Chapter 14

Residential Rental Housing Finance

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Introduction

Recent years have witnessed the fast development of residential mortgage markets all over the world. In countries such as India, China, Turkey, Mexico, and Morocco, the introduction of market-friendly reforms has permitted the private mortgage sector to start expanding rapidly.

By contrast, rental housing remains underdeveloped and underfinanced in many emerging economies. An inhospitable environment facing the rental sector is directly reflected in the large portion of the housing stock that is outside the bounds of formality. Without alternatives to buying a formal dwelling, which is often unaffordable to a large portion of the income distribution, households resort to informal housing, be it owned or rented. Thus, in many countries a large informal rental market exists, in which the landlords are mostly individuals, not firms. The financing of this rental stock is overwhelmingly based on equity.[1] By contrast, in developed countries a number of financing options for rental housing has developed over the years.

1. In parallel, there may exist a small rental segment at the higher end of the market, owned by private investors and operated by professional firms, and aimed at housing more wealthy

In many countries, the rental sector houses the youngest and poorest parts of the population. In emerging economies, many renters would not be able to buy property, even if mortgage finance were more developed. The challenge facing policy makers is thus to provide affordable rental housing opportunities for these categories. One of the tools that can be used to achieve this is rental subsidies. These subsidies must navigate between two conflicting goals: they have to enable the supply of affordable rental housing for low-income households, while at the same time not discourage investment in rental housing; for example, maintaining attractive risk-adjusted returns for rental investors. Developed countries have put in place various types of rental subsidies, either for the sector as a whole in order to stimulate investment, or more targeted to middle- and low-income households. The main issue with these subsidies is that they are usually fiscally expensive, and therefore may seem beyond the reach of most countries, which face at the same time more pent-up housing demands and less favorable macroeconomic conditions.

The main objective of this chapter is to take stock of the various ways by which residential rental housing in emerging economies could be financed and subsidized in order to enable the provision of affordable rental accommodation for middle- and low-income families.

The Rental Sector in Housing Policy

The Importance of Enabling a Vibrant Rental Sector

Enabling the development of a healthy formal rental-housing sector is important for a number of reasons:

First, the rental sector is a natural outlet for households that do not have sufficient income to afford buying a home, or that have not saved enough to meet down-payment requirements for ownership. Young adults and the poorer fractions of the population fit into these categories. In countries where the private rental market is small or declining, the interim role played by the rental stock is missing, and one sees young adults living longer with their parents.

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categories of the population including young professionals.

Second, vibrant rental markets are key to active resale markets and flexible labor markets. Mostly because of transaction costs, ownership entails high mobility costs, which can penalize mobility. Ownership can thus provide negative incentives to relocate closer to jobs (mobility trap). In contrast, mobility within the rental sector entails relatively low fixed costs, which can be seen as an advantage in societies going through rapid changes in the structure and localization of employment. This would characterize most transition countries (see World Bank 2005).

Third, a robust rental sector is needed to give households a larger choice for asset investment. In most countries, housing as an asset has the two drawbacks of being indivisible and relatively illiquid, which affects the way households can manage their portfolios. As a tenure choice, rental may allow households to avoid overinvestment in housing, compared to other assets. As an investment, rental housing generates a source of income that complements other income sources. In many developing countries it can also be a substitute for nonexistent pension systems, thus being a critical element of welfare improvement for the elderly (UN-Habitat 2003).

Lastly, affordable rental markets make it easier for households to accumulate down payment funds and thus promote mortgage markets, increase the value of housing assets, and facilitate the fluidity of resale housing markets. The importance of a functioning formal rental market is all the more crucial when the mortgage market is not fully developed, because access to ownership is more difficult. Usually, as mortgage markets develop, LTV limits tend to increase, which facilitates access to homeownership by households at early stages of the life cycle (for example, with low savings but high future income streams). In parallel, credit providers tend to serve more families in lower-income brackets, thus allowing a greater portion of the middle- and low-income population to access homeownership. Before these favorable outcomes are realized, though, rental markets have an important role to play in the life cycle of most families.[2]

2. A manifestation of the need for rental markets in undeveloped financial systems is the existence of intermediate systems between ownership and rental. Residential leasing is one such system. *Antichresis*, by which landlords basically raise equity from tenants in exchange for a limited time of rental without payments, is very popular in some Latin American countries. The *Chonsei* system in Korea is another well-known example. Such practices are obviously made easier by the absence of low-down-payment mortgages, and would probably tend to disappear when the mortgage market expands.

Imbalance between Rental and Homeownership

Despite compelling reasons for enabling a vibrant rental sector, the rental sector has received, at best, limited attention in many developed countries and emerging economies, in comparison to homeownership.[3]

Support of homeownership has emerged from different perspectives depending on the regions and historical contexts. Homeownership has been actively supported by many governments on the grounds that it promotes citizenship, essentially by giving a stake to individuals in the society. This paradigm is characteristic of the United States which subsidizes homeownership through the tax system (deductibility of mortgage interest and property taxes, non-taxation of imputed rent, virtual non-taxation of capital gains) and the financial system (lower cost finance through support of government-sponsored enterprises). Ownership of one's home has been seen as providing many social and economic benefits, including in particular the free usage of the space allowing families to set up businesses or income-generating activities within the premises. Homeownership is also thought to provide neighborhood externalities through maintenance and improvements. For example, promoting homeownership has been an explicit policy choice in most countries of Latin America. Transition economies constitute a special case, in the sense that high ownership rates mainly result from mass privatization of the housing stock undertaken in the post-Soviet era (see World Bank, 2005).

In many countries, the stated or implicit preference of the government for ownership has resulted in an uneven playing field between the two main tenure modes and ownership often benefits from more favorable tax regimes and subsidies. A result of this imbalance is that in many countries, rental housing is considered as an unprofitable and risky investment. It is not uncommon to see private investment in the sector stopping for whole periods of time, up to a point where the size of the sector decreases. This happened, for example, in the United Kingdom after drastic rent controls were put in place in the aftermath of World War II.

As argued above, the role of rental markets is potentially greater in countries still at earlier stages of mortgage-market development. What often happens in those countries, though, is that formal rental markets are weak or

3. For a complete discussion on this issue, see UN-Habitat (2003).

virtually nonexistent. As families need shelter whatever the circumstances, these countries witness the development of informal rental and ownership markets in all kinds of forms, often resulting in economically and socially suboptimal outcomes.

Overall, this is all the more regrettable, as no sustainable alternative to public rental housing has yet emerged in many developing countries. Public rental housing played a major role in the 1960s and 1970s in almost every region of the world, but has steadily declined since. Plus, the bulk of subsidies to households have been shifted to sustaining homeownership. Private-sector tenants receive little help of any kind. As a consequence, some entire segments of the poor populations have been mostly left out of the subsidy system.[4]

Rental Housing as an Investment

Rental investment can basically be decomposed in a series of cash flows. The first cash flow consists in an initial investment in a property (development), including land costs, construction costs, financial costs, "soft" costs such as fees, and taxes. After completion of the units, the project generates a series of periodic cash flows reflecting on one hand the collection of rents from the dwellers, and on the other hand the operation and maintenance costs as well as the taxes incurred by the landlord. After the end of the exploitation phase, the property can be sold by the owner, which generates a positive cash flow and is generally subject to tax.

This sequence of cash flows determines the net present value and the internal rate of return of the rental project. Net operating income, defined as the difference between rents and operating and maintenance costs, is the key element considered by financiers when considering whether to provide financing for a rental project.[5] The one positive component of net operating

4. For example, the rental market still houses between 20 and 40 percent of households in Argentina, Brazil, Chile, Mexico, and Peru, and data show that the homeownership rate among the poorest households (first quintile) has declined in all those countries during the last decade (World Bank 2004). In other regions of the world the rental sector is by far the dominant tenure status for the poor; yet a negligible proportion of housing subsidies is reaching them.
5. The availability of ways of financing involving leverage is of the utmost importance, especially for institutional investors.

income, the rent, is of course a critical element of the profitability of a rental project.

Other elements impacting the net operating income relate to the various costs borne by the landlord during the rental period. The main costs relate to the following:

- Management of the building—this comprises physical management of the structure, tax and administrative management, and commercial management, including minimizing the vacancy periods.
- Maintenance of the building—in many countries this item can become problematic, as the division of responsibilities between landlords and tenant relative to maintenance are not clearly defined.
- Taxes and fees—there are two components to this item: taxes and fees applying to the structure, which can in part be paid by the renters, and taxes on rental income which are paid by the landlord.

Looking at the structure of these costs, it appears that management costs, and to a lesser extent maintenance costs, allow for economies of scale. Thus, higher returns can potentially be achieved for multifamily buildings than for single rental houses. In order to achieve these economies of scale, however, two conditions must be met:

- Financing must be available—the size at which economies of scale are maximized is significant; thus, investments of the appropriate size will necessitate leverage.
- Professional real estate management capacities must exist.

These two conditions are often not met in emerging economies.

Most of the cash flows generated by a rental project are uncertain. Thus, the decision of the investor to invest or not in rental housing is dictated not only by return considerations, but also by risk considerations. The main uncertainties that distinguish rental investment from homeownership investment concern the collection of rents, which constitute the bulk of the positive cash flows generated by the project. In addition to rent payment risk, risks peculiar to rental versus ownership include the following:

- Vacancy risk, stemming from the fact that the probability that a given unit in the project will be vacant and may remain vacant for a long time, is not known;
- Eviction risk, meaning that evicting a delinquent renter involves costs and may prove difficult, whether because the judiciary system tends to interpret the texts in favor of tenants, or because the execution of judiciary decisions against tenants is not enforced;
- Disposal of the asset, in the sense that the law may restrict the landlord from using the dwelling units as he or she wishes (for example, to renovate, remodel, sell or destroy the unit).

These risks are influenced or directly governed by the legal and regulatory framework that regulates relations between tenants and landlords. When this framework is perceived as too coercive by landlords, the latter stop investing in formal rental housing, and, when alternative investments are missing, which is frequently the case in emerging economies, informal rental develops.

The Challenges of Developing Rental Housing in Emerging Economies

The development of rental markets in emerging economies is hindered by many constraints that do not specifically relate to the lack of finance for rental housing. These bottlenecks can be classified into two main categories. The first category includes adverse macroeconomic conditions and inappropriate regulatory environments applying to housing construction (building codes, housing standards) in general.

In some countries, macroeconomic fundamentals do not permit the two sides of the market to match. A fairly common case is the combination of low incomes and high interest rates, which generates a basic affordability problem. Household income is very low, and a small fraction of households could afford to pay the rent of a minimal-size dwelling as defined legally. The problem is compounded in a high-interest-rate environment, because the opportunity cost of investing in rental housing is high. As a consequence, at the required level of financial return, there is no demand for the minimum-standard product developers are allowed to construct. Or, conversely, current rent levels are not attractive enough to generate new investment. This has been the case in Brazil, for example, because of consistently high interest rates.

Minimal habitability standards are often set too high by the national housing policy. Unrealistically set minimal habitability standards are potentially a stumbling block to affordability policies, both in the ownership and rental sectors. In some countries, the construction costs of the "minimal unit" (that is, a unit having the minimal characteristics deemed to necessary to provide "decent" shelter) are far above the means of a large portion of the income distribution. This means that, either large subsidies will have to be provided in order to make standard housing units affordable to everyone, or some portion of the population will have to be housed in units not matching minimum habitability standards. Mobilizing enough (direct or indirect) subsidies to house all households in standard units often just proves to be unsustainable. As governments cannot explicitly recognize the necessity to lower minimal standards, there will be room for a large informal or substandard rental sector.

The existence of a repressed rental demand for units smaller than the minimum standards is visible in many big cities of the world where low-income workers choose to live close to jobs in substandard rental tenements, where they usually pay high rents. The so-called *tugurios* in Lima and the *cortiços* in Brazil are Latin American examples; collective rental accommodation in Dhaka, Bangladesh, is another example. A common feature of informal rental products in Dhaka and São Paulo is that they are reportedly very profitable. Thus, it is probable that there would be both social gains and a profitable niche for private-sector involvement, were the governments willing to accept to lower standards to include similar types of dwelling units.

The second category of obstacles includes other factors related to the environment of the rental sector, and specifically:

- the legal and regulatory framework governing the landlord-tenant relationship,
- rent control, and
- the tax system applying to rental housing.

Box 14.1. Returns on Formal Rental Housing in São Paulo, Brazil

In many cities comparable to São Paulo, the rental sector would be a natural outlet for low-income housing demand. A survey done for the municipality of São Paulo in the central districts of the city in 2004 showed that the rental stock has been in constant decline, going from 60 percent of dwellings in 1980 to 22 percent. This can be associated with low returns on rental investment in general. Data from the survey showed that average gross returns ranged from 7.6 to 14.4 percent, depending on the type of units. When adjusted for maintenance costs, vacancy, and nonpayment risks, these returns are far lower than those of other types of investments (in 2006 the current yield of government securities wass around 18 percent).

Generally speaking, in many countries, government policies in these domains tend to depress returns (often by increasing the costs associated to rental operation), while at the same time increasing risks of rental investment. When the overall environment of the rental sector is perceived as too coercive by potential investors, private investment in formal rental housing stops. This may provide a rationale for the government to start providing rental housing directly but, in turn, the existence of an important public rental sector may hinder the development of the private rental market.

Rights of Landlords and Tenants

Many of the cash flows determining the returns on a rental investment are inherently uncertain. The risks associated with the income streams associated to a rental property are influenced or directly governed by the legal and regulatory framework that governs relations between tenants and landlords. Many governments like to present themselves as the defenders of tenants, versus landlords, and impose stringent conditions on the scope of rental contracts, as well as on their execution. Examples include the following:

- imposing minimal durations for lease contracts and legal limitations to the yearly increase in rents,
- imposing strict conditions to recovery of the dwelling by the landlord,
- systematic interpretation of the texts by the judiciary system in favor of the tenants, and
- reluctance or refusal of the executive branch to enforce court decisions of eviction against defaulting tenants.

All these circumstances basically increase the rental risk faced by investors. This type of problem has plagued countries as diverse as Egypt, India, France, and Morocco. In addition, the political sensitivity of these issues makes changing the legal framework a real challenge that cannot be tackled frequently.

Rent Control

The introduction of rent controls used to be a standard measure even in market economies if rents in the private rental market were considered too high from a political standpoint. A famous example is the rent freezing introduced in several European countries during the First World War, which was maintained for decades thereafter. As a consequence, the private rented stock almost disappeared in the United Kingdom and suffered from lack of maintenance and underinvestment in France, which eventually built up the political pressure for mass production of public rental housing in the post-World War II period.

The economic effects of rent control have been analyzed extensively.[6] Economists traditionally distinguish "first generation" rent controls, which basically freeze the rents to their current nominal level, from "second generation" rent control, which apply milder constraints. A particular sort of second-generation rent control is tenancy rent control, whereby initial rents are set freely (for example, the rent can be freely adjusted whenever a new

6. See, for example, Arnott and Johnston 1981, Arnott 1995, Basu and Emerson 2000 and 2003, Fallis and Smith 1984 and 1985, Glaeser and Luttmer 2003, Gyourko and Linneman 1989, and Igarashi and Arnott 2000.

tenant moves in), but the progression of the rent for the duration of the lease is fixed or capped by an index.[7]

First-generation rent control, when imposed on the existing housing stock, constitutes a forced, uncompensated transfer from the landlord to the tenant. In some countries (for example, Egypt), the controlled unit can pass to the heirs of the sitting tenant with no or minimal adjustment of the rent, in which case the unit itself is practically transferred to the tenant, while all the costs and liabilities remain on the owner's shoulders. This has resulted almost universally in high vacancy rates (owners prefer to leave their units empty than to rent them out), absence of maintenance, absence of rehabilitation and upgrading of the controlled stock (in some cases going up to the collapse of buildings), as well as low residential mobility. Illegal subletting and increased key money charges are also common practices in the rent-controlled sector, as in public rental housing (see for example, Arnott and Anas 1992 for the Swedish case). The main other effect of rent control is to deter any new investment in the rental sector. Egypt and France after World War II offer extreme examples of the negative effects of rent control.

Evidence on second-generation rent controls is more mixed. While it may have positive effects in cases where landlords may have some monopoly power (Igarashi and Arnott 2000), it is nonetheless thought that such systems penalize frequent movers (in practice, mostly young people), because landlords factor in the fact that the rent is fixed for the duration of the lease into the initial rent (see Basu and Emerson 2000 for a discussion on India on this aspect).

To summarize, countries that have imposed hard types of rent control have witnessed a dwindling of the rental sector. Unsatisfied rental demand, as well as investors' money, has been carried over to the informal housing sector, with precise outcomes depending on the countries.[8] It is now widely accepted that the best remedy against situations of scarcity and high prices in the private rental market is comprehensive housing market deregulation and, where appropriate, introduction of explicit public subsidies.

7. For example, this form of rent control is the prevailing regime in France, and is also prevalent in India.
8. In developing countries, informal housing has played a role of adjustment between demand and (insufficient) formal supply. In transition countries, where the stock was already produced and impossible to hide, many ingenious ways of circumventing rent controls have been devised, with the same motives of escaping the administration.

It often proves difficult, however, to shift from a system in which implicit subsidies are paid to tenants by landlords, to one in which subsidies must be paid for up-front by the government.[9] Countries wanting to phase out rent control have often proceeded gradually. Usually, rent control on the existing stock is maintained, while new construction is exempted from it. This creates a dual rental market, with very low rents in the rent-controlled segment, and very high rents for uncontrolled units. This can be seen in Egypt and Lebanon.

Unfavorable Tax Regimes

In many countries, the stated preference of the government for ownership versus rental as a tenure status has translated into a favorable tax treatment for homeowners. By contrast, rental housing often offers limited tax advantages compared to other types of investments. The asymmetry between rental and ownership for tax purposes is often visible in the form of the following:

- Favorable tax treatment of capital for developers, such as accelerated amortization, exemption of construction tax, etc. For example, in Morocco, considerable tax breaks are granted to developers constructing social housing (defined as units with value under an MDH 200,000 [US$24,000] ceiling) for ownership; these advantages are not available for rental programs.
- Tax advantages to homeowners such as income tax deductibility of mortgage interest (India, Mexico), temporary exemption of property tax, and more favorable local taxes.

For individual investors, the proportion of gross rental income that can be deducted for income tax purposes is often not sufficient to cover the real management and maintenance costs, or the provisions for amortization of rental investment are not as attractive as those applying to other forms of capital investment.

9. Rent control can be a highly inequitable form of income redistribution as well. As it is unit based at opposed to individual or household based and not means tested higher income individuals or households frequently benefit.

As a result of these tax policies, the choice between rental and ownership from the point of view of both investors and households is biased, because the cost of capital is lower for ownership than for rental.[10]

Social Rental Housing

Historically, social rental housing in developed countries may be seen as the outcome of a situation where the housing conditions of the poor were seen as unacceptable or generating too many negative externalities (notably in terms of health conditions and crime), and private finance was not available for production on a significant scale. Countries wanting to implement social housing programs thus had to find low-cost resources to finance them. In a country like France, specialized financial circuits allowing for subsidized resources for lending to social housing companies were put in place.

In the version that was widely developed in socialist economies, in the United States and in Western Europe after the Second World War, most units produced under the system were managed by the government (local or central) or by companies controlled by the government. Units were allocated to households selected according to more or less transparent criteria. Generally, rents were set with no or few references to market rents.

This model of housing production and management has generated many economic and social issues. Therefore, over time, developed countries have adjusted their social rental programs. Although the degree and speed of change has differed across countries, some general patterns can be identified:

- There is a general tendency to disengage government at all levels from the ownership of rental properties and from direct management of social units. A well-known example is the policy of privatization of the municipal housing stock in the United Kingdom, through a right-to-buy scheme or the transfer to housing associations.

10. This issue has been thoroughly investigated in the United States. See for example Poterba 1980, Hendershott 1980, Hendershott and Shilling 1982, Hendershott and Ling 1984, DiPasquale 1989, and DiPasquale and Wheaton 1992.

- Rents in the public-rental sector are more often set in reference to private rents—be it through "fair market rents" (United States), rents found in comparable units in the neighborhood (United Kingdom), etc.
- Governments and regulators tend to introduce competition in the attribution of subsidies and off-market (low-cost) financing, by promoting competitive biddings and yardstick competition (for example, in the United States for tax-exempt bonds or projects financed by the housing tax credit, and the United Kingdom for additional financing for rehabilitation).

There is also a general trend toward using market-based funding for public rental housing, made possible by the development and liberalization of the financial sector in the 1980s. Macroeconomic stability and decreasing interest rates after the introduction of the Euro further encouraged social landlords to turn to market finance. For example, the Housing Finance and Development Centre of Finland (ARA) uses modern financial-market instruments, including securitization. France and Austria are now the only countries in the Euro zone that still use a state subsidiary to finance the social rental sector.

Specific intermediaries, however, are often needed to help smaller investors access capital markets and secure guaranteed loans (for example, in Finland, the Netherlands, and the United Kingdom).

In the 1960s and 1970s, many developing countries replicated the basic public rental model with even less success. Reasons for failure included, among others:[11] (i) units built at too-high standards and unaffordable to low-income residents, even with low rents; (ii) lack of basic commercial concerns, resulting in construction of public units in places where there was no demand for them; (iii) politically driven attribution of units or implicit encouragement by politicians not to pay the rents; (iv) exacerbated social problems resulting from the absence of basic infrastructure, water and sanitation, jobs, and services in the neighborhoods of the public compounds, resulting in economic segregation of the residents; and (v) lax management practices, resulting in low rent collection and financial stress for the public companies,

11. For a discussion on this point, see UN-Habitat (2003) and Villoria Siegert (2004), and references therein.

and eventually in lack of resources for operation and maintenance, then for new production.

This lack of sustainability has led to the scaling down or abandonment of public rental programs in many countries. Public rental housing has been abandoned in most Latin American countries, with the notable exception of Brazil, which has developed a residential leasing program (Programa de Arrendamento Residencial [Residential Leasing Program; PAR]). Poland has also been an exception, with the creation of a special fund for municipal rental housing. Both programs, however, are currently facing sustainability problems. The experience of these two countries is discussed in the section on country examples.

Some Market Financing Models for Rental Housing

This section briefly outlines various financing strategies relying on the market that can be applied to rental housing, from the least to the most sophisticated financially. Obstacles relevant to emerging economies are also discussed.

All-Equity Based

This model is prevalent in many developing countries where access to financial market is limited, and rental housing is perceived as too risky by institutional investors. This could be a valid description of the context prevailing in Morocco, for example. Households already owning a dwelling (formal or informal) having saved enough cash decide to add one floor to their house (or to build another house in the neighborhood) in order to rent it out, after comparing the return they get from this investment to the returns they could get on alternative investments (the set of which may be fairly limited, especially for non-banked households).

Compared to institutional investors, individual landlords often largely escape the tax system, both during the production phase and the exploitation phase, which increases the return on the investment. They also are able to enjoy a closer relationship with their tenants, which confers the following advantages: (i) usually, there is only one tenant household, which avoids contagion problems; (ii) the landlord may install individual meters for water and electricity or at least individual connections, which he may cut in case of nonpayment of the rent; this, along with the risk to the neighborhood reputation of the tenant, lowers the risk of nonpayment; (iii) very often there is no formal lease contract, which allows the landlord to bypass legal and judicial difficulties in case of problems. For all these reasons, the returns to individual landlords can be higher than those of institutional investors and explain why the latter are absent from the rental sector.

This strategy has obvious drawbacks:

- the invested money is not leveraged;
- because of the (varying) degree of informality of the process, the constructed dwellings largely escape the tax system, but also the benefit system—renters are difficult to identify and be provided benefits;
- the investment is very illiquid, especially in the case of a floor in the landlord's home;
- there is no diversification of risks.

There are many variants to this case. In Saudi Arabia, some real estate companies are beginning to invest in multifamily rental apartments, based mostly on own equity. At the same time, these companies are actively paving the way for alternative ways of funding projects (bank loans or direct tapping of capital markets).

Real Estate Investment Trusts (REIT)

A more sophisticated form of rental investment consists in investment funds (whose legal nature and structure can vary depending on the country), whose purpose is investment in rental housing. The prototype of such funds is the U.S. equity real estate investment trust (equity REIT). The funds raise equity from investors, and then buy, develop, or manage the rental properties directly. The basic concept of these structures is to allow the pooling of equity for investment in rental projects in a tax-efficient manner. Simply stated, an equity REIT serves as a conduit through which income is passed, in the form of dividends, from a real estate portfolio to shareholders. If certain conditions are met the income that is passed through is not taxed at the REIT level. Such vehicles provide liquidity to the rental equity market, both because individual investors can invest in shares with low unit value compared to a physical investment in rental housing, and because shares can be traded on a secondary market.

North America has well-established REITs. Australia, Japan, Singapore, Hong Kong, New Zealand, and South Korea also have well-established, or newly formed, REITs. In the EU, four countries (Belgium, France, Greece, and the Netherlands) have clear tax-efficient REIT structures in operation, while Italy utilizes a hybrid structure. The two largest economies in the region, Germany and the United Kingdom, introduced tax-transparent REITs in 2007. Two other European countries, Russia and Turkey, also have existing REIT structures.

Compared to the individual investor model described above, the advantages of real estate investment funds such as REIT or the French Société Civile de Placement Immobilier (Real Estate Investment Trust; SCPI) are the following:

- net returns are potentially higher because of professional rental management and economies of scale;
- risks are reduced because the portfolio of the fund consists in multiple properties, which can be located in different regions or parts of the cities, and thus, rental and geographic risks are mitigated;
- there is no "indivisibility effect" (no minimum investment required), which is good in terms of portfolio composition for individual investors;
- the investment is more liquid.

Of course, appropriate regulation, especially in terms of accounting, prudential rules, and consumer information, has to be set up by the regulating authority in order to avoid misuses of investors' funds. In France, SCPI are submitted to regulations that closely resemble those of other financial products, in terms of governance, accounting, and disclosure of information. SCPI owners also benefit from the tax incentives applying to individuals investing in new rental housing.

Usually, commercial rental investment is more profitable than residential housing, which in turn is more profitable than social rental housing. Thus, private investors attracted by those structures will not necessarily be interested in social housing investments, unless additional tax advantages are granted to social projects. Examples of equity REITs used to finance social housing exist, however. A prominent example of such a REIT is the Community Development Trust based in New York, the primary goal of which is to preserve and increase the stock of affordable housing through long-term equity investments and mortgage lending. This privately held REIT invests in affordable housing in more than 20 states and has attracted private investors who are currently receiving a yield of nearly 5 percent per annum.

Bank-Supplied Credit for Residential Rental Investment

Lending for rental housing investment is essentially long term. Therefore, all the potential issues associated with long-term lending by banks (liquidity and interest rate risks, instruments for matching asset and liability durations, existence of a demand for long-term paper) are relevant and should not be underestimated. These issues, however, are not specific to rental investment lending, and we refer the reader to other chapters of this book for a thorough discussion. In this chapter, we start from the premise that banks do lend long term to other sectors, for example, mortgage lending for homeownership. What, then, are the obstacles that could prevent lending for residential investment?

The provision of loans to investors eager to undertake residential rental projects relies on the willingness of the banks to engage in this activity, as well as their getting sufficient know-how in this kind of product. The two conditions can be problematic in specific countries.

First, in many countries (including developed countries), residential rental housing is perceived as less profitable and more risky than commercial rental.[12] Thus, banks will tend to engage first in commercial lending.

Second, lending for residential rental housing is very different from retail lending for ownership. Multifamily housing financing is a complicated venture, involving a whole range of stakeholders. In addition, unlike

12. The reasons for high risks in the residential rental market have been elaborated on in the previous section. For example, the capacity of enforcing the lease contracts may be low. Low forecasted returns can be the consequence of legal caps to rent increases, low household incomes, or high maintenance costs.

Box 14.2. Underwriting Criteria for Multifamily Rental Loans

Contrary to owner-occupied loan underwriting, which involves evaluating the borrower as much as the property, underwriting residential rental loans is closer in spirit to underwriting business loans and relies heavily on the examination of the cash flows generated by the project. Although the assessment of the risk of rental loans will include commercial criteria such as market need, zoning, architectural merits, availability of community resources, etc., lenders will typically focus on three ratios when underwriting income properties:

- Loan-to-value, similar to mortgage lending for ownership;
- Debt coverage ratio (defined as net operating income over debt service), and
- Breakeven ratio (debt service + operating expenses over gross operating income). Breakeven measures the amount of vacancy the property is able to sustain without incurring negative operating income.

In the United States, there are some commonly accepted benchmarks for these ratios. For example, a debt coverage ratio of 1.20 or more is necessary to get a mortgage. In the case of replacement of credit enhancement facility, credit providers or enhancers also typically require that the property has performed well in terms of occupancy rates over a specified period prior to closing.

single-family construction, no standardized debt instruments or financing process exists and multiple funding sources are common. As a business line, it is closer to project finance, as it relies heavily on the examination of the cash flows generated by each particular project. As such, it is less subject to automated procedures of loan approvals and other refinements that have facilitated mortgage lending in many countries. This implies that lending for multifamily housing will generally be done by a specific department in the financial institution, comprising specific profiles of staff and using specific models for assessing the risks of the projects. For all theses reasons, some banks choose not to develop this activity.

Finally, lack of information on rental markets and on housing markets in general can be detrimental to the development of a lending activity to multifamily housing. The assessment of the financial viability and profitability of a rental project relies heavily on projections of future rents, operating expenses, and real estate prices. The first two parameters determine the sequence of net operating income streams, while the second drives the behavior of the investor's net equity in the project. A lack of information on the housing market as a whole, which is common in developing countries, thus translates into difficulties in projecting key financial parameters over the life cycle of the project. This results in the price of credit being higher to compensate for the higher perceived risks and, secondly, banks will be less inclined to develop specific products for rental investment.

Capital Market Financing

In a rental investment project, at least two kinds of cash flows can be used for the purpose of structuring financing instruments: the repayments of a mortgage taken on the project, and the cash flows (net rents) generated directly by the project. Consequently, there are different avenues for tapping capital markets: Examples include the following:

- issuance of bonds or securities backed by the mortgages made by banks or other lenders for rental investment (residential commercial mortgage-backed securities);
- direct financing of the rental project on capital markets by bonds, with or without backing from a non-bank intermediary (used in the United Kingdom for the financing of social housing);
- issuance of bonds by local governments, the proceeds of which are lent to rental projects (municipal tax-exempt bonds in the United States).

The first type of bond is a particular kind of mortgage bond or MBS. The second case is closer to methods used for the financing of infrastructure, whereby the bond yields are directly based on the future income streams generated by the project. In the third case, what the investor is buying is the municipality's (or its affiliate's) signature, not directly the individual project owner's quality.

Commercial Mortgage-Backed Securities

Lenders can access the capital market through securitization of the mortgages provided to rental investors. In the case of rental housing, the associated products are called (multifamily) commercial mortgage-backed securities.[13] In the United States, GSEs such as Freddie Mac purchase multifamily rental loans for securitization. In Europe, some social housing entities have been using transactions similar to commercial mortgage-backed securities to sell some of their portfolio loans. The best known example is the Fennica transactions of ARA (which is the Housing Fund of Finland) (see box 14.3).

Box 14.3. Securitization of Multifamily Rental Loans and Social Housing Loans

In the United States, Freddie Mac buys rental loans for securitization. The products ("Multifamily PCs") are secured by structures with five or more units designed principally for residential use, with terms generally ranging from five to 30 years. They offer the Freddie Mac guarantee of timely payment of interest and full and final payment of scheduled principal. Generally, Freddie Mac requires the following of all mortgages it purchases:

- be secured by properties with occupancy rates of at least 90 percent for the three months prior to loan closing and as of the loan closing date,
- have debt coverage ratios of at least 1.25 for the first mortgage and 1.15 for the first mortgage and any subordinate mortgages, and
- have LTV ratios not exceeding 80 percent for the first mortgage or 85 percent for the combined first and subordinate mortgages.

(continued)

13. Commercial mortgage-backed securities are similar to MBSs but backed by loans secured with commercial rather than residential property. Commercial property includes multifamily, retail, office, etc.

Box 14.3. Securitization of Multifamily Rental Loans and Social Housing Loans *(continued)*

Social housing is provided throughout Europe, and there are a number of examples of the use of securitization for funding purposes in a wide range of methods in quite a few countries.

- In Sweden, through the *Framtiden* issues made between 1995 and 2001, the city of Gothenburg sold a number of portfolios of loans to multifamily housing companies that provide low-cost rental houses for families to an SPV, which raised funds in the asset-backed capital markets.
- Similarly, in Finland through the *Fennica* issues, funds have been raised in the asset-backed capital markets by the sale of loans made by ARA subsidized by another agency of the Republic of Finland to social housing borrowers for the purchase or construction of multifamily rental housing.
- In Belgium, this is also the case with the Atrium and Eve issues, where loans made to social housing companies for the provision of low-cost single-family housing were securitized; and in the Netherlands with the Colonnade and Dutch Housing Association Finance issues going back to 1997, which financed the securitization of loans to Dutch housing associations guaranteed by a specially established state entity.

Direct Tapping of Capital Markets

Securitization of rents is a technique that can be compared to the securitization of mortgages. Future flows of rents from a given project and for a limited period of time are sold to an investor, like future loan repayments. The default risk is also transferred to the investor. Investors and rating agencies will be interested by the potential for the project, as measured by the expected evolution of rents (and allowances when applicable) and vacancy rates.

Since the introduction of securitization in the United Kingdom, securitizations of social housing receivables have been completed by housing associations and other Registered Social Landlords (RSLs). While the biggest housing associations have gone to the market on their own, The Housing Finance Corporation Limited (THFC) has played an increasing role as a provider of funds for RSLs that will not or cannot do the same. THFC issues bonds on behalf of its client RSLs. Before the financial crisis, 30-year bullet (interest-only) structure bonds issued by THFC on behalf of RSLs achieved margins under 100 basis points under the treasury-bond rates for similar durations, with a AA rating.

The motives of social lenders in the United Kingdom to use rent securitization (as opposed to secured financing) are not so much capital efficiency or bad credit conditions;[14] for most RSLs, banking credit remains the most asset-efficient source, based on current asset-cover ratios being achieved. Rather, the demand stems from the potentially loan-capital-intensive nature of RSL development activity and the need to underpin the supply of assured investment funds for supporting a long-term business.[15]

Credit Enhancements and Insurance Products

A number of financial products aim at rendering the investment in residential rental housing more attractive. A distinction can be made between:

- insurance products devised to insure the cash flows produced by the property to the landlord,
- credit enhancement products applying to individual mortgages (aimed at primary lenders), and
- credit enhancement products applying to the bonds issued to finance the investment (aiming at achieving a triple-A rating for the bonds).

Among the first category, one finds insurance for rental payment for landlords (timely payment or nonpayment). In Europe, insurance companies

14. There is no equivalent to the Basel capital adequacy regime for housing associations. Equally, the sector has an extremely good credit track record.
15. Undiversified social lenders are (arguably) countercyclical businesses, whereas wholesale bank funding tends to be cyclical. Hence, measures to diversify funding to include elements of capital markets funding, as well as bank and building society funding, should be considered prudent.

offer this kind of product to landlords through real estate agencies. Subsidized versions of this product also exist (for example, LocaPass in France, financed out of the "1 percent levy").

In the second category, mortgage insurance is the most popular product. Mortgage insurance insures lenders against loss on mortgage defaults. In so doing, it makes capital more readily available to developers. In the United States, HUD provides mortgage insurance for profit and non-profit sponsors in Section 221(d)(3) and Section 221(d)(4) for the construction or rehabilitation of rental and cooperative housing for moderate income groups. The program allows for long-term mortgages (up to 40 years) that can be financed through Government National Mortgage Association MBSs.

In Europe, local and central governments have often played a role in guaranteeing loans made to social housing institutions. Guarantees are still offered by local governments to public housing projects (France)[16] or by mutual funds to social housing projects (France, United Kingdom, the Netherlands). In Slovakia, the state guarantees loans for the construction of rental apartments for lower-income groups in order to provide incentives to the use of private finance. In the Netherlands, a complex system of guarantees for social housing loans has been put in place, in which the state and municipalities play the role of last-resort guarantor on top of other guarantees.

Alternative or additional securities can be provided to the lender by securing reserve funds that can be tapped in the event of late payments or default. Recent loans to housing associations in the United Kingdom were secured by mortgages on social housing properties and cash reserves in favor of the issuer and bond trustee. In the event of default, the bond trustee will have the right to collect the rents and manage the secured property.

Bond enhancement products provide security for the bondholders and impact the bond rating. A higher rating translates into a more favorable bond interest rate and ultimately a lower mortgage rate. These products are distinct from mortgage insurance in that they typically do not look at the quality of individual credits within a pool. Rather, they provide additional security on top of what is already provided by, for example, mortgage insurance. In the

16. In return, there is a reservation of 20 percent of the units financed with the guaranteed loan.

Box 14.4. Bond Enhancement Products for Multifamily Rental Housing

Credit enhancement products used for securities based on multifamily housing are of the same kind as those existing for other types of mortgage securities. In particular, they include the following:

- guarantee of payment of mortgage principal and interest that is used to pay the bond investors;
- liquidity facility, aimed at meeting the scheduled cash flows in the event the borrower is not able to meet its commitments; and
- principal reserve fund, particularly in the case of variable rate bonds. Principal payments may be made to a principal reserve fund held by the trustee rather than directly amortizing the bonds. Payments made to a principal reserve fund will accumulate. At the maturity of the bonds, the funds accumulated in the principal reserve fund will be paid to the bondholders. Alternatively, they can be used to redeem bonds.

United States, all bond-financed mortgages issued under tax-exempt bond-financed programs must be credit enhanced.[17]

Country Examples

This section discusses examples of programs of public support to the financing of rental housing financing from selected developed countries and emerging economies. The choice of the countries and programs is aimed at illustrating the variety of the subsidies used and the diversity of public-private partnership arrangements through which they are implemented. The examples also try to highlight the difficulties and pitfalls embedded in public support programs.

17. Eligible credit enhancers include banks, mortgage insurance companies, bond insurers, the FHA, Fannie Mae, Freddie Mac, and Ginnie Mae. The difficulties of bond insurers and mortgage insurance companies in the financial crisis have led to a virtual cessation in private sector credit enhancement.

The Low-Income Housing Tax Credit (LIHTC) in the United States

Affordable rental housing in the United States is provided through a combination of federal and state programs, very often with supplementary financing or subsidies from other institutions (NGOs, local governments).[18] Each state has its own housing finance agency, whose goal is to provide affordable housing opportunities for low-income families throughout the state. State agencies review and select projects for financing on federal programs, based on transparent criteria.[19] Federal subsidies are rationed and awarded through competition between projects. Housing finance agencies usually also have their own programs, which can complement federal programs (in some cases, a development becomes eligible for state credits once the housing finance agency has approved an application for federal credits. If a development does not receive federal credits, it cannot receive state credits).

The two main federal programs directed at affordable rental housing are embedded in the Tax Code:

- LIHTC is a 10-year tax credit granted to investors investing in affordable rental equity. Housing tax credits can either be syndicated to generate part of the required equity or be utilized directly to offset the borrower's tax payments.
- Tax-exempt bonds for multifamily rental housing financing are bonds issued by local governments for special government purposes, including the production of affordable rental housing.

The purpose of the federal LIHTC program is to create a financial incentive (in the form of tax credits) for private investors (both profit and nonprofit) to invest in the development of low-income rental housing. The

18. Apart from subsidies to the production of affordable rental housing, the United States also has an important federal program of direct subsidies to renter households (Section 8 vouchers). This program has been analyzed in a number of papers to which we refer the reader (for example, Crews Cutts and Olsen 2002).
19. In addition to evaluating applications for credits, the housing finance agencies monitor housing credit properties to ensure that rents are maintained at the agreed levels, that tenants' incomes do not exceed the allowable limits, and that the apartments are well maintained.

developer sells the tax credits to a private investor (both individuals and corporations) through a process know as "syndication." A "syndicator" is an organization that helps set up a partnership between the developer and the private investor to cooperate on tax-credit projects. The developer is typically the general partner, while the private investor is a limited partner. The development capital thus raised will be paid through the syndicator's equity fund in stages, which are subject to negotiation.[20]

The private investor benefits by using the tax credits to reduce its annual tax liability each year during 10 years. The tax credit is an actual dollar-for-dollar reduction in the amount of taxes due to the tax authorities. As a partner and co-owner of the project, the investor enjoys other tax advantages, such as accelerated depreciation on the buildings and passive losses.

During the period 1995–2005, 1,100,000 housing units have been constructed under the program, and their financing, design, and target populations have varied significantly according to state and local needs and preferences. On average, an additional 110,000 units are created each year, representing approximately 30 percent of all multifamily housing construction annually. The program has proven successful at both creating affordable housing and providing good returns on investments. Competition for tax credits has increased as investors have become more familiar with the program. For example, the amount of private investment raised per dollar of tax credit rose from $0.47 when the program was originated in 1987 to $0.62 by 1996. As investors have become more comfortable with the program's minimal risk level, the returns they require in order to invest in an LIHTC property has fallen from an internal rate of return of 28.7 in 1987 to 18.2 by 1994 (assuming an eight-year pay-in) (Cummings and DiPasquale 1998).

Brazil: the Residential Leasing Program (PAR)

Brazil offers a good example of a country in which the legal framework governing the relations between tenants and landlords are judged well balanced,

20. A typical payment schedule would be 30 percent upon formation of the partnership, 40 percent upon completion of construction, and 30 percent upon completion of occupancy. Therefore, the developer will need to secure predevelopment loans, construction loans, and "bridge" loans to finance the development until tax-credit payments are received.

but where adverse macroeconomic conditions have prevented private rental markets to develop during the recent years.

The PAR constitutes an attempt by the Brazilian federal government to introduce a residential leasing program aimed at reaching low- and middle-income groups. The PAR is targeted at households with income between four and six minimum salaries. Beneficiary households rent their units and have a buy option after 15 years. The program applies to newly constructed units and to renovated units as well.

The PAR is managed by the main public housing bank, CEF. Municipalities play a key role in the program.[21] They negotiate with CEF on the location of the program and the counterpart funding that will be brought by the municipality (usually in the form of land provided for the construction of buildings, or through the donation of municipal residential buildings to be renovated); they participate in the design of the construction or rehabilitation program (approval by CEF is needed). They propose a list of beneficiaries of the program to CEF, which then screens applications and makes the final selection of beneficiaries.

It can be estimated that the value of the financial subsidy embedded in the PAR corresponds to 55 percent of the unit value; however, the total subsidy rate is higher, because some costs are not included in the value of the unit used for rent calculation, such as the value of the land donated by the municipality when applicable, the value of infrastructure built and not included in the unit price, the value of exemptions of local taxes, etc. Overall subsidy rates for the PAR can be estimated to be around 70 percent of the total unit value.

The PAR is considered in Brazil as a successful example of cooperation between municipalities and actors from other government levels. Since the inception of the program in 1999, 160,000 housing units had been constructed or renovated and 75,000 were under construction at the end of 2006.

However, the PAR illustrates the difficulties faced by governments wanting to deliver finished housing units meeting minimal quality criteria to low-income households who could not afford them otherwise. Because of very high subsidy rates, the financial balance of the program has been put at risk,

21. PAR also works with associations (very often cooperatives gathering members of professional corporations). The cooperative usually provides the land and selects the applicants.

despite the existence of low-cost resources from the provident fund FGTS. Maintaining such a high level of subsidies is simply not sustainable in the long run.

Poland: the TBS Experience

Private residential rental markets are currently underdeveloped and underfinanced in Poland. Among other factors, this can be attributed to unfavorable legal and tax environments.

The National Housing Fund (KFM) is a public rental program that has financed, between its inception in 1996 and the end of 2005, the completion of 61,600 new rental units for moderate income tenants (an additional 11,800 dwellings were under construction at the end of 2005). The program has been steadily growing in size, with production in 2004 staying at 9,100 dwellings, but in 2005 declined to 8,000 dwellings.

The Fund is directly administered by the state bank, Bank Gospodarstwa Krajowego (Bank of the National Economy) through long-term credits extended to nonprofit landlord organizations (TBS). No fee or margin is applied (but the bank's treasury may commercially invest the budgetary allocations before disbursement). The repayment performance of this subsidized long-term portfolio until 2004 was excellent, partly because of subsidized credit rates.

The main operators and borrowers are non-profit associations (TBS) championed by municipalities, and some rental cooperatives and sometimes even private developers (in total about 450 institutions by the end of 2004). The applied rents must cover the credit repayment and all maintenance and renovation costs, and should not exceed 4 percent of the replacement investment value. The KFM also finances infrastructure loans directly to municipalities, but this activity is still relatively marginal in size.

The rental associations or cooperatives are required to provide 30 percent equity, the fund financing up to 70 percent of the project. This down payment may be derived from the tenants, who as a result consider themselves as quasi-owners and are selected through this qualification. This situation may end up running against targeting goals[22] and create problems for housing allocations.[23]

The program does not target low-income tenants in particular. The KFM does not control the declared incomes, as this responsibility is delegated to the TBS and the sponsoring municipality according to its own local housing policy, but anecdotal evidence suggests little follow-up monitoring and evaluation.

This experience is unique in transition economies. The KFM was designed at a time of high market interest rates, a depressed construction cycle, and a moribund public rental sector. After ten years of operations and important changes in the economy and housing markets, the following assessment could be made.

The funding of the KFM depends excessively on budgetary grants from the national housing budget. As repayment inflows from the long-term loans are marginal, any expansion is affected by planned budgetary cuts. Out of PLN5.3 billion of credits disbursed by the KFM until 2005, about PLN3.2 billion, or 60 percent, has been funded by government budget grants. The rest was mainly funded by long-term public debt contracted after 2002 from two multilateral institutions in order to keep expanding the program.

This vulnerability would be reduced if KFM loans were less subsidized. Narrowing the gap with market conditions seems increasingly needed for the next generation of KFM loans that would not target lower-income tenants. Co-financing and refinancing with commercial banks, as well as issuing domestic bonds, should be considered to relieve the pressure of budgetary funding. In order to bridge its funding needs, the KFM is currently considering refinancing by selling its current portfolio for a 20-year period to mortgage banks. It is also paying for the interest rate differential with the requested market rate, including a margin for the purchasing banks.

22. Households that provide a large down payment may not receive subsidies through low rents funded by subsidized credits.
23. Many of these households will not become legal owners when their incomes increase.

Conclusions

As mentioned in the introduction, rental financing in most developing countries is still in an emerging state. Although it can be argued that the circumstances vary a lot across developing countries, most often the reasons behind this lag can be found among the following main obstacles and bottlenecks.

In many countries, the environment remains hostile to a thriving private rental sector. In many emerging economies, some stumbling blocks remain for the development of formal rental markets, relating to the inadequateness of the legal and judiciary framework and to adverse macro-economic conditions. Such an adverse environment may in turn result in the absence of financial-sector involvement or absence of investors' demand for rental products or derivatives.

Among all the possible ways to finance rental housing, banking credit is likely to develop first in many countries, because the banking and financial infrastructure is already in place. It requires specialized lines of product that do not necessarily exist, however, even in countries where the banking system is fairly developed. Rental finance is a complex enterprise. Financing apartment communities—both existing buildings and new construction—is more complex than single-family financing, because of the greater diversity of properties and the perceived higher risk associated with apartments. In addition, unlike single-family construction, no standardized debt instruments or financing process exists and multiple funding needs and multiple funding sources are common. Affordable housing adds to this the need for additional subsidies or "gap financing" to bridge the shortfall between available debt and equity.

In the context of most emerging economies, helping the low-income populations through rental subsidies is challenging on many grounds. Making rental housing affordable amounts to finding ways to design "smart" subsidies in order to attract private capital toward rental housing. Rental subsidies, however, pose special challenges when compared to ownership subsidies. They tend to be fiscally expensive, and their implementation faces information problems. As a result, it is difficult to target the neediest populations.

The public sector alone cannot solve the housing problems of low-income households. More and more often, interventions on rental housing markets occur through public-private partnerships, by which different levels of government participate in various forms to the financing of the units located in their jurisdictions, together with private entities. The diversity of these partnerships across countries also suggests that there is no single best (one-size-fits-all) choice of partnerships in financing affordable rental housing. Rather, the solutions chosen should depend on the institutional context of the country (for example, the degree of executive and financial autonomy of local governments); on the tax system; on the development of the financial and capital markets; and on the fraction of the population that is targeted (private involvement is higher for middle-income households than for low-income households).