Chapter 10

State Housing Banks

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At some stage of their financial development, many countries have established and used state-controlled banks to provide finance for housing. Although their overall performance has been quite disappointing, both in terms of financial performance and social impact, this model continues to attract the attention of policy makers, as observed for example in Africa, where more state-owned housing banks are being created or contemplated.

Housing has deep social implications and is part of any national shelter strategy. Hence, confronted with a market failure, the absence of provision of finance, or a deficient coverage of mortgage markets throughout the income distribution, governments are induced to choose an intervention method that may quickly yield results—or at least be seen as a visible sign of a political will. The temptation is then great to use the state housing bank model, which has kept resurfacing in many countries, although the model often does not offer an appropriate answer to the issues underlying the market failures. Like many other types of state-owned banks, housing banks often fail to achieve the balance between conducting efficient and viable banking operations, and pursuing their social housing goals.

The chapter is organized by first providing a short description of state housing banks (SHBs), then by delineating their rationales, and analyzing the reasons why many of them failed. Available safeguards and alternative options to achieve the same goals are then discussed. Finally, some strategies to make existing institutions evolved are discussed.

A Brief Overview of State Housing Banks

Definition and Classification

SHBs in this discussion are taken as public-sector financial institutions operating in the retail housing finance market. This definition excludes state-sponsored second-tier mortgage institutions, be they state-sponsored entities acting as liquidity facilities or securitization agencies, or vehicles channeling public resources toward primary lenders (Federal Mortgage Bank of Nigeria [FMBN], Gabon Compte de Refinancement de l'Habitat, Venezuela Banco Nacional de la Vivienda [National Housing Bank, Venezuela]). Provident funds that are retail housing lenders but are not banks (for instance, INFONAVIT in Mexico, PAG-IBIG in the Philippines, and Housing Trust in Jamaica are also excluded [see chapter 11, where housing provident funds are treated in greater depth]).

Because of the importance of funding in the business model, and the different kinds of issues that it raises, a simple typology of SHBs can be made according to their dominant source of funding.

1. Most of their funds are deposits, as in Chile (BancoEstado), Brazil (Caixa Economica), Algeria (Caisse Nationale d'Epargne et de Prévoyance [CNEP]), Tunisia (Banque de l'Habitat), Iran (Bank Maskan) or Thailand (GHB). These banks, which are typically savings banks, have a strong funding basis, and the ability to offer a wide range of banking products.
2. Specialized banks without any large-deposit collection capacity that raise funds on bond markets. This was the case with Banco Hipotecario Nacional in Argentina; Crédit Foncier in France, a quasi–SHB until 1999; and the Credit Immobilier et Hotelier in Morocco.

3. Banks that mostly use public finance sources such as mandatory savings or wage taxes, central bank facilities, or government grants and loans. Although rarer, this model exists or has been used, for instance, in Cameroon (Crédit Foncier du Cameroun), Pakistan, and Bangladesh (House Building Finance Corporation [HBFC]).

Types of State Housing Banks

There are many variants of SHBs driven by financial policies and shaped by the local environment and its evolution. For example, some SHBs date back to the post-World War II period prior to the macroeconomic reforms and financial liberalization that started in the 1980s. Since then charters, mandates, sources of funds, regulations, and operations have often changed for the SHBs.

In Latin America, state housing banks that combined apex functions (refinancing facilities), some regulatory powers, and direct lending were created in most countries in the late 1960s and early 1970s. Most have been closed during financial crises, but some survive in some of the smaller countries and financial markets of the Caribbean and Central America (Dominican Republic, Guatemala, or Nicaragua).

In Brazil, Caixa Economica Federal is a hybrid of a development bank and a retail commercial bank, including the functions of a SHB. It offers a large variety of services, and has become the largest mortgage lender after the takeover of the Banco Nacional de Habitaçao. Caixa, which has a large deposit base, and also channels most of the payroll tax funds earmarked for housing finance from the Fundo de Garantia do Tempo de Serviço (FGTS) provident fund, and fiscal transfers from the government.

In Central and Eastern Europe, state-owned savings banks have taken a large share of the mortgage lending market, but have also evolved into universal commercial banks exposed to increased competition from other mortgage lenders.

In economies where the commercial banking sector is small and the mortgage finance infrastructure is only partially in place, there is considerable interest in creating new SHBs. This is the case in Sub-Saharan Africa where

SHBs have been established or revitalized (examples: Ivory Coast, Congo, Mali, Senegal, Gabon, Namibia, and Rwanda).

In some countries, state entities combine retail housing-loan services with real estate developer functions. Examples can, or could, be found in Thailand, Indonesia, Algeria, Egypt, Rwanda, or Pakistan. This is a dangerous combination, notably when projects are driven by some political considerations, because of the lack of independent assessment of development market risks and the absence of a specific capital buffer that a prudent lender requires from developers.

The Rationale for Creating a State Housing Bank

The rationale for SHB is linked to the broader issue of state involvement in finance. In extreme cases, some SHB, for instance in Pakistan, Algeria, or Iran, reflect a legacy of specialized sector banks implementing a centrally planned economy policy. With economic liberalization, the debate has shifted toward how to best address the observed failures of market forces in responding to social or economic needs: (i) Should the state intervene through SHB to serve the population underserved by the private sector? or (ii) Should the state implement background reforms, adequate regulation, and proper incentives to favor the expansion of markets?

As set out in other chapters in this book, the government should play a role in supporting the development of housing finance systems. There are segments of the population that are underserved, or not covered at all by the market, and not only during the early phases of development. None of the successful mortgage finance systems in existence today have developed without some form of active support by the government. The practical question is whether, and under which conditions, an SHB has the ability to efficiently fill market gaps. Within this context, SHBs generally represent an attempt to provide an institutional answer to three kinds of actual and relevant issues:

- Provide a financial service that the market fails to offer. As a driver to jump-start the market ("the infant market argument"), the SHB is then seen as a pioneer and leader in housing lending, helping to

improve the lending infrastructure and demonstrating the commercial feasibility of such lending among other financial institutions.

- Cater to the needs of segments of the population underserved by the commercial financial sector. Lending to lower- or informal-income groups, or to households who live in areas not served by bank networks, involves higher origination and servicing costs, higher risks, and fewer cross-selling opportunities. SHBs are perceived as a natural substitute to mainstream lenders, notably because their profitability goals may be lower than private lending institutions, and because of to the implicit state backing of their risk exposure.
- Provide a useful policy implementation tool, as SHBs are visible and easy to create. They can react to instructions given by governments. For instance, the Thai government selected housing as one of the drivers of the economic recovery from the 1997 crisis, by using GHB to channel below-market mortgage loans to stimulate construction and absorb an excess of unsold homes on the market. In France, Crédit Foncier, which had a quasi-monopoly on the main type of subsidized housing loans, was used to transmit the variations in the volumes of housing subsidies deemed necessary to enliven, or dampen, demand cycles.

The Model Failed in Many Countries

A striking feature when looking at the large number of SHBs created since the middle of the 20th century is the frequency of bailouts and rescue operations. This has been observed across different economies and institutions, such as Algeria (CNEP, 1997), Argentina (Banco Hipotecario Nacional, 1990–3), Brazil (Banco Nacional de Habitaçao, 1996, and Caxia Federal in 2001), Cameroon (Credit Foncier du Cameroun), Colombia (Banco Central Hipotecario, 1998), France (Credit Foncier de France, 1996–9), Indonesia (Bank Tabungan Negara, 1997), Ivory Coast (BHCI recapitalized twice), Pakistan (HBFC, 2001), Rwanda (Caisse Hypothécaire du Rwanda, 2003), Tanzania (1995), and Uruguay (Banco Hipotecario del Uruguay [BHU], 2002), among many others.

Box 10.1. The Fiscal Cost of Bailing Out State Housing Banks

Banco Hipotecario del Uruguay (BHU). Made vulnerable by a high delinquency rate (40 percent NPL in 2001) and considerable asset-liability mismatches, BHU collapsed during the Uruguayan financial crisis of 2002. Besides a restructuring plan that included a change of business model, the bank was recapitalized—for the third time since the mid-1960s. A first capital injection was carried out by the government in 2002, for about $730 million. At the end of 2004, the company's equity was still negative by an equivalent amount. BHU's lending activity was interrupted until 2006, which did not prevent its financial situation from worsening. Further recapitalization measures through the transfers of assets and liabilities were still ongoing in early 2006. The recapitalization needs could amount to $1.5 billion, or 93 percent of the loan portfolio outstanding in 2001.

Bank Tabungan Negara. This Indonesian SHB had been entrusted in 1974 with the distribution of subsidized housing loans. Bank Tabungan Negara had a monopoly on the subsidy scheme. Being funded by loans from the Central Bank at privileged conditions enabled it to extend much longer-term loans (20 years) than the private sector, and to win an 80 percent market share in volume despite charging a larger intermediation margin. The poor recovery performance—the delinquency rate went above 25 percent at the end of the 1980s—put Bank Tabungan Negara in a precarious financial situation. The bank managed to improve its risk management, achieving some improvement in this area, but at the same time sought to expand its business by diversifying it toward corporate lending. The lack of capacity in this area was evidenced by a high level of arrears: 100 percent of the corporate loans went into default during the 1997 Asian crisis. When Bank Tabungan Negara transferred its impaired loans to the agency in charge of restructuring the banking system, it incurred an overall loss exceeding $1 billion, more than 20 times the yearly budgeted amount of housing subsidies.

Crédit Foncier du Cameroun. This is a specialized institution that was established in 1977 by the government. Its loan portfolio, about $150 million * at the end of 2004, is mostly funded by a wage tax and marginally from savings deposits. In

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Box 10.1. The Fiscal Cost of Bailing Out State Housing Banks *(continued)*

the 1990s, CFC ran into deep difficulties caused by two main reasons: (i) very low recovery performances—80 percent of the portfolio was nonperforming—partly because of defaults by the government itself and other state-owned entities, and (ii) excessive operational costs. The company incurred large recurrent deficits, made an irregular and ill-conducted diversification attempt toward commercial banking, and went into deep organizational and financial distress, resulting in a sharp reduction of its activity. The regional Central Bank required several times that draconian measures be decided by the public shareholders. Restructuring plans were designed in 2003–4, and a de facto recapitalization took place by allocating the accumulated proceeds of the wage tax to the company's own funds, a non-budgetary support that can be estimated to have amounted to at least two thirds of the gross loan portfolio.

Sources: Moody's Investors Service Banking System 2004; Gandelman and Gandelman 2004; and Hoek-Smit and Diamond 2004.
* Gross figure

Some have been closed down; others have been recapitalized several times. The fiscal cost of the respective bailouts both through the SHB and their clients has been staggering, notably in comparison with the on-budget programs of social housing subsidies, suggesting a dramatic policy failure in these countries in the long run. For example, the last restructuring of the Caixa Econômica Federal (CEF) in Brazil in 2001 fiscally cost about $8 billion, or 25 budgetary years of the main federal program of social housing subsidies.

These failures evidence a higher degree of vulnerability than normal banks. This reflects structural weaknesses within the SHB model, related to a permissive attitude toward risk management and operational policy, and administrative- and rule-based culture (rather than risked based), amplified by some implicit state backing. The sensitivity to crisis is also caused by specialization, which may lead to an excessive exposure to real estate market downturns, amplified by hazardous diversification attempts in commercial real estate. This section analyzes more precisely the factors behind this structural fragility.

State Housing Bank Failings

Weak Corporate Governance

A first series of flaws can be found in the legal foundations of SHBs, which are often governed by a special legislative act in derogation of general corporate and banking status. These acts often lower the accountability and profitability requirements that private entities must meet because of the quasi-state-agency status of the bank. Related to this status are also restrictions in the business model, in particular over lending operations (types of loans, specified interest rates, business limitations, and so forth), which add some.

More important perhaps than majority ownership itself is the power of appointing the management and control over the bank's business policies through management. These powers most frequently belong to a financial authority. In many cases, management results from appointment of a senior official from the ministry of finance, central bank, or another state institution, rather than professional bankers, giving the institution a more administrative than financial culture. Moreover, the government exercises direct access to the management of the bank and the conduct of its business; for instance, in the setting of lending conditions. This organization goes hand in hand with often weaker oversight by the financial supervisors. State banks are often subject to less stringent prudential requirements than other banks, as well as reporting obligations. This, jointly with a prevailing administrative approach, facilitates weak accounting systems and internal controls. One of the telltale signs of major problems at a housing bank is when it does not produce reliable and timely reports on its financial position and on its subsidy programs.

Government control also makes the role of the board of directors often of little relevance as an outside evaluator of the bank's performance and its compliance with the public interest objectives that it is supposed to pursue, often characterized by quantitative housing-policy targets. Too much government intervention in the bank's management, as well as the board of directors' incomplete mandate, can lead to accountability deficiencies.

Seeking a balance between social goals and financial efficiency should be the core function of the management, but this often turns into a compromise between political interference and rent-seeking behavior. Opportunities for politically driven business interventions trade off against privileges exploited

by the SHB to its own advantage, at the expense of the public good. This may result in some kind of implicit agreement by which the SHB bows to political pressures while the politicians allow the SHB to capture some public benefits. The linkage to government often gives the bank the ability to influence policy decisions. This would typically be to promote the interests of the SHB and may not coincide with the best interests of the wider population.

Lax Management of Credit Risk

The portfolio performance of SHBs is often poor, with a common NPL ratio of 20 to 30 percent in emerging economies. It has reached 70 percent or more in some cases. The intensity of NPL problems may even be hidden by poor accounting practices and misleading loan classifications.[1] Several reasons may explain this unfavorable outcome:

Because of the subsidization of loans and the application of administrative rules, risk-based lending may be partially replaced by "formula lending" that does not allow SHBs to differentiate among customers according to their credit risk.

In mortgage markets where private players are active, adverse selection takes place that is confined to "formula" lending, to the detriment of the SHB.

As a public policy tool, the government assigns the SHB goals based on new loan production rather than improving performance or pursuing politically unpopular measures such as recoveries from nonperforming loans.

Loan servicing in SHBs is often mediocre, because such lenders tend to be more lenient than commercial lenders, and borrowers are more inclined to be delinquent when borrowing from a state-owned bank. Moral hazard is significant in the model, and seems difficult to avoid.

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1. For instance, the classification of nonperforming accounts takes place after a longer-than-normal arrears period, or is partial (interest only, or one loan only despite a larger exposure of the same debtor).

Assets/Liability Mismatches

One of the major policy motivations for setting up a SHB is to offer long-term loans, notably at a fixed rate (more attractive and secure for households). The private sector may not offer such loans if it cannot manage the liquidity and interest-rate risks. This may be because of an inherently unstable core deposit base, underdeveloped bond markets, or an absence of hedging tools. Providing long-term fixed-rate loans may be a reason to establish an SHB, but such an institutional move does not provide a remedy to the underlying issue: creating an institution does not create a source for long-term resources. This confusion often ends up transferring a significant amount of financial risks to the taxpayer. Some selected examples show how common this problem is:

In Japan, the Government Housing Loan Corporation was created in 1950 to finance the postwar reconstruction. Its funding was mainly public (special government program and grants). The Government Housing Loan Corporation loans to house purchasers would have a first 10-year period with a fixed rate below market and a 25-year period with a preset fixed interest rate.[2] As such conditions could not be matched by private markets, other lenders were crowded out in this spectrum of maturities (and focused on shorter-term loans).

In Iran, the Bank Maskan offers long-term loans up to 20 years at fixed rates funded mostly with savings-for-housing schemes where the minimum requested duration of the preliminary savings period varies between six months and 3.5 years and the ratio between accumulated savings and the amount customers are entitled to borrow can be as high as 7. There is no hedge for the long-term loans the bank commits itself to extend.

In Mali, the Banque de l'Habitat was established in 1995. Despite a short-term funding base (including savings-for-housing schemes of a maximum and minimum period of one year) and a lack of external matching resources (limited bond markets), it has been granting mortgage loans for up to 20 years. Its liquidity risk is large,[3] and interest risk worse, especially with contractual housing schemes, which set the level of rates in advance.

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2. In 2002: 2.755 and 4 percent respectively.
3. Public entities have been directed to deposits funds with Banque de l'Habitat (Mali)—a far from stable solution.

The Banco Hipotecario de Uruguay (BHU) was created in 1912. BHU was the predominant provider of housing finance and had 80 percent of the market in 2002. BHU cumulated three types of asset-liability mismatches: (i) liquidity risk—20-year loans, while most of the funding was sight deposit; (ii) interest rate risk—loans were granted on a fixed-rate basis before switching to a variable rate regime; and (iii) currency risk: after 1980, U.S.-dollar-denominated deposits grew to a significant percentage of BHU's liabilities while loans remained mostly denominated in indexed local currency.

Many housing bank failures resulted from this type of imbalance, taking a heavy toll on the national resources as the mismatches worsened during a crisis and the subsequent rescue operations.

Misallocation of Subsidies and Rent-Seeking Policies

As part of their social lending mandate, SHBs are often the privileged and sometimes exclusive vehicles of rationed subsidies. That channeling may create various problems. The SHB that allocates the subsidized loans is in a position to exercise some discretion in the allocation of the assistance, even if it must comply with eligibility criteria. In some cases, this leads to fraud or corruption among the bank's staff. More commonly, part of the subsidies end up supporting the SHB itself. There is always a temptation to use a "free" resource to cover operational costs, which are often higher than normal and would be difficult to sustain in a commercial environment. The problem is aggravated when subsidies are incorporated in the funding of the SHB; for instance, through the provision of resources at below-market rates, as this lower funding cost results in an above-normal intermediation spread and is not entirely passed through to the borrowers.

In this case, economic inefficiency develops on top of the social misallocation of benefits.[4]

More indirect forms of support exist, such as government guarantees along with their impact on investors (lower risk weight, eligibility for liquidity ratios, or reserve requirements), but also implicit guarantees, tax relief, or

4. These flaws are amplified when government funding is carried out through Central Bank lending. Creating high-powered money to finance long-term investments is bound to eventually lead to escalating inflationary pressures.

other preferential features granted to the SHB, such as more effective foreclosure proceedings unavailable to other lenders. These indirect benefits seem less costly, as they do not appear in budget expenses, but (i) they make any social cost-benefit analysis of the SHB intervention difficult to measure, and (ii) they may prove difficult to remove when the market has developed.

SHB as Obstacles to the Growth of Housing Finance Markets?

Many of the design flaws presented above are interrelated. Poor governance is involved in a loose recovery policy and free purchase of financial hedges; that is, through transferring balance-sheet mismatches to the government. Capturing subsidies is an inducement not to observe strict discipline in managing risks. When all these shortcomings are present, SHB can have a negative effect on the development of the market and the extension of access to housing finance, if this privileged subsidy circuit excludes other players from the market, and if the privileges do not remedy the deficiencies of the infrastructure of credit markets, such as the dearth of long-term capital in the economy. To the contrary, SHB may introduce further market distortions by being able to offer products that no competitors can ever match. This impact goes beyond the moderate-income segments that SHBs are supposed to serve. Because of their low profitability and poor track records in managing credit risks, it is fairly common to see SHBs shift their actual commercial target upward in the income distribution and finally compete with mainstream lenders on their ground.

Available Safeguards and Alternative Options

Before creating an SHB, government should determine what type of market failures are constraining the development and deepening of the market. If the unwillingness of the commercial financial sector to promote housing finance is the result of structural deficiencies and not the existence of more profitable and easier lines of business, an SHB will not foster the development of the supply—and to the contrary may stunt it. This will also be true if the

market impediment lies in macroeconomic conditions. There are examples where the strengthening of the market infrastructure and the improvement of the macroeconomic conditions were sufficient to jump-start the market. For instance, Estonia has built in a little more than a decade a housing finance system that reaches 25 percent of its 2005 GDP. In Pakistan, the improvement of the financial parameters and the liquidity of the banking sector triggered a surge in the supply of housing finance. Loans outstanding went from YSD 330 million at the end of 2003 to 900 million at the end of 2005. This was achieved without any involvement of the SHB, which was itself being overhauled.

If the government considers that an institution is the right answer because the problem is the absence of a "market maker" and of development engine, then its design should meet some critical conditions to ensure it efficiently fulfills its social and economic purposes.

Good Governance

The first condition for making an SHB work is to establish its operation on strong corporate governance principles and insulate it from short-term political interference. These principles include the clear definition of corporate goals, transparency of results, independence and accountability of the management with respect to the board of directors, clear and independent risk management organization, separation of ownership, and control functions.[5] One prerequisite is to submit the SHB to general corporate laws and, above all, to the standard oversight of the banking regulator.

Public-private partnerships can be a way to ensure the existence of checks and balances, by creating an inner pressure for corporate results and helping to insulate the SHB from political interference. This solution runs the risk of exacerbating the capture of subsidies or other benefits by the private sector.

5. For a detailed analysis, see OECD 2004 and BIS 2006. See also van Greuning, Hennie, and Bratanovic 2003.

Autonomy of Funding

Establishing an SHB without ensuring its ability to raise funds autonomously is a sure recipe for the failure of the model. Without a savings mobilization capacity, resulting from either the absence of a deposit network and/or to the underdevelopment of the capital market,[6] an SHB is entirely dependent on government support. Funding loans through budgetary resources opens the gate for abuses and market distortions as mentioned above. Moreover, it is an economically inefficient solution, since it results in stringently constraining lending volumes and subjects them to uncertainty and volatility. Private lenders are never on an equal footing. Most of the limited number of examples of SHBs that have evolved successfully are banks that are issuing mortgage-related securities, thereby pioneering at the same time the development of the capital market: BancoEstado in Chile, GHB in Thailand, Banco Hipotecario in Argentina, and Crédit Immobilier et Hotelier in Morocco (which opened the MBS market in 2003).

Alignment of Corporate Interest with Market Development

The challenge of SHBs comes from mixing financial objectives and social objectives. It is extremely difficult to keep a balance between the two series of incentives. Any organization that enjoys privileges and a rent situation will seek to maximize for itself the benefits stemming from these advantages—a risk that not only exists in the case of wholly state-owned banks, but also when private partners are associated with the structure.

That is why it is of utmost importance to separate subsidies from finance and not let them become a source of income for the bank. Also, it is critical, besides good governance rules, to design business plans that clearly include performance objectives, define indicators, make the renewal of special advantages conditional on the achievement of objectives, and ensure the transparency and the publicity of the actual achievements by the SHB.

6. An essential feature for a specialized, nonbank. An archetypical example of such an arrangement is Crédit Foncier de France, the inception of which in the mid-nineteenth century was backed by the simultaneous creation of mortgage bonds.

Examples of SHBs Meeting These Conditions

Success is defined by contributing to the overall market development and providing finance to underserved categories, while achieving self-sustainability both in terms of financial results and of funding. Very few SHBs are reported to have fulfilled these expectations.

In Asia, the GHB of Thailand has been operating on a commercial basis without being dependent on state subsidies and has managed to run its commercial activities in a professional and competitive manner. Its leadership in lower-income housing finance rather reflects its strategic position vis-à-vis other lenders, than any privilege. The bank has played an innovative role and was a price leader during the takeoff of the housing finance system during the 1980s and early 1990s.

In Chile, BancoEstado is an example of where the market differentiation between the SHB and other banks reflects different business strategies, not the existence of special privileges. Its case is reviewed as such below.

Box 10.2. The Case of BancoEstado (Chile)

BancoEstado—originally Banco del Estado de Chile—was created in 1953 through the merger of four state-owned S&L institutions. While historically mainly focused on lending for housing, it has recently engaged in strategic diversification and has become the third commercial bank of the country. The bank's customer profile evidences the emphasis on low- and middle-income groups; * it has a 25 percent market share of mortgage loans in terms of value, but over 70 percent in terms of numbers of loans. Yet, the recovery performance of the bank on these loans is high, with a three-month delinquency rate steadily below 1 percent (0.62 percent in 2007) and better than the average of the Chilean banking system. ** Its net return on assets is satisfactory (0.48 percent in 2004–5), albeit lower than the countrywide average of 1.27 percent.[†] The two key success factors are (1) BancoEstado has always been operated on commercial principles. Although the government appoints its board members, except one, its management is composed of professionals rather than political appointees or civil servants. The bank is subject

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Box 10.2. The Case of BancoEstado (Chile) *(continued)*

to normal banking regulation and supervision, including asset-liability management norms. Its shareholder, the state, imposes a strict profitability requirement: the bank pays a corporate income tax at a higher rate (40 percent) than private companies, and pays out 75 percent of its profits as dividends. The bank is managed with full autonomy vis-à-vis its sole shareholder. It is prohibited to lend to other state-owned entities. (2) BancoEstado has a large savings-collection network resulting in attracting a large population of small savers (80 percent of the country's savings accounts, but the average amount of its accounts is about one-third of other banks). Moreover, the active geographic extension policy allowed the bank to be the only financial institution present in 65 percent of the municipalities. Thanks to its customer base, and not because of some distribution privilege,‡ BancoEstado is the main channel for housing subsidies.

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* Below the income threshold for bankability, it is the government that provides housing finance—until 2002 through mortgages directly extended by the Housing Ministry (with a very poor recovery rate); now merely through subsidies.

** This quality is of utmost importance for the cost of funds in Chile, where a large portion of mortgages are funded through bonds that are PT securities guaranteed by the loan originators and collateralized by the loan's portfolios.

† Fitch Ratings 2006.

‡ Housing subsidies in Chile do not pass through the accounts of lenders, but benefit directly to households, with a requirement of prior savings, and their allocation is neutral vis-à-vis the distribution network.

Box 10.3. The Case of the Government Housing Bank (GHB) of Thailand

GHB was established in 1953 under specific legislation with a dual purpose: housing finance and housing development. The latter activity was transferred to another government body, the National Housing Authority, in 1973, when the company experienced a crisis triggered by losses on its developer loans. The GHB was recapitalized and assigned a new strategy. It became a commercially run institution, which abides by good corporate governance rules, focuses on the quality of its portfolio, and posts positive results ($109 million in 2005 for assets totaling $13.3 billion). GHB developed a network of more than 120 branches, which allowed it to mobilize funding through its deposit base. GHB succeeded in combining the support to lower-income groups and the function of a driver

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Box 10.3. The Case of the Government Housing Bank (GHB) of Thailand *(continued)*

for the whole market development. It does provide loans at below-market conditions, by concentrating on providing lower-income borrowers with the benefits of the advantages its enjoys as an SHB: lower spread on bond issues, absence of dividend, and, for a long time, lesser capital requirements than other lenders. Also, GHB participates in some government-lead social housing and slum upgrading programs—targeting households that the financial system would not serve. At the same time, GHB plays a role as a market developer. Its activity has not prevented the overall growth of the supply of finance for housing, provided now by 17 other players. It played a countercyclical function during the 1997–2001 fall of the mortgage market: while lending by commercial bank dropped, GHB's activity level remained the same and its market share jumped from its traditional 29 percent range to over 35 percent. It is sponsoring market infrastructure developments through its involvement in the inception of a retail credit bureau, a real estate information center, and a mortgage insurance scheme. In mid-2006, the Housing Bank announced a $1 billion issue of MBSs, the largest securitization transaction ever in Asia except Japan.

Policy Alternatives

Market development can start spontaneously, but this is not the most common process. More often, there is a need for a driving force, or a "market maker," to spark the growth of the supply in an embryonic market. Besides establishing a SHB, a government may want to consider alternative routes to broaden access to housing finance. It must be stressed that whatever option is chosen, it cannot be successful if, in parallel, the basic obstacles that motivate the abstention of market players—mortgage lending infrastructure, stability of funding, macroeconomic conditions, and so forth—are not addressed.

Regulatory or Contractual Credit Orientation

In some countries, credit direction has been used to overcome market failures. In the United States, the Community Reinvestment Act of 1977[7] seeks to prevent "redlining" of underserved areas by imposing on banks minimum requirements to provide financial services—and, in the first place, offering bank accounts. India is another example of administrative direction, with the concept of "priority lending" requirements, including for the housing sector, which lending institutions must fulfill. In underdeveloped markets, this approach can be ineffective if the basic environment remains weak, in particular in terms of adequate funding and effective credit-risk management tools. In Nigeria, for instance, quotas for home lending—5–6 percent of total lending—had been prescribed in the early 1980s, but remained ineffective because of the shortcomings of the lending environment, and despite sanctions provided for by the Central Bank. The regulation was dropped in 1993.

A more fruitful approach, which can better take into account lenders' constraints, is to induce financial institutions to serve lower-income groups through contractual arrangements. This is the route chosen by South Africa, where the largest commercial banks signed in 2005 a memorandum of understanding with the government, in line with the broader 2003 Financial Sector Charter, in which they committed themselves to provide a certain volume of loans to the low-income market segment over four years. Participating banks adjusted their lending policy accordingly, developed new products,[8] and established new departments dedicated to affordable housing loans.[9]

Second-Tier Institutions

Instead of creating a primary market lender that may ultimately compete with or crowd out other lenders, a government may consider supporting a

7. Diamond 2002.
8. See FinMark Trust 2007, Rust 2007 and 2008.
9. It should be noted that this solution is not without its problems. Issues surrounding sharing of credit and market risk have meant that it is not fully implemented in South Africa's townships.

second-tier institution (liquidity facility or conduit as described in the capital markets chapter). There are two potential advantages: a second-tier institution may have a catalytic effect on the market by opening up new funding channels, and it may reduce barriers to lending by mitigating uncertainties or additional risks that block market development. This approach only works if the primary market is sufficiently developed and bond markets exist, however. Government ownership or backing (for example, through guarantees) of a second-tier institution can be a more efficient form of subsidy because it benefits the whole primary market instead of being reserved to a privileged circuit at the detriment of other players. There are therefore convincing examples of secondary market facilities that have actually played a catalytic role in the development of the housing finance market (see the related chapter in this book). Such an approach, however, does not address in itself all the concerns described above, in particular the shortcomings of mixing finance and subsidies and the risk of the institution capturing part of the state support. Care must be taken to calculate and budget the contingent liability of such support, for which the institution must be an agent with fiduciary obligations rather than a recipient that is in a position to pass only part of it on to the market.

Public-Private Partnerships

As an alternative to creating a specialized housing bank, a government may wish to stimulate mortgage lending through strategic investment in or initial support to housing finance companies. The advantage to this model could be the ability to combine private-sector managerial efficiency with government policy goals.

The main successful example is HDFC in India. HDFC, established at the end of 1977, was promoted by Industrial Credit and Investment Corporation of India (ICICI), the then state-owned development bank, and particularly by the personal involvement of its chairman. ICICI, however, only invested a small amount—5 percent of the total of seed capital in the new institution. The government also brought initial support by guaranteeing the company's long-term debt, and directed public-sector institutions, in particular, insurance companies, to finance HDFC. Moreover, a regulation was passed that made loans to specialized housing finance companies eligible for the priority

lending obligations imposed on commercial banks. HDFC grew to become the main driver of the market development, acting as the promoter of other specialized institutions as well as the supporter of other housing-related services, while at the same time being a successful business. Key for this success was the actual, but limited, support by the government that did not conflict with a business model focused on recovery policy and resource mobilization.

Such a combination has been difficult to replicate elsewhere up to now. HDFC helped establish similar institutions in other countries, for instance, Bangladesh and Ghana. Despite the expertise and dynamism of these two institutions, the model has not been successful as in India because of unfavorable context—lack of efficient external funding and negative impact of an SHB in one case, macroeconomic instability in the other. This shows that an institutional model is itself not enough, but that structural and environment conditions conducive to housing finance are required in any case.

"Double Bottom Line"—Social and Commercial—Private-Sector Lenders

There is an increasing interest around the world in combining financial viability with social benefits in sectors such as housing that are at the crossroads of finance and social purposes. Instead of developing a proprietary instrument, government may want to foster the development of entities susceptible to bringing business-based solutions to the needs of households underserved by the mainstream financial sector. In many countries, there is an array of microfinance institutions or financial cooperatives that can, or could where a proper environment exists, develop housing finance products. This is the case in several African countries, for instance: Caisses Populaires du Burkina Faso, Nyesigiso cooperatives in Mali, Banques Populaires du Rwanda, and MUCODEC in Congo. In Paraguay, the quasi-sole providers of housing finance are credit unions or financial cooperatives. Given the often deep penetration of such networks in the income spectrum, they might be a more efficient use of public sponsorship than specialized state entities with a narrow scope.

Exit Strategies

For the countries where inefficient SHBs exist, there are few exit solutions besides winding them down. These alternatives are constrained by the bank's condition and the financial context in which it operates.[10]

Enable a "Corporatization Process" to Create a Commercially Run Institution

Ensure the SHB operates on commercial principles (profitability, as evidenced by tax and dividends-payment capacity, a condition for sustainability). This approach typically involves the removal of privileges and distortion factors to establish a level playing field for other lenders. In turn, this requires the separation of subsidies from finance by having two separate balance sheets: one for the social subsidy program of the state managed by the bank, preferably for a fee, the other being the commercial balance sheet of the bank meeting the reporting standards of any commercial bank.

The government must make sure that the housing bank falls under the direct regulation and supervision of the bank regulators. Also, the corporatization process typically involves bringing in a new set of experienced bank managers who will instill financial and administrative discipline.

Two recent experiences illustrate this strategy: Pakistan, with the transformation of the HBFC, and Algeria, with the turning around of the once-crippled CNEP.

HBFC, in Pakistan, established in 1952, was for a long time the sole provider of formal finance for housing. HBFC was an institution run by non-professional bankers. It relied mostly on Central Bank for its funding at below-market conditions. It did not target modest households as it should have, and had a very lax recovery policy. The government decided in the late 1990s to put HBFC back afloat, and to bring it up to acceptable efficiency standards with the view of eventually selling it to private investors. Shutting the institution down was seen as politically unfeasible since HBFC was at that time the only lender of any significance in the country. A recapitalization

10. A valuable perspective on state-owned banks can be found in Caprio, Fiechter, Litan, and Pomerleano 2004.

was carried out, mainly through Central Bank debt forgiveness. The granting of new credit facilities by the Central Bank was brought to a halt. Consequently, HBFC was obliged to considerably reduce its new lending activity and to focus on payment recoveries, which had become its only source of funding. A new management was appointed, chosen from among professional bankers. A deep modernization of internal procedures and information system was undertaken, and corrupted practices were fought. Currently, new demand-driven products are being designed, and the participation of private shareholders in the company's capital is being considered.

CNEP in Algeria is basically the Algerian savings bank, with more than 6 million accounts. It used to have the monopoly on real estate finance within a state-owned banking system, both for individuals and for public housing programs. The state massively used this savings channel for financing public developers. For many years, CNEP operations were largely driven by administrative and political criteria. Many loans were granted without clear property title, especially to public developers, to which land used to be allocated through simple administrative allotment letters. Moreover, CNEP's own development subsidiary was directed by public authorities to build programs that met low demand. Nonperforming loans ended up amounting to about 75 percent of the portfolio, including loans to the in-house developer.

In 1997, the government bailed out the institution plan at a time where a deregulation policy opened real estate finance to other players. The "Caisse" was recapitalized and turned into a commercial bank subject to Central Bank oversight—instead of being based on a specific law and regulated by the Ministry of Finance. Part of the impaired public-developer portfolio was exchanged for treasury bonds. In a new restructuring plan in 2000–1, the government bought unsold stocks of housing units for DA 13.7 billion (US$180 million) and sponsored the selling of 35,000 other units.

New management launched a forceful reorganization, focusing on the overhaul of the accounting system and on the recovery policy. The emphasis on recovery implied a fall in the production of new loans, but the recovery rate reached 85 percent on the pre-restructured portfolios, and 95 percent on the post-2000 production. Since 2004, CNEP has resumed more active lending.

Partial or Full Privatization

Bringing in market discipline and economic business strategies can be strongly buttressed if private partners, who will require profitable results and risk-based management, are brought in, while at the same time the shareholding government retains a say in the general strategy of the institution. The danger with partial privatization, however, is that private investors may be rent seekers who exploit privileges rather than pursue sound business or development strategies.[11] Therefore, seeking to establish a private-public partnership should rely on a true commercial franchise for which the government provides initial support, and should be accompanied by the dismantling of any market-distorting advantages.

Banco Hipotecario in Argentina[12] is an example of success in achieving the association of private shareholders who pursue a commercially oriented policy and a government with enough influence to guide the company toward market segments that are complementary of the mainstream banking sector. Banco Hipotecario Nacional was an SHB operating since the last years of the 19th century. In the 1980s, it was the main provider of mortgage loans in the country. Its funding sources were deposits from public sector entities and loans from the Central Bank.[13] Its performance was increasingly poor. Its customer base shifted upward in the income distribution. The bank incurred considerable mismatches between short-term liabilities and 25-year maturity assets that followed different indexation mechanisms. Because of the discrepancy between the loan balance appreciation and housing prices, as well as a lax recovery policy, the portfolio quality drastically deteriorated, ending with a 67 percent rate of nonperforming loans. These conditions resulted in a severe crisis, leading the Central Bank to intervene in 1987. Banco Hipotecario Nacional's deposits were transferred to Banco de la Nación, and it was prohibited from direct lending.

For a while, Banco Hipotecario Nacional became a wholesale lender extending loans through a network of correspondent banks. In 1991–3, it

11. The example of American government-sponsored enterprises shows that the benefit of government support can be diverted not only by the corporation's staff, but by its shareholders.
12. See Cristini and Moya 2004 and Gautier, Hassler, Freire, Goytia, Clichevski, Cristini, and Moya 2006.
13. This is the opposite of the company's original concept, which implied the issuance of mortgage bonds.

went through a deep restructuring. It contributed to the promotion of the market by providing funding to primary lenders. It developed original construction finance structures, set out underwriting standards for unsalaried borrowers, and entered into partnership with some provincial housing agencies in charge of low-income housing (Instituto Provinciales de Vivienda). In 1996, following a 1995 law that established a securitization framework, it pioneered the issuance of MBSs.

The next step was to partially privatize the company, a part of a more general policy promulgated in 1996. In all, 46 percent of the bank's capital—from then on, Banco Hipotecario SA (BHSA)—was sold to private investors in early 1999. Interestingly, despite retaining a majority of shares, the government handed over control of the board of directors to the latter, who appoint nine out of 13 directors. The privatization law authorized the bank to directly lend to primary borrowers again. In exchange for various obligations meant to support social policy goals,[14] the law kept the benefice of certain privileges,[15] but provided for a sunset clause, set in August 2007.

During this decade, housing finance surged in Argentina, with all the major banks offering the product. BHSA retained a leading position in the market.[16] The company's recovery performance and profitability strongly improved, and it became the first Latin American company to issue AAA mortgage securities in the United States. Yet, BHSA kept a special role in moderate- and middle-income market segments, resulting in particular from partnerships with local government assistance programs. The soundness of its operation was demonstrated by the way it overcome the 2001–2 crisis, despite being deeply affected by it. It was the first Argentinean entity to reschedule its external debt, and reopened the domestic securitization market in 2004. NPL ratio quickly fell below the 2001–2 crisis level.[17] The company's main challenge is to diversify its funding sources and expand its deposit base.

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14. The main obligations are to allocate 10 percent of the construction loans to small cities, to maintain a fund allowing debt forgiveness to borrowers in distressed economic situations, and to ensure a balanced geographical distribution of loans.
15. Income tax relief on loans extended before 1997, right of selling and managing mortgage-linked insurance products, and special procedures for forced sales.
16. BHSA market share jumped to over 30 percent of new lending after the 2002 crisis, which brought mortgage lending to a halt for awhile. In terms of loans outstanding, its market share is about 20 percent.
17. A total of 7.3 percent of all loans at the end of 2005, and 5.9 percent in December 2006 (Fitch Ratings 2006).

Conversion of an SHB into a Second-Tier Refinance Institution

This option is rare because it is generally not realistic. The administrative culture that prevails in many housing banks is incompatible with that of a capital market organization; in addition, the operations and systems would need a total overhaul. Although the Argentine case experienced some success in becoming—temporarily—a second-tier financier, the example of Nigeria is more representative of the difficulties of such a conversion.

State Support to Private Sector

SHBs often are the sole, or at least the dominant, provider of housing finance (Brazil, Mali, Pakistan before 2003, and Uruguay). In this case, their operation cannot be stopped suddenly: market capacities have to be built up first or in parallel, for fear of depriving households of an already all-too-limited supply of financial services.

Several experiences can be mentioned as being very successful in avoiding an interruption in the finance supply, and in fostering the growth of alternate finance providers on a sound basis.

In Jordan, the government in 1973 created the Housing Bank for Trade and Finance, according to the classic, pre-liberalization-era housing bank model: a special law, a specialized activity, and implicit subsidies (tax exemption, reserve requirements). The bank—which was a public-private partnership—was conservatively run, with the objective of economic efficiency prevailing over political interferences. Its existence, however, was not favorable to the entry of new players in the market, and its actions did nothing to establish a source of long-term capital. Therefore, the Jordanian government decided to change its status in 1997. Its specific framework was removed, and it was authorized to become a full-fledged commercial bank. The Housing Bank for Trade and Finance diversified its activities, and progressively stopped lending for housing. In the meantime, a second-tier liquidity facility, the Jordan Mortgage Refinance Corporation (JMRC), was created with the purpose of raising capital from the nascent bond market and of lending this relatively long-term resources to any participating mortgage lender. As described in chapter 12,

Box 10.4. The Case of the Federal Mortgage Bank of Nigeria

At the end of the 1960s, in the context of National Development Plans, the government of Nigeria developed a policy of direct intervention in the housing sector, both as a provider of new units and of housing finance. The existing specialized lender, the Nigeria Building Society, was bought by the government, and, in 1977, converted into a new organization, the Federal Mortgage Bank of Nigeria (FMBN). Established on a specific legal basis, and wholly owned by the federal government, FMBN was entrusted with providing long-term housing credit, either as a retail or a wholesale lender. Its funding sources were the federal budget, the Central Bank, and the banking system, which was directed to allocate a minimum percentage of its lending to housing. The system proved ineffective. FMBN recovery performance was very low. The overall investments in housing dropped during this period.

At the end of the 1980s and early 1990s, the government switched to a liberalization policy, and sought to foster private-sector lenders, but within a specialized, subsidized circuit led and supervised by public institutions. Primary mortgage institutions (PMIs) were established within a framework for specialized companies, modeled on building societies. FMBN transferred its primary lending activity to a state-owned PMI, the Federal Mortgage Finance Limited, to become a second-tier refinancier and also the regulator and supervisor of the PMIs. * In 1992, the National Housing Fund (NHF), mainly funded by mandatory contributions from salaried employees, was created to provide funds at below-market conditions to the PMI system through FMBN. The new structure failed to have any catalytic effect on the supply of housing finance. The Federal Mortgage Finance Limited, which inherited a portfolio of mostly nonperforming loans from FMBN and had excessive operating costs, did not play the expected role of market leader for PMIs. It was liquidated in 2004. FMBN suffered from impediments affecting the role of the NHF, both from cumbersome procedures in its PMI refinancing activity and from poor management that translated into recurrent operational deficits. The FMBN-NHF channel provided the equivalent of only $40 million in mortgages over 13 years (excluding developer loans). As part of a broader policy revision, FMBN's business model is being revised. FMBN should become a second-tier facility channeling capital market resources toward primary lenders, a perspective that became realistic with the establishment of fully funded pension funds in Nigeria.

* The oversight function was transferred to the Central Bank in 1997.

JMRC has had an impact in setting quality standards for loan origination and servicing and improving the lending terms. It became a catalyst and triggered the entry of new mortgage lenders. In all, eight banks are now active in the mortgage market and their supply of loans did much more than offset the withdrawal of the Housing Bank for Trade and Finance.

In Pakistan, while the housing bank HBFC was being overhauled, a conducive framework for lending for housing in general was established: an out-of-court foreclosure procedure was created (2001), credit reporting systems were developed for loans to individuals, tax incentives were devised for mortgage borrowers, and a strengthening of the real estate developer industry was promoted. Comforted by a noticeable improvement of the macroeconomic environment, in particular by a sharp fall in interest rates, commercial banks entered the market. In less than two years (2003–4), 20 lenders were active and together offered a higher volume of finance than the hitherto dominant HBFC.

In Korea, the evolution of the SHB was quite different. The Korea Housing Bank (KHB) operated on a commercial basis from the day of its creation in 1967 within a financial policy environment of strong directed credit as the only mortgage lender. A critical step took place in the 1970s, when the government agreed to separate social operations from the balance sheet of KHB and to finance the NHF from explicit fiscal resources; KHB was paid a fee to service the loans. KHB's charter changed from a specialized to commercial bank and became the Korea Housing and Commercial Bank (KH&CB) in 1997. The new charter, however, committed KH&CB to making no less than 50 percent of its loans to housing. The Ministry of Finance also maintained its power to appoint senior executives. In order to strengthen its performance by means of strategic investors, KH&CB became the first Korean bank to be listed on the New York Stock Exhange the same year. KH&CB was among the small minority of banks that weathered the 1997 financial crisis unscathed because it did not make loans to large business groups, or chaibols. It maintained a bad loan ratio of below 3 percent. In 2001, KH&CB had become the largest commercial bank in Korea through its merger with Kookmin Bank. Today, Kookmin Bank (the name the merged institution retained) maintains it quasi-monopolist dominance of the mortgage market and it remains the sole servicer of the NHF social lending. Together, the two portfolios represent 85 percent of the Korean mortgage market. Meanwhile, the new govern-

ment-owned Korea Housing Finance Corporation started operating in 2004 as a secondary market institution that aims to diversify mortgage distribution channels and to lower the heavy dependence of the Korean market on ARM loans of very short maturities.

Conclusion: A Decision Tree for Policy Makers

One major problem with SHBs is that they apparently fill a vacuum immediately and provide loans for a few years before the risks and distortions embedded in the model start unfolding on a full scale. It is therefore critical that policy makers draw the lessons from the past and from other countries, and clearly define the goals they want to achieve before jumping to a solution that seems an easy answer in the short term, but tends to become a fiscal time bomb or an impediment to market development.

The question that is the root of many others is whether the government wants primarily to provide financial services itself, and replace the market, or develop the market as deeply as possible.

If the second option prevails, the next question is to determine what prevents the commercial sector from offering this service. If, as is usually the case, the answer lies with fundamental deficiencies in the market infrastructure and environment, the government's priority should be to focus on remedying such deficiencies. Establishing a state entity under such conditions will do little good, as the state-owned housing bank will encounter the same problems as commercial lenders (and more so given the difficulties of a government lender in controlling risk through underwriting and collections). Establishing a secured lending environment, providing access to adequate funding sources, and ensuring macroeconomic stability, in particular a decline of risks premiums included in interest rates, will likely trigger the growth of lending for housing.

If the main obstacles rather lie with the strategies of mainstream banks, which prefer other business lines and are not keen to invest in housing loans, then a government may want to support the emergence of "market makers" susceptible to having a catalytic effect on market development. This can take the form of specialized institutions as in India or Mexico, with indirect government support, or of second-tier institutions as in Jordan or Malaysia,

along with a strategy of improving the legal and regulatory infrastructure. If the market failure mostly affects lower-income groups, the government may want to strengthen alternative lenders that "naturally" cater to their needs. It can also devise an assistance policy—direct demand subsidies, support to mortgage insurance or to savings for housing scheme—opened to any loan distribution channel, which can provide the required incentives for private institutions to enter new market segments.

If a new institution seems definitely needed to drive the market expansion or deepening, governments should prioritize the second-tier facility model. This model will be ineffective without a conducive environment, both in the primary mortgage market and on the capital market. Moreover, to be successful, it also requires good governance rules and a clear distinction between subsidies and corporate results.

It is only when none of the options of this decision tree are feasible that the SHB concept should be considered—and preferably not as an exclusive implementation tool of the development strategy. But many conditions must then be met: all of the above plus good governance principles, sunset clauses on regulatory or financial privileges, and a road map toward privatization. This is the best way to ensure that the institution is demand driven and has successfully established a new market.