for rental income. One of the most important sources of low-cost rental property, which is becoming more important as the years pass, is the extra room built on to a home and rented out to a stranger for rent, or to a co-villager or relative for no rent but some other benefit (if only to satisfy family obligations). It is obvious that improvements in housing can benefit home-based income generation, including room rentals. Thus, lenders should take account of the likelihood of income improvements in the application procedure, through a process which factors in future income generated by the housing goods to be provided under the loan.

The cost of urban housing can be reduced by the adoption of more appropriate standards. In many countries in the South, the cost of urban housing is increased significantly by the high standards to which it must

comply. The introduction of lower standards that are more appropriate to the local context could potentially make housing more affordable to a far greater proportion of the urban population. Lower standards would still, however, have to safeguard the health and safety of the occupants and protect the public interest.

There is much to be gained from encouraging multi-occupied housing development where it fits in with local norms. Most national shelter policies, some of them supported by official development assistance, are based on the provision of independently serviced, single household dwellings, owned by their occupants. However, this is by no means the main form of occupation by households living in poverty. Instead, large numbers of households live in buildings occupied by many households.

Financing schemes to assist small-scale landlords, in the context of informal settlement upgrading, are necessary. Small-scale landlords in informal settlements are a major source of affordable housing for a growing majority of households living in poverty in the towns and cities of developing countries, but there are few initiatives to assist them. It is imperative, therefore, to understand how best to assist the informal rental sector within informal settlement and slum upgrading programmes, and at the same time preserve affordability so as to preclude gentrification.

Finance to provide healthy liquidity among small-scale contractors and single artisans is an essential prerequisite to effective housing supply to scale. In the spirit of the Habitat Agenda, and if the current massive housing backlog is to be cleared at all, it is vital that all actors in the housing process are involved in the role in which they are most efficient. The most important suppliers of dwellings for urban low-income communities, and their ancillary services, are the millions of small-scale building contractors, the single artisans or small groups of skilled people and the labourers who service their needs. However much demand there is for housing, it can only be supplied as quickly as the construction industry can build it.

In developing countries, large-scale developers of both private rental housing and housing for sale to owner occupiers need financing systems capable of providing bridging loans. In countries where the housing supply system is efficient and speculative of what the market demands, developers are often an important part of the process. Some mechanism for recognizing their contribution with financial assistance, especially for bridging loans, may be very beneficial for the housing supply process in developing countries and could institute the efficient speculative building of housing which is common in developed economies.

Domestic savings play a crucial role in the development of robust and effective shelter finance systems. The countries in which most of the urban growth will take place in the next 20 years have very low domestic savings measured as both per capita and as a percentage of gross domestic product (GDP). As savings are the foundations for investment, this does not auger well for urban shelter development. It is important that developing countries maintain as much of the investment and savings

arising from local economic activity within their borders, or benefit from net inflows from investments overseas. The importance of reliable banks and low inflation in discouraging capital flight cannot be overemphasized

CONVENTIONAL MORTGAGE FINANCE

In recent decades, governments have generally sought to encourage homeownership and have, in many cases, provided preferential financing to influence consumer choice. There has been a general shift towards market-based mechanisms for the provision of housing, with attempts to reduce subsidies and deregulate markets. In part, this is due to the past ineffectiveness of housing strategies that depended on direct provision by the state. This trend is also consistent with the overall direction of macroeconomic strategies in recent decades.

Mortgage finance has been expanding during the last decade and is increasingly available in many countries. Many developing countries now have access to market rate housing finance, which was not the case 20 years ago. New mortgage providers include commercial financial institutions, or in some cases, mortgage companies. However, only the middle- and upper-income households have access to such finance while the poor, especially in developing countries and countries with economies in transition, are largely excluded.

It is in the interest of governments to extend mortgage markets down the income scale, as homeownership is beneficial economically, socially and politically. Measures that have been adopted by some countries, and could be emulated by others, include: reducing the cost of lending, especially through reduction of interest rates; supporting the system of mortgage financing, especially through extension of secondary markets and reduction of risk; and providing direct capital grants to reduce the size of the households' mortgage in comparison with the dwelling cost.

Loan periods and loan-to-value ratios are vital components of mortgage loans that have important access implications, especially for the urban poor. These are determined by the lender rather than the global macroeconomic environment. Decisions about them can be the difference between success and failure of the mortgage company and determine who can afford to borrow, at least at the margins. Low loan-to-value ratios (and, therefore, high initial deposits) reduce risk but increase the need for upfront capital. The level of repayments can be varied to help households meet their obligations. Adoption of variable-interest loans allows low payments at the beginning, increasing as income improves to repay the loan on time.

Well-run mortgage facilities are undoubtedly important to the health of the housing supply systems, although they generally fail to reach the poor. Conventional mortgage facilities constitute the dominant means of shelter financing in developed countries and may be a major contributor to housing improvement in countries

with economies in transition. They are also important in providing upper- and middle-income groups in developing country cities with housing finance, without which they would claim the shelter opportunities provided for those lower down the income scale. However, as mortgage finance is unlikely to assist the majority of the people, it must not be allowed to divert attention from financing helpful to lower-income groups, or to drain resources away from low-income households towards those in the middle- or upper-income groups.

SUBSIDIES AND FINANCING OF SOCIAL HOUSING

Three specific trends with respect to social housing that are consistent with privatization and deregulation are well established in a number of countries:

- 1 governments have shifted away from the direct construction and management of public housing and have used several strategies to reduce their stocks, with large-scale transfers to occupiers in some cases;
- 2 there is increasing assistance for homeownership through direct demand (capital) subsidies; and
- 3 consistent with the two trends above is the greater use of housing allowances (rather than direct provision) to assist low-income families renting accommodation in the private or non-profit sectors. Despite their focus on lower income households, direct subsidies are often smaller in scale than interest rate subsidies when the full costs of the latter over the life of the loan are considered.

Those who cannot afford homeownership or market rents in the private market need shelter through public rental housing. Social housing is, almost by definition, subsidized housing. The subsidy element is a financial credit to the occupier and, thus, often constitutes an important element in a nation's housing finance system. Although social housing is becoming residual in Europe and in countries with economies in transition, the need to provide more housing that is affordable to low-income households is still present.

While subsidies are necessary for deserving low-income groups, the need for them can be reduced by adopting effective shelter-financing systems. At present, subsidies come in many guises, including: direct interest rate reductions; allowing mortgage interest payments to be deducted from income tax; supporting housing-related savings; supporting insurance of mortgages; supporting the secondary mortgage markets; and direct grants for shelter (or capital grant subsidies). If appropriate housing finance is in place, the proportion of households requiring subsidy should be minimized, i.e. to only those too poor to afford the real cost of the shelter available. The need for subsidy can, thus, be reduced by adopting effective financing systems. The work of some non-governmental organizations in providing funding to help individual households attract a

subsidy is very helpful. In some countries, revolving funds that provide the down payment necessary to obtain a national housing subsidy grant have been very effective.

SHELTER MICROFINANCE

The majority of urban poor households can only afford to build incrementally in stages as financial resources become available. These stages may be separated by many months, or even years. In new building, this is usually implemented a room or a few rooms at a time but it may, less commonly, occur in construction stages, i.e., all the foundations, followed by all the walls, etc. Complete houses available through mortgage finance are far too expensive for the poor and they are unable to meet the deposit and income criteria set by mortgage institutions. It is therefore imperative that national and international institutions recognize that low-income people build incrementally and provide microfinance suitable for that process. This may also call for reform of building regulations that often do not allow incremental building of formally recognized dwellings.

Short-term, small-scale loans of one to eight years and in amounts of US\$500 to 5000, are more useful for incremental development than the long term, large value loans favoured by the mortgage markets. Improvements and efficiency gains possible through incremental building with small loans, rather than with savings, include: greater likelihood of building well (though small) immediately and avoiding high annual maintenance costs arising from poor construction; avoidance of the wasteful process of improvising a dwelling in temporary materials and then discarding them as they are replaced with permanent materials; and reducing the age at which a householder can afford to be an owner, as stages do not have to await money being saved but can be paid for in arrears.

Small housing loans, disbursed through housing microfinance institutions, are some of the most promising developments in housing finance during the last decade. They are suitable for extending existing dwellings, building on already serviced land, adding rooms (often for renting out), adding facilities such as toilets and house improvements within *in situ* neighbourhood or slum upgrading. They tend to reach much further down the income scale than mortgage financing, but not to the households close to or below poverty lines. Experience shows that there is great demand for microfinance even if interest rates are high.

In the context of large numbers of new low-income households in cities over the next two decades, it is important to increase the number of lenders in the housing microfinance sector rather than concentrate only on mortgage finance. Mortgage finance inevitably serves the middle- and upper-income groups, while generally excluding the poor. However, there is a serious issue of funding for on-lending by microfinance institutions. Many have received concessionary funds and their lending reflects the low price of the capital. If they are to expand their operations, they may have to borrow at international market rates and reflect this in their loans.

Guarantees are important in broadening the appeal of microfinance institutions to lenders.

Microfinance institutions continually look for ways of reducing their risks, even though the lowest-income groups tend to be assiduous at repayment. The establishment of formal guarantee organizations is an important prerequisite to lending in many circumstances. Governments have much to gain from setting up guarantee funds to allow microfinance institutions to lend to low-income households at reduced risk. In addition, development assistance should be directed towards guarantee funds in order to capture their full value as catalysts for shelter development for the urban low-income groups.

COMMUNITY-BASED SHELTER FUNDS

Another significant trend in the last decade has been increasing interest in shelter community funds group loans. The growth of these funds has partly arisen from a general acknowledgement that small-scale lending has been somewhat successful and that the urbanization of poverty is a growing challenge. Two further current trends related to the development of shelter community funds are: first, the growing interest by local government in the possibility of using such funds to extend essential infrastructure; and,

second, the expansion of Shack or Slum Dwellers International (SDI), a community/NGO network whose strategies incorporate savings and lending activities for shelter improvements.

Community-based financing of housing and services has been used for both settlement upgrading and for building on greenfield sites, and, in a context where small loans are evidently successful and where there is an increase in poverty, it has many advantages for low-income and otherwise disempowered households.

It provides the benefits of scale – strength in lobbying, ability to affect neighbourhoods comprehensively rather than just single dwellings, ability to raise capital funding – and it builds the cohesion of the community because its members act together. It takes strength from the willingness of people to work together as communities through a variety of self-help cooperation traditions. The experience of the affiliates of the Shack or Slum Dwellers' Federation (SDI) has demonstrated that there is great potential for community-based organizations to manage development finance to the benefit of large numbers of relatively poor households. The evident success of community funds has attracted some governments to take part in their financing. However, there are issues about how far non-members of such community groups are excluded by the activities of groups who so successfully lay claim to limited resources.