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Philippine Institute for Development Studies

Housing Policy, Strategy and Recent Developments in Market-based Housing Finance

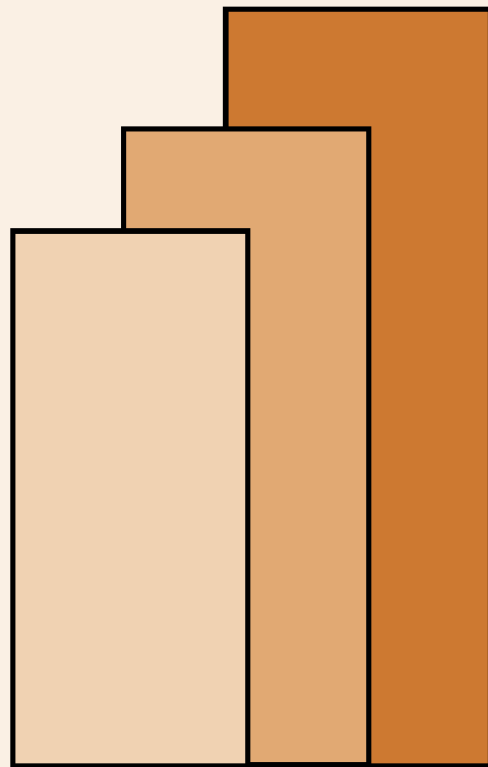
Gilberto M. Llanto and Leilanie Q. Basilio

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HOUSING POLICY, STRATEGY AND RECENT DEVELOPMENTS IN MARKET-BASED HOUSING FINANCE

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I. INTRODUCTION

The paper discusses current government attempts to shift to market-based housing finance in the context of the past performance of the government's housing policy and strategy. The paper analyzes some of the main constraints faced by low cost housing in accessing mainstream finance and draws attention to recent developments in market-based housing finance that can inform the government's housing finance strategy.

Section II describes the housing situation and the government's past interventions in the housing sector¹. Section III is a brief assessment of the National Shelter Program. Section IV discusses recent developments in market-based finance that can inform the government's housing finance strategy. The last section concludes and provides some policy recommendations.

At the onset, it is important to state that the paper does not concern itself with the performance of the housing market for middle and higher income groups. While housing policies and interventions impact on housing markets for all income classes, the assumption this paper makes is that housing markets for the middle and higher groups work. These income groups can either self-finance or borrow from lending institutions to finance the acquisition of the desired form of housing, i.e., condominiums, townhouses, single detached dwellings, etc². Thus, the paper focuses on the government's housing policies and interventions intended to provide the low-income groups access to housing because more often than not, the low-income groups have been excluded from formal housing credit markets for a variety of reasons, e.g., perceived affordability problems, credit risks and information asymmetry.

¹ A critique of government's overall policy framework for the housing sector was first discussed in Gilberto M. Llanto, "Housing Subsidies: A Closer Look at the Issues", PIDS Policy Notes, September 1996.

² For example, life insurance companies give housing loans to policy holders.

II. THE HOUSING SITUATION AND GOVERNMENT'S INTERVENTION³

A. The Housing Situation

The past administrations estimated that approximately 3.72 million new housing units would be needed for the period 1993-1998. Renovation and upgrading of old housing units would involve another 873,000 units for the same period. These are composed of the following: (a) 444,000 housing units for households that are living with other households under one roof; (b) 422,000 housing units to replace those located in areas classified as danger areas or lands needed by the government for major infrastructure projects; (c) 7,000 housing units for individuals or households who live in parks, sidewalks and bridge ways. The remaining 2.5 million units account for the future need for new dwellings.

The paucity of data prevents a systematic analysis of the real situation in the housing sector. The absence of demand studies creates a serious gap in our understanding of the sector⁴. However, recent (available) estimates suggest that the number of housing units in the Philippines grew by as much as 30% during the 1980s. The rapid increase in the number of applications for residential building permits over the period 1992-1997 indicates a growing housing market. There seems to be considerable unmet demand for additional and improved housing.

A very rough indicator of the situation is the 1990 Census of Population and Housing Report that of 11.4 million dwellings, about 47.8% of owner-occupied units had durable roofs and external walls; 66.4% had floor areas of less than 30 square meters. Occupancy rates were almost 97% with a large number of households living under one roof. The median floor area of a housing unit for urban and rural households is 20.5 square meters.

Rising prices of land for housing in Metro Manila and outlying areas reflect excess demand for housing.⁵ Land values have increased faster than the inflation rate, arising from land speculation. Rapid urban growth swelled by migration from different parts of the country has made Metro Manila residential lands prohibitively costly for most of the population.

³ This section is from Gilberto M. Llanto, "Rationalizing the Government's Housing Program," unpublished paper.

⁴ The studies by Edna Angeles and Orville Solon were done in the 1980s.

⁵ The escalating prices of higher end real estate, e.g. condominiums, high rise buildings and plush subdivisions reflect speculative behavior much more than in the lower end, socialized housing market.

Owner-households in urban (50.5%) and rural (61.9%) areas constructed their housing units by themselves or with the help of relatives and friends. Only 2.3% of all households have availed themselves of government assistance through financing institutions such as the Home Development Mutual Fund (HDMF), Government Service Insurance System (GSIS), Social Security System (SSS) and Development Bank of the Philippines (DBP). Two percent reported borrowing from private persons; 0.6% had assistance from employers while 0.4% had loans from private banks, foundations or cooperatives. Urban households had more access to government assistance than their rural counterparts.

The rapid formation of new households, especially in urban areas, has contributed to an acute demand for housing that the market has not satisfied. The demand-supply gap is mostly noticeable at the lower end of the housing market as low-income households fail to have access to decent housing. In response, the government tried to intervene in the housing market in a bid to address the demand-supply gap especially for the lower-income households.

B. Government Intervention

Over the years, the government has intervened in the housing market through a variety of instruments: (a) regulation, including rent control, (b) production of housing units, (c) finance and (d) provision of infrastructure.

Direct housing production and control. The Marcos government was directly involved in the production of housing units and imposed rent control on privately built housing units for rent.

During the 1970s and up to the mid-1980s, the government had direct involvement in the production and provision of housing units and related services. It also imposed rent control in an attempt to make housing more affordable to the low and middle income groups. The Marcos government also initiated the creation of a secondary mortgage system operated through the National Home Mortgage Finance Corporation (NHMFC) that purchased the mortgages of loan-originating private financial institutions. The NHMFC drew funding from the Home Development Mutual Fund (HDMF) at an interest rate of 12.75% per year. Those funds were in turn lent to HDMF members at subsidized interest rates.

The immediate results were government assistance at an average of more than 50,000 housing units per year in the 1980s (Morato 1993). However, despite the heavy involvement by government in housing, a huge housing backlog remained.

Unified Home Lending Program. In 1987, the Aquino government issued Executive Order No. 90 that created the Housing and Urban Development Coordinating Council (HUDCC), the highest policy making and coordinative body for urban and housing development⁶. HUDCC was tasked to formulate housing policies and guidelines to accomplish the targets of the National Shelter Program.

The Ramos government continued the implementation of the National Shelter Program (NSP) which became the government's major response to the housing problem. Over the period 1992-1996, the NSP produced and financed more than 500,000 additional low and middle-income housing units with substantial government support. The main vehicle for implementing NSP is the Unified Home Lending Program (UHLP) that provided households access to mortgage finance.

To strengthen the government's housing program, the legislature passed the Urban Housing and Development Act of 1992 (RA 7279). This law has the following objectives: (1) provide decent shelter to the poor; (2) develop a framework for the use of urban land; (3) involve the community in shelter development and construction; (4) maximize local government participation in socialized housing; and (5) employ the services of the private sector in socialized housing programs.

Two companion pieces of legislation are the Comprehensive Shelter Finance Act of 1994 (RA) and the Local Government Code of 1991 (RA 7160) gave local government units responsibilities over the provision of socialized housing and regulation of shelter-related activities.

Regulation. Government intervenes through regulation of land use and land tenure. Private developers intending to develop raw lands for housing must secure the necessary permits and clearances from

⁶ HUDCC also coordinates, monitors and exercises oversight functions over the activities of the government housing agencies such as the National Housing Authority (NHA), National Home Mortgage Finance Corporation (NHMFC), Home Insurance Guaranty Corporation (HIGC), and Housing and Land Use Regulatory Board (HLRB). NHA is the sole government agency responsible for housing production. HDMF, SSS and GSIS provide funds to the NHMFC that has been tasked to administer the government's Unified Home Lending Program (UHLP). The Ramos government basically followed the housing policies and interventions of the Aquino government.

the Housing and Land Use Regulatory Board and the local governments concerned. A bidding process determines the private developer that would be allowed to develop government owned raw lands for housing. Many local government units still have to issue their respective local land use policies and regulation that will guide the utilization of lands within their territorial responsibility. The absence of a National Land Use Code has been a major reason for the inconsistent land utilization policies at the local level.

Private developers have to secure development permits for socialized housing from a number of agencies. They are the following: (a) preliminary approval from the Housing and Land Use Regulatory Board; (b) environmental clearance certificate from the Land Management Bureau (DENR); (c) conversion clearance or certification of exemption of lands from agrarian reform from the Department of Agrarian Reform; (d) applicable permits from the Department of Agriculture and the Philippine Coconut Authority; (e) permits from the concerned city or municipal planning and development office; (f) approval of land use by the local development councils; (g) issuance of license to sell by the Housing and Land Use Regulatory Board; (h) issuance of individual titles by the Land Registration Authority of the Department of Justice; (i) and approval from the Board of Investments, Bureau of Internal Revenue or local government Sanggunians for fiscal incentives that the private developers might seek.

Production. The National Housing Authority and the Home Insurance and Guarantee Corporation operate joint venture programs with the private sector. In general, private builders construct housing units after posting performance bonds with insurance companies. They are responsible for everything from procurement of materials and supplies to construction of the housing units. Payment is made on turn-key basis.

The government continues to play a significant role in the direct production of housing units through the National Housing Agency (NHA). The major production programs are (a) sites and services, (b) resettlement of squatter families, (c) joint venture with the private sector, (d) emergency housing and (e) dormitory and apartment housing.

The NHA also has a medium-rise housing program intended for the low and middle income groups. The program finances 3- to 4-storey residential buildings in high density urban areas. The NHA provides the land while the private contractor constructs the buildings.

Infrastructure. The government builds the primary infrastructure. Secondary infrastructure such as on-site water supply, sewerage and power lines are for the responsibility of the private developers. The developers may build the housing units or contract private construction companies to produce the units. On the other hand, homeowners or communities may be involved in the development of sites and services in community development programs.

Housing finance. The government provides development loans, mortgage take outs, guarantee and tax breaks to private developers and builders who participate in the National Shelter Program. Development loans for socialized and economic housing are given at subsidized rates of interest. The Community Mortgage Program charges a subsidized rate of 6% per year while developers of low cost housing pay interest rates ranging from 9.5% to 16% under the Abot Kaya Pabahay and the Social Housing Developmental Loan Program. The Home Insurance and Guarantee Corporation insures development loans.

Under the mortgage take out scheme are the following:

- NHMFC'S Unified Home Lending Program (UHLP)
- HDMF's Expanded Housing Loan Program
- Home Insurance and Guaranty Corporation's Retail Guaranty Program
- SSS and GSIS housing programs

The government provides private developers financing for large-scale housing production under the following:

- Social Housing Development Loan
- HIGC's Development Guaranty
- HDMF's Group Land Acquisition Development
- SSS corporate housing program

The Social Housing Development Loan is a development financing assistance to private developers, NGOs, landowners and local governments for social housing projects that cost P150,000 and below per unit catering to the lowest 70% of the target income groups. The HDMF finances private sector proponents while

NHMFC funds government sector projects. The HDMF provides loans to private developers, project proponents or banks that implement low cost housing projects. The assistance is available for housing projects composed of a minimum 20 housing units. The NHMFC wholesales funds to participating government and private financing institutions which in turn directly lend to private parties.

The Community Mortgage Program (CMP) targets squatters occupying private lands. Target beneficiaries shall organize themselves into a community association and shall purchase the private lands using funding from either the local government, NGO, NHA or HIGC. The private owner must consent to the purchase of the land.

A separate program is the Abot Kaya Pabahay Fund that provides a 5 year amortization support to families with monthly income below P5,000. The Fund has 3 components:

- amortization support for families with monthly incomes not exceeding P5,000 and borrowing not more than P10,000 for the first 5 years of their housing loan
- development financing assistance to private developers of low cost housing projects not exceeding P100,000 per house and lot package and
- cash flow guarantee for funding agencies like SSS, GSIS and HDMF to absorb the risk of loans granted to developers of low cost housing projects, and to families which applied for home acquisition, home repair and improvement.

Low interest loans for social and economic housing are provided through Pag-Ibig Fund (HDMF), SSS, and GSIS. Private developers/builders originate mortgage loans from eligible borrowers and/or offer purchase arrangements known as Contract to Sell between the homebuyer and the private developer/builder. Once construction of the housing unit is finished, title to the housing unit passes from developer to the borrower/buyer via a Deed of Absolute Sale and finally, from buyer to lender via a mortgage take out by Pag-Ibig Fund from the developer or private bank.

Alternatively, the title to the housing unit passes directly from the developer to the lender via an Absolute Deed of Assignment. Under the latter arrangement, the borrower gets title of ownership to the unit once the loan that was arranged by the developer with the lender on behalf of the borrower gets fully paid.

In general, private developers and/or private banks originate mortgages for economic and social housing that are taken out by either NHMFC or Pag-Ibig Fund. The ultimate lender is the government either through the NHMFC, Pag-Ibig Fund or the pension funds⁷.

C. The National Shelter Program

The government's present housing policies and interventions are provided in the National Shelter Program, the Urban Development and Housing Act of 1992 (UDHA), the Comprehensive Shelter Finance Act of 1994 (CISFA) and the Local Government Code of 1991 (LGC).

The National Shelter Program (NSP) was the Aquino and Ramos administrations' comprehensive strategy to address the housing problem of the country. It rests on three basic principles, namely:

- (1) reliance on the initiative and capability of beneficiaries to solve their housing problem with minimum assistance from the government and focused assistance to families within the poverty line;
- (2) the use of the private sector as the principal producers and providers of housing units;
- (3) the role of the government as enabler, facilitator and catalyst in the housing market.

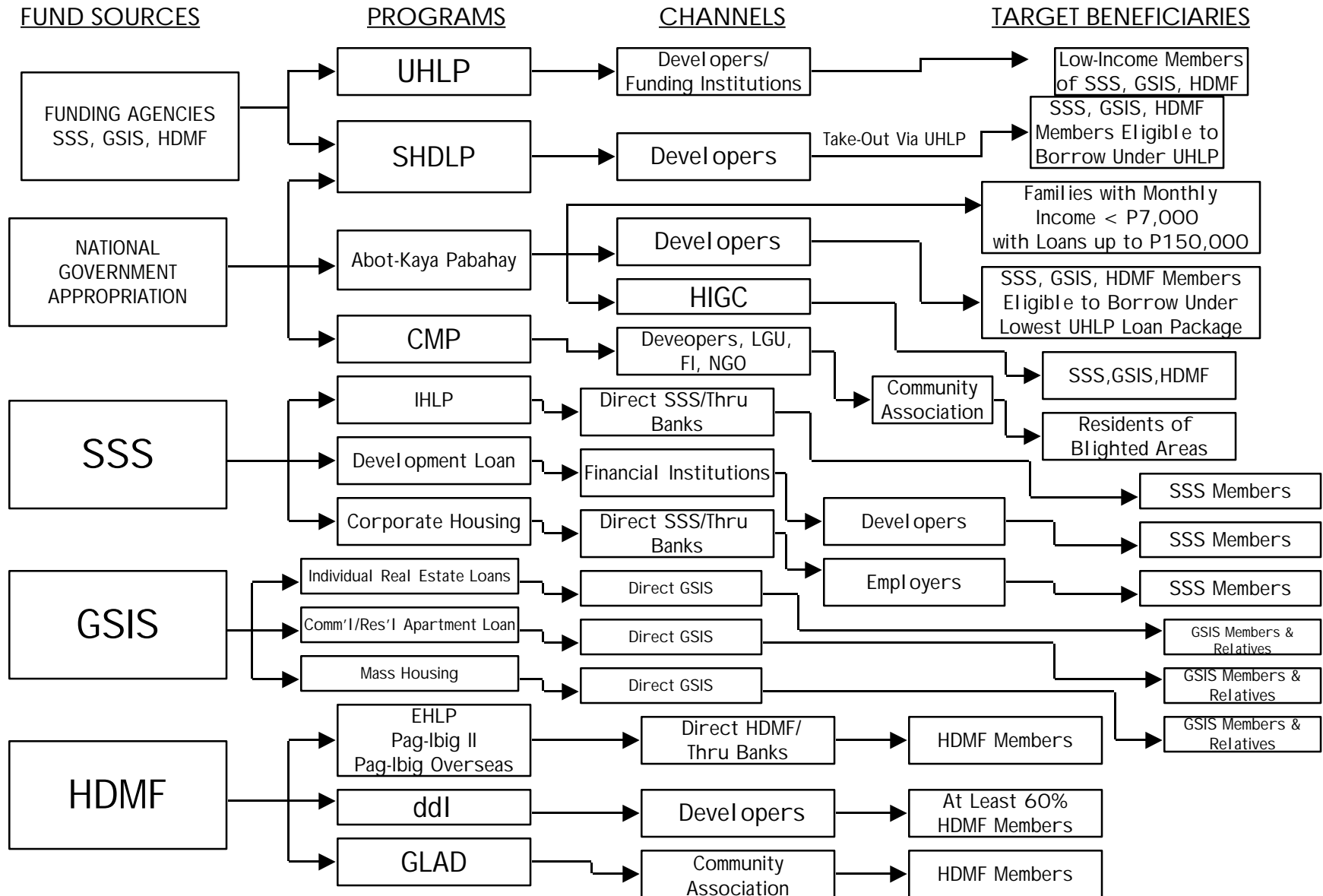
The NSP has four major programs: (a) production of housing units, (b) mortgages, (c) development loans and (d) community programs. These programs target either direct end-beneficiaries/households or private developers/private banks, the intermediary institutions used by the government to direct assistance to beneficiaries.

III. ASSESSMENT OF THE NATIONAL SHELTER PROGRAM⁸

The government has exerted a huge effort in providing housing to targeted sectors, that is, the low and middle-income groups. It has constructed an elaborate network of agencies and programs to address the housing situation. **Figure 1** shows the structure and funding of the government's housing program. It has

⁷ The ultimate lender is really the members of the pension funds whose contributions finance the various housing schemes of the government. The bulk of housing finance comes from these contributions.

FIGURE 1
FLOW OF FUNDS FOR GOVERNMENT HOUSING PROGRAMS



also intervened in several ways: production of housing units, regulation of the housing sector, provision of mortgage and development finance and provision of infrastructure. Its biggest exposure, that is, in terms of fiscal and financial resources provided is on housing finance. This section gives an overview of the housing sector's performance and identifies some policy problems and gaps that the government should address.

Despite elaborate intervention, government fell short of the target.

Between 1987 and July 1996, UHLP mortgage take-outs have reached a total of ₱45.6 billion, equivalent to 2.3% of gross national product (GNP) in 1995. This makes the UHLP the single largest mortgage program in the country. In all, 235,695 housing units were built benefiting 271,020 people.⁹ The UHLP's growth has particularly been impressive in the past three years (1993-95), with mortgage take-outs totalling ₱29.4 billion compared with the ₱15.3 billion recorded from 1987-92. Out of the ₱29.4 billion mortgages taken out from 1993-95, only 26% are mortgages below ₱150,000; mortgages in the ₱225,000 and ₱375,000 range make up 41% of the mortgage portfolio while those from ₱150,000 and ₱225,000 amount to 33%.

On the other hand, of the 133,700 units given assistance from 1993-95, units financed with loans up to ₱150,000 numbered 53,480 or 40% of the total units while those financed under the middle and highest loan packages comprised 33% and 27%, respectively of total assisted units. However, despite the government's determined effort to provide housing to the targeted sectors, the low income group still has very limited access to housing. The middle income class, however, have access to housing through the Unified Home Lending Program of the government. Mortgage finance provided through HDMF gives them the opportunity to own housing units. The irony is that the low income group constitutes the main target beneficiaries of the government's economic and social housing program.

For the Plan Period 1993-1998, the National Shelter Program (NSP) aimed to extend 1.24 million units of housing assistance. Target of household assistance is distinguished from the target of the number of households since in some cases, a household applying for a single unit of housing may simultaneously receive

⁸ This section is from Gilberto M. Llanto, "Rationalizing the Government's Housing Program," unpublished paper

⁹The difference between the two figures is due to "tacked-in" borrowers (up to three individuals related to the second degree of consanguinity) who jointly borrow for a single loan.

Table 1
NATIONAL SHELTER PROGRAM
Summary of Accomplishments, 1993-September 1998

Major Programs	Number of Household Assistance			Value of Household Assistance (PM)		
	Actual (As of Sept 1998)	Target (Up to Dec 1998)	% of Target	Actual (As of Sept 1998)	Target (Up to Dec 1998)	% of Target
1. Resettlement	61,430	174,581	35.19	3,708.72	3,916.13	94.70
2. Community Mortgage Program	67,022	140,807	47.60	2,010.57	3,281.57	61.27
3. Direct Housing Provision	376,950	506,060	74.49	74,799.18	127,187.73	58.81
UHLP Assisted	197,663	377,853	52.31	43,685.48	104,316.48	41.88
Pag-IBIG Regular Programs	154,037	120,511	127.82	29,187.77	22,388.72	130.37
Special Projects	25,250	7,696	328.09	1,925.93	482.53	399.13
4. Indirect Housing Provision /2				58,347.31	49,874.78	116.99
HIGC Guaranty Program				48,244.75	32,341.50	149.17
Retail Guaranty	117,651	68,056	172.87	43,153.24	29,399.00	146.78
Developmental Guaranty				5,091.51	2,942.50	173.03
Securitization				2,698.14		
Municipal Finance				73.72	1,482.44	4.97
Pag-IBIG Programs				7,330.70	16,050.84	45.67
TOTAL	623,053	889,504	70.04	138,866.00	184,260.00	75.36

1/ Only 52.5% of funds, however, were actually released from CISFA

2/ Only HIGC's Retail Guarantee was included in total number of households to avoid double counting

Source: HUDCC, MTPDP for Shelter (1999-2004)

several forms of assistance from different housing agencies. The NSP target then translates to assistance for around 889,504 households, or equivalently 23.9% of the total housing needs for the Plan Period.

As of September 1998, the NSP has extended 1,357,025 units of housing assistance to 623,053 households. Please see **Tables 1** and **2**. This measures up to an overall accomplishment rate of 109.46% and 70.04% of the targets, respectively. However, of these only 281,443 households or 45.2% of the total benefiting households fall within the socialized housing programs. This means that altogether, only P26 billion or 18.94% of NSP spending actually reached the poorest 30 percent of the population. On the other hand, the better performing programs (e.g., guarantee schemes), the ones contributing to the seemingly acceptable accomplishments of the NSP, are not designed and are not intended either for socialized housing.

Table 2
SOCIALIZED HOUSING PROGRAM ACCOMPLISHMENT
1993-September 1998

Program	Actual Number of Households Assisted	Percent share to Total NSP Accomplishment
Resettlement	61,430	9.86
CMP	67,022	10.76
UHLP	76,418	12.27
EHLP	61,375	9.85
GLAD	13,988	2.25
Coop Housing	1,210	0.19
Total	281,443	45.17
Value	P 26.30 billion	18.94

Source: HUDCC, MTPDP for Shelter (1999-2004)

(a) Unified Home Lending Program (UHLP). As of September 1998, UHLP has provided assistance to 197,663 households or scarcely half of its target (52.3%). In terms of loan values, it reached only 41.9% of the initial goal and performed the poorest among the direct housing provision programs.

Initially, the UHLP impressively grew in 1993-95, with mortgage take-outs totaling P29.4 billion compared with the P15.3 billion recorded from 1987-92 (Llanto, et.al., 1998). However, take-outs have progressively declined since 1996 (**Table 3**). UHLP had an accumulated loan value of P13.4 billion from

March 1996-November 1998, or 60,450 units of accounts. This means a 54% and 59% decrease, respectively, from the previous three-year performance. The share of the 9%-interest loan package (< P180,000 loans) classified as socialized housing stagnated at a quarter of the total UHLP take-outs, 26% in 1993-95 and 25% in 1996-98. Thus, UHLP assisted roughly 77,400 low-income households.

Table 3
UNIFIED HOME LENDING PROGRAM
Take-out By Interest Rate
March 1996 to November 1998

Year	Loan Value (in million pesos)				Number of Units Accounts			
	9%	12%	16%	Total	9%	12%	16%	Total
1996	1817.8 <i>23.2</i>	2922.8 <i>37.4</i>	3083.1 <i>39.4</i>	7823.7	12079 <i>34.6</i>	13494 <i>38.6</i>	9343 <i>26.8</i>	34916
1997	1385.7 <i>27.6</i>	1945.7 <i>38.8</i>	1682.2 <i>33.6</i>	5013.6	9119 <i>39.5</i>	9032 <i>39.1</i>	4954 <i>21.4</i>	23105
1998	136.5 <i>24.9</i>	196.6 <i>35.9</i>	214.7 <i>39.2</i>	547.8	894 <i>36.8</i>	903 <i>37.2</i>	632 <i>26.0</i>	2429
Mar96 to Nov98	3340.0 <i>25.0</i>	5065.1 <i>37.8</i>	4980.0 <i>37.2</i>	13385.1	22092 <i>36.5</i>	23429 <i>38.8</i>	14929 <i>24.7</i>	60450

Figures in italics represent percent share to total

Source: HDMF

Among the reasons for this dismal performance are (a) the inadequacy of fund released by the pension institutions vis-à-vis their commitment to the National Home Mortgage Finance Corporation (NHMFC) and (b) the inefficient loan collection by NHMFC from the end-borrowers.

For the period 1993-1998, only 52% of the total commitment funds were released to the UHLP (**Table 4**). There was a significant decrease in the actual fund releases in the later years, averaging at only 27% of the total commitment, compared to releases of 94% in the first three years of NSP. In 1998, the fund release rate has gone down to 3.1%, after excluding the HDMF advances in 1996 and 1997¹⁰.

It seems, however, that the reluctance of the pension institutions to infuse more of their resources to UHLP arises from their risk-aversion given the incapacity of the NHMFC to collect loan repayments. For the concerned period, the collection rate for the UHLP worsened, averaging around 63%. As of December 1998, it had a total of 56,776 uncollectible accounts or P12.4 million defaulting loans vis-à-vis its total loan portfolio. Please see **Table 5**.

¹⁰ This plight can be explained partly by the funders' prioritization of their members and respective programs given their limited resources and private difficulties (e.g., GSIS)

Table 4
UNIFIED HOME LENDING PROGRAM
Funders' Commitment vs. Actual Releases
1993-1998
(In million pesos)

Year	SSS			GSIS			HDMF			Total		
	Commitment	Releases	% Released	Commitment	Releases	% Released	Commitment	Releases	% Released	Commitment	Releases	% Released
1993	5600	6760	120.71	1600	800	50.0	1600	580	36.3	8800	8140	92.5
1994	6200	6200	100.00	1800	1760	97.8	1000	1560	156.0	9000	9520	105.8
1995	6800	6285	92.43 1/	2000	1040	52.0 2/	3000	2940	98.0 3	11800	10265	87.0
Subtotal	18600	19245	103.47	5400	3600	66.7	5600	5080	90.7	29600	27925	94.3
1996	5000		0.00	5000	650	13.0 4/	7824	7824	100.0	17824	8474	47.5
1997	3000	5000	166.67	5000	1000	20.0	8000	5014	62.7	16000	5014	31.3
1998	3000	3000	100.00	5000	500	10.0	10000	560	5.6	18000	560	3.1
Subtotal	11000	8000	72.73	15000	2150	14.3	25824	13397	51.9	51824	14047	27.1
TOTAL	29600	27245	92.04	20400	5750	28.2	31424	18477	58.8	81424	41972	51.5

1/ Net of SSS In-house Financing from January to December 1995 (P515 M)

2/ Include P40 under 1994 L.A. (GSIS)

3/ Actual Releases (P649 M buy-back of SSS collaterals not affected)

4/ Released to NHMFC in 1996

Italicized Figures:

Figures for the SSS and GSIS represent releases of their UHLP Funding Commitments to HDMF for the previous calendar years. Since March 1996, HDMF has advanced funds for the take out of UHLP loans of SSS and GSIS Members.

The figures for HDMF are inclusive of these advances.

The SSS and GSIS releases for 1997 and 1998 were not added in the total because these represent Reimbursements to HDMF for advances made in 1996 and 1997.

Source: HDMF

Table 5
COLLECTION EFFICIENCY RATES
1993-1998
(In percent)

Program	Average Collection Rate						Annual Average
	1993	1994	1995	1996	1997	1998	
	UHLP	65.34	62.53	62.60	64.62	63.34	
CMP	69.30	72.64	83.41	81.40	77.34	76.23	76.72

Source: HUDCC

The deficit incurred by the NHMFC prompted a P7.5 billion bail out from the HDMF in 1995. Subsequently in 1996, UHLP implementation was officially transferred to the HDMF, albeit retaining the collection responsibility of NHMFC. New loan enrollment under the program is currently insignificant and the transactions primarily dwell on the processing of the leftover accounts after the transfer.

(b) Other Programs. In view of the difficulties of UHLP and its funding problem, the government also suspended the **Socialized Housing Development Loan Program (SHDLP)**. This was also originally an in-house program of the NHMFC which aimed to complement the UHLP through financial assistance to private developers, NGOs, landowners and local government units for undertaking social housing projects. Another major program that performed below satisfactory expectation is the **Community Mortgage Program (CMP)**. Under this program, NHMFC lends to organized slum dwellers assisted by accredited CMP originators. These loans primarily enjoy interest subsidies as each loan account is charged only with 6% interest rate over the 25-year payment period. Funding of the program comes as an appropriation from the National Government and takes most of the annual budgetary requirement of the NHMFC. The unutilized portion of the Abot Kaya Pabahay Fund is also appropriated to augment the total CMP funds.

For the period 1993-September 1998, CMP extended loan assistance amounting to almost P2.0 billion to 67,022 households. Against its targets, this translates to accomplishment rates of 47.6% and 61.3%, respectively. However, the program performed poorly in the last three years, exhibiting a 5-percentage point decline in the number of households reached compared those served in 1993-1995.

The CMP suffered the same problems as the UHLP: inadequate fund releases, collection inefficiency and tedious procedures involved in loan processing. During the period, the CMP received only 52.5% of its expected funds. And its collection rates, after peaking at 83.4% in 1995 has since then gone down to 76.2% in 1998 (**Table5**).

Another NHMFC in-house social housing program is the **Abot Kaya Pabahay**. Its subprograms include (i) amortization support, (ii) developmental financing, and cash flow guarantee. According to the

HUDCC, the developmental financing program that lends to private proponents of low-cost housing project has stopped plainly because of the funds have been used up. On the contrary, the funds allocated for amortization support are still available because of the limited number of eligible borrowers. Eligible borrowers are those with monthly income not exceeding P6,000 for loans up to P144,000 and P7,000 for loans not exceeding P180,000.

The **Resettlement Program** under the National Housing Authority, while using up P3.9 billion or 94.7% of its total targeted housing provisions served only 35.19% of its targeted number of households. This can possibly be attributed to the huge costs associated in acquiring private lands and site development especially in urban areas. The achievements in turn constituted a mere 9.8% of the total NSP accomplishments measured in terms of household assistance.

The rest of the socialized housing programs (EHLP, GLAD and Coop Housing) reached about 12.3% of NSP household beneficiaries. However, GLAD is currently under suspension. The program is being considered for a transfer by the HDMF.

The Home Insurance and Guaranty Corporation (HIGC) and the Pag-IBIG Regular programs, on the other hand, performed beyond their targets. These two averaged around 141% accomplishment rate of NSP's the total value of assistance.

The HIGC's **Guaranty Loan Programs** seemingly achieved the best results among the NSP programs. During the Plan Period, it has released a total of P48.2 billion worth of housing assistance, exceeding its target by 50%. And for the period 1995-1998, guaranty call payments took up only 1% of the total guaranty loans.

Guaranty loans under the lowest package (< P180,000) account for just approximately 11% of total portfolio as of 1997. This, however, is not surprising since the guarantee programs works through private lending institutions which cater mostly to high income borrowers. Given this market and the efficiency advantages of private lenders, the HIGC has been spared from the collection difficulties and financial depletion.

Huge subsidies were transferred but the incidence was regressive¹¹.

A summary of the housing subsidies transferred to beneficiaries is shown in **Table 6** below. Using available data, subsidies in the period 1993-1995 amounted to some P25.4 billion. Most of the subsidies represented interest rate subsidies provided under UHLP. **Figure 2** shows that the bulk (90%) of the subsidies to the housing sector consists of interest subsidies provided through the home mortgage programs (UHLP and EHLP) and the developmental loan programs (CMP, SHDLP, and Abot-Kaya Developmental Loan).

¹¹ This sub-section is from Gilberto M. Llanto, Aniceto Orbeta, Teresa Sanchez and Christine Tang, A Study of Housing Subsidies in the Philippines," PIDS Discussion Paper, 1998.

Among these programs, the UHLP loans carry the largest subsidy totaling ₱18.8 billion or 74.1% of total housing subsidies from 1993-95. This amount is almost six times bigger than the second biggest subsidy program, the HDMF's EHLP, and 20 times the subsidy under the CMP. In fact, it is nearly three times the total subsidy of all the other programs taken together. The magnitude of the subsidies under the developmental loan programs are only 4.4% of the subsidies under the mortgage programs. Of the developmental programs, the CMP provides the largest subsidy amounting to ₱933.8 million or 3.7% of the total housing subsidies over the three-year period.

Next to the interest subsidy programs, land cost subsidy under the NHA's resettlement program constitutes the largest subsidy program. Total subsidies under this program equaled ₱1.3 billion, or 5.1% of the total subsidy to the housing sector. Among individual programs, it ranks third in terms of subsidy size.

In the case of the UHLP, only 38 percent of the beneficiaries belonged to the low income group while 33 percent and 29 percent (or a total of 62 percent) belonged to the middle and high income brackets. In terms of loan value, only 26 percent of the mortgages were availed by the low income group while 33 percent and 41 percent of the mortgages were availed by the middle and the high income groups. In terms of delinquent accounts, about 53 percent of the delinquent accounts were incurred by high income mortgagors. The middle and low income mortgagors incurred 36 percent and 11 percent of the total delinquent loans, respectively. UHLP is a program where there is active participation by the middle and the high income members of the pension funds. The principle of cross subsidization does not seem to work well in this program since high income borrowers captured most of the interest rate and loan arrears subsidies.

In the case of the EHLP, the bulk of the beneficiaries (67 percent) were middle income mortgagors while only 12 percent and 21 percent were from the low and high income groups, respectively. EHLP is a program actively participated in by the middle income group. A major feature of the program is the presence of the employer counterpart contribution that shifts part of the cost of the subsidy to the employers and increases the probability of program participation by the low income group. On the other hand, the CMP benefitted families belonging to the low income group (bottom 30 percent of the income distribution). The CMP is a well-targeted program because it is the low income group who availed themselves of the subsidies provided.

The National Shelter Program approach led to a heavy fiscal burden for the economy.

The government uses a combination of (i) direct subsidies through subsidized interest rates, and (ii) indirect subsidies, e.g., tax breaks, guarantee schemes, etc., to finance the acquisition of socialized and economic housing units. In addition, the periodic recapitalization of insolvent housing agencies also forms part of indirect subsidies to the housing sector.¹² Lending rates to end-borrowers are fixed and generally subsidized.

The motivation behind the subsidies in the housing markets is the conviction that the majority of the population will not be able to afford housing units unless some form of subsidy is made available to them. Subsidies bring down the cost of production of housing units, or the cost of acquisition of a housing unit for the end-user.

The prevailing public viewpoint is that every household must own a house, no matter how humble it may be. Its opposite, renting a house is a less preferred, second best situation. Home ownership is preferred because of the assurance of a place to live in, its investment value, the status given by society to home ownership and the uncertainties of its opposite—renting. Private developers have reinforced the policy bias for homeownership by declaring that the National Shelter Program (NSP) targets can be attained given adequate funding from the government.

This policy has led government to try to raise as much funding as possible for home ownership by low and middle income households and make it available as cheaply as can be provided. Making cheap funds available became synonymous to providing interest subsidies to prospective homeowners, and other types of subsidies to the housing sector in general. To make the subsidy transfer possible, government “borrows” pension funds and provides fiscal resources.

The bias for homeownership has created a huge fiscal burden on society as well as the wrong incentive structure for efficient private sector participation in the housing markets.¹³ The end result is a huge burden

¹²By "direct" subsidies, we mean those going to or enjoyed directly by end-beneficiaries, in contrast to "indirect" subsidies that reach the beneficiaries through the housing agencies, private developers, and private banks. Part of the subsidies is that arising from low loan recovery rates that is effectively an income transfer scheme for those not paying their housing loans.

that may prove to be very disproportionate to the government's ability to muster resources for the housing sector, let alone other sectors.

Pension fund members and taxpayers bore not only the funding responsibility but also the credit risk.

The private developers, private financial institutions and to some extent NGOs and local governments act as conduits of funds for on-lending to home buyers. The government also lends directly to target beneficiaries through SSS and GSIS.

Despite its growth in meeting the country's housing backlog, the UHLP has increasingly met with difficulties prompting the government to review the entire system. Among the problems realized during the program's nine-year implementation, the most serious are perhaps the low repayment rate and the inadequate funding support for the government's main housing program.

During the three year period from 1993-95, the collection efficiency rate is estimated at only 63.5%.¹⁴ The NHMFC is saddled with uncollected accounts. As of end-1995, some 108,722 accounts, representing 63% of total accounts numbering 172,654 were delinquent for over three months. This prompted the NHMFC to undertake a two year (1994-1996) loan restructuring program, involving penalty condonation. To date, only 5,816 accounts representing 3.4% of delinquent accounts, have been restructured under this program.¹⁵

Data from the NHMFC show that from 1988-1992, the three funding agencies released only 75% of their total commitment to the UHLP. Albeit this figure improved to 94% for the period 1993-1995, the UHLP has by then, incurred a deficit of P6.2 million. By 1996, large uncollected loan accounts under the UHLP made the funders feel reluctant to provide more funding because they did not want to risk more of their members' contributions.¹⁶ At the same time, the funding agencies were trying to meet their members' mortgage loan needs through their own, respective mortgage programs.

¹⁴Collection efficiency varies depending on loan type and originator type. That is, the collection performance for high-priced loans (carrying higher interest rates) are generally lower than low-priced loans (57% for 16% loans compared with 73% for 9% loans). Also, collection efficiency for developer-originated loans are lower than that for loans originated by financial institutions (59% vs. 69%, respectively). *Source: Board Committee Findings.*

¹⁵The figure includes Community Mortgage loans restructured under the program.

¹⁶HDMF recently provided P7 billion to enable continuing implementation of UHLP.

In addition, the program encountered other problems, including: (a) the worsening financial position of the NHMFC as take-outs increased while loan collection slumped; (b) manpower constraints at NHMFC which made it increasingly difficult for the agency to handle the UHLP's loans and attend to collection as well; (c) a perceived conflict of interest on the part of developers who act both as loan originators and house builders; and (d) tedious and relatively expensive foreclosure procedures.

Because of these, HUDCC, under Council Resolution No. 12 (April 1996), implemented the following changes to the UHLP: (a) the creation of a multi-window lending system for the UHLP in which the funds will no longer be coursed through the NHMFC but will be handled directly by the funders themselves, or through financial institutions; (b) origination of mortgages by developers limited to those below ₱150,000; loan approval will still be based on formula lending; (c) mortgages more than ₱150,000 up to ₱375,000 will be approved based on the borrower's capacity to repay; and (d) adjustment upwards of the loan ceiling (from ₱150,000 to ₱180,000) under the lowest housing package, with the additional ₱30,000 charged a 12% interest rate. These changes will take effect after a six-month transition period, during which time, the HDMF acts as sole take-out window. Interest rates for the higher packages were proposed to be market-oriented instead of being fixed at 12% and 16%.

Credit subsidies created various disincentives.

The housing subsidy program is well-intentioned. It seeks to provide the low and middle income households access to homeownership. However, the credit subsidies which are the major component of the subsidy program have motivated strategic behavior among various players in the housing market at great fiscal cost to the government and to the prejudice of low income borrowers. Under the formula lending approach, borrowers took loans not necessarily because they have the capacity to repay the loan. On the contrary, borrowers have automatic access to the loan window on the basis of their monthly income or the combined income of several related borrowers and their contribution to the pension fund. Borrowers may overborrow or even be tempted to get a loan that they do not need at all. This is a sure fire formula for non-repayment of loans. Thus, high rates of non-repayment and loan delinquencies plague the government's housing program. Realizing this, the government has belatedly shifted to an approach that considers the creditworthiness of borrowers.

Private commercial banks do not participate in the government's housing program because they can not compete with the subsidized loans offered by government financial institutions. Thus, they act as mere conduits of government loans for a fee. The origination fee is 5% of the loan that is charged for processing, approving and channelling public loanable funds to target clientele. The end result is heavy dependence on limited public funds for meeting the goals of the National Shelter Program. With a very limited participation in the National Shelter Program's socialized and economic housing, private banks have not been motivated to develop innovative housing loan products.

The formula lending approach allows private developers to produce and market thousands of housing units to eligible, but not necessarily, creditworthy borrowers. There is little credit risk for developers because they immediately seek the take out by the NHFMC of the originated loans. The only risk they face consists of the delays in getting reimbursement from the NHMFC. On the other hand, there is the danger that unscrupulous developers could supply sub-standard housing units and defective on-site infrastructure to unsuspecting borrowers. It seems that building and selling housing units that are financed from the public till with a guaranteed take out of the initial loan exposure create tremendous moral hazard problems. The cost to society is the fiscal burden shouldered by taxpayers when the loans do not get repaid and the welfare loss suffered by borrowers with defective housing units.

IV. MARKET-BASED HOUSING FINANCE: INSIGHTS FOR THE PRESENT HOUSING FINANCE STRATEGY

Given the failure of formula lending and the distortions created by credit subsidies, what options are open to the government to address the housing problem? There are options: (a) free the rental market that has constricted the supply of dwelling units for rent and (b) use market-based housing finance to enable low income borrowers to finance their purchase of houses through loans.

Two options

The prevailing bias for homeownership for all households regardless of the economic capacity of the potential owner rests on the wrong assumption. Not everyone in society can afford to buy and own a house. There always will be a segment of society too poor and destitute to even think of purchasing a housing unit, but who need decent shelter. In fact, even in developed countries homeownership is available only to some 55% (Singapore) or at most, 65% (United States) of the population. The real problem is not how to provide everyone a house to own. Rather, it is how to provide access to affordable and decent shelter. This objective can be achieved through several mechanisms: (i) renting, (ii) ownership through purchase or private transfer (e.g., through inheritance, donation) or (iii) public housing to certain sectors of society (e.g., the poorest of the poor). For this to happen, housing markets, including housing finance should work efficiently. This means that the rental market should be freed in order to encourage greater supply of dwelling units for rent¹⁷.

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

The second option is the use of market-based housing finance. On this, several developments in the housing finance markets indicate that it is possible to have a low cost housing program that relies on the market for financing. Before we discuss these recent innovations, it is important to understand why banks seem reluctant to venture into low cost housing finance.

The banking system has more than three-quarters of the total assets of the financial system.. However, except for their limited participation in NSP's formula lending, banks have not taken an active role in low cost housing finance¹⁸. This can be partly explained by the deleterious effect of government subsidized programs which have discouraged the development of the primary market for housing, and by the short-term orientation of bank assets. Some explain the latter in terms of the mismatch between banks' short-term liabilities and the households' housing loans which are long-term. Banks substantially draw from short-term deposits as source of loanable funds. It is fundamentally a system based on the mobilization of savings directly from the general public. On the other hand, mortgage loans are long-term contracts. This mismatch of borrowing short and lending long then assumes risks of term intermediation.

Deposits are bank liabilities that are subject to withdrawal at any time. Banks try to balance the maturities of their investments to maintain a confident level of liquidity. Illiquid goods like ownership housing are scarcely favored. Banks often prefer to invest their excess liquidity in government securities that offer superior returns relative to consumer and housing loans. Or they choose to provide foreign currency services that proffer profitable gains and are of short-term horizon (Lea and Renaud, 1995). Moreover, in the event of loan defaults, mortgages arising from low cost housing are non-earning assets that are relatively not easy to dispose. Given institutional rigidities, foreclosure of property when permissible is usually long, costly and uncertain.

Most mortgages are fixed-rate investments, so if these loans were made on the basis of short-term deposits, a loss would result if the interest rates rose (Stiglitz, 1990). In government programs, not only are lending rates fixed, they are often arbitrarily designed at preferential rates below market due to social commitment. Even when there prevail positive real interest rates in the economy interest ceilings deter banks from enjoying competitive spread structure. Also, erosion of value of long-term, unadjustable saving may subsequently occur in case of unstable prices.

Retail lending also implies that banks have to deal with individual households. In the low cost housing sector, banks have do face not only high transaction costs but also information asymmetry. The lack of information on creditworthiness, relative credit risks and other risks can discourage bank lending to low

¹⁸ They are understandably active in the middle and high income mortgage market.

income households. Under asymmetry of information, documentation on the characteristics of businesses and their owners may provide on creditworthiness and risks. In addition, collateral and equity, in the form of downpayment for a loan, are commonly used by lenders to sort good from bad borrowers. Unfortunately, neither of these, the low income households have. The offset could be high interest rates that will cover risks and generate some profit for the lender. However, adverse selection and moral hazard problems arise, making this approach untenable. Thus, in the absence of information, collateral and substantial equity from the low income borrower, and the lack of long-term funds, banks rarely take on mortgage loans of low income households.

Because of the traditional constraints to bank lending, we turn to recent innovations in market-based housing finance that seem to offer a way out of the impasse. Here we sketch three innovations: (a) contract savings for housing, (b) role of contractual savings and (c) mortgage-backed securitization.

Some Market-based Instruments for Housing Finance¹⁹

Contract Savings for Housing Scheme. Contract savings for housing (CSH) system is essentially a contract between a household and a financial institution concerning the granting of a loan provided that the household meets the minimum savings commitment over a specified period of time, at a prescribed rate. The scheme guarantees the availability of loans to savers at a certain time and at a pre-specified rate depending on the contract.

CSH is a specific, 'loan-linked' housing program. Most CSH instruments are heavily patterned after the German '*Bauspar*' System and subsequently, the French '*épargnelogement*.' It is not to be confused with the broadly-based contractual savings system, which includes pension funds and life insurance (Lea and Renaud, 1995). Contractual savings institutions deal with wide range of financial instruments and investments. On the other hand, the CSH is particularly dependent on household savings as source of loanable funds and has a well-defined purpose.

CSH aims to deeply integrate the households into the banking system. In the absence of sufficient sources of long-term deposits for banks, CSH offers a disciplined, regular saving pattern from households. This

¹⁹ The literature and current experience in the developed countries offer a wealth of insight and information. This paper merely mentions some of the recent innovations. Another paper will have a fuller discussion of market-based housing finance.

springs from the motivation of a definite goal, that is, a future loan at some future time, unlike mandatory saving schemes with a relatively indeterminate purpose. The amount of loan may depend on the accumulated savings or the interest earned on the savings. The design of the 'loan multiplier', as in the German model, where the loan is a direct multiple of the amount saved, provides incentives for larger amount of deposits. The CSH also assures the household of an accumulated equity at the initial stage, thus solving its collateral deficiency.

From the perspective of the financial institution, the CSH establishes firm bank-client relationship over time. The saving period provides monitoring of the true characteristics of the contingent borrowers. This reduces information asymmetries that are prevalent in credit markets. Accumulated savings also minimize the maturity gap of short-term borrowing and long-term financing within the financial institution. Since the deposits are kept for a specified purpose, they are not easily called. However, the pre-specified interest rates should not differ significantly from the prevailing market rates as to preserve current holders and attract new savers. The drawback however is the inapplicability of the scheme in a severely inflationary environment where early saving, though earning larger interest, is penalized with erosion of value. This brings to mind the need to have a stable macroeconomic environment characterized by low inflation and low interest rates that brings confidence to savers and investors alike.

The CSH, albeit laudable, cannot stand alone as a financing scheme. Though it helps savers build equity that makes them eligible for future loans, the financial institutions still have to raise the total amount of the primary loan after the waiting period. This, then, requires the development of stable, long-term financing sources as investment in securities and bond markets. As such, the CSH should not be dissociated from a broad-based, integrated capital market system (Lea and Renaud, 1995). The important insight here is that CSH brings into the open the importance of linking it and the banks that implement it with the contractual savings institutions.

Contractual Savings Institutions. Contractual savings institutions comprise of varied non-bank financial intermediaries and institutional investors such as social security, pension funds, insurance companies and mutual funds. Such institutions mobilize savings but do not accept deposits from the public at large (Vittas, 1997).

Contractual savings institutions are showing how important they are in the country's financial system. In 1995, all non-bank financial intermediaries (a broader category) account for a mere 20% of the total assets of the financial system. Of this, the share of government NBFIs', primarily the social security programs, has since increased from 34% in 1980 to 64% in 1995. These institutions have the potential to accumulate vast amounts of resources and become an integral part of the capital market system. They normally have greater coverage and guaranteed contributions in case of occupationally-based mandatory security schemes.

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

In the process of development, pension funds can also play a major role in integrating housing finance into the capital market system. This means that the pension institutions do not have to limit mortgage extension to their members but channel resources through the secondary mortgage markets. Fund managers have a wide array of portfolio investments. They provide capital for productive sectors through corporate securities and foreign currency exchange, finance national deficits through government bonds and invest in bond issues of mortgage credit institutions. Conservative investment policies though often shy away from equities because of concerns about the volatility of equity prices. Conversely, mortgage bonds are relatively fixed investments which more modest returns but connote lower risks for the investors.

The success of these institutions, however, depends on the stability of contributions, proper regulatory framework and efficient investment management. The problem of underdevelopment of most contractual savings institutions in less developed countries is the low level of per capita income. Excess earnings when available are rationally invested in liquid assets as bank deposits which they can easily withdraw in the events of need. Furthermore, even in an economy that invests in long-term funds, a decline in household income causes subsequently fall in saving capacity (Intal and Basilio, 1997). Therefore, levels of accumulated resources greatly depend on economic growth.

The growth and development of contractual savings institutions are also anchored on the proper design of the institutions that consequently leads to consumer confidence. Mandatory contribution schemes

are often tempting because they minimize the cost of savings mobilization for the government. Through this, the state can also exercise central control over the allocation of resources²⁰. However, established credibility rather than imposition better encourages greater contributions. Although the system can often meet the minimum limit of contributions, it does not generate further resources from individuals outside the establishments if they are not perceived to gain from its investments. Oftentimes, restrictive regulations impede competition, innovation and efficiency²¹. Because contributions are automatic salary deductions, employees do not have the option to invest in other intermediaries who may better manage funds and generate higher returns. Hence, poorly designed and managed social security system simply crowd out rather efficient private participants.

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

Mortgage-backed Securities. An important innovation in the financial market is the securitization of assets. Asset securitization is the process of pooling assets and using the pool formed as collateral for a security. The securities created are referred to as asset-backed securities.²² There are many kinds of assets that underlie the loan pool: auto loans, trade and credit card receivables, first and second mortgages, lease receivables, etc. However, in most developed secondary markets, securitization of mortgages has taken on the largest share of securitized assets by far. Thus, mortgage-backed securities (MBS) fundamentally changed home financing in developed countries.

The proliferation of securitization instruments has improved access to mortgage financing by separating origination from funding, which as a consequence integrates home mortgage finance into the overall capital market²³. It provides liquidity through *recycling mechanism* at interest rates that are often more profitable than what the issuer of the assets would get under more conventional financing given its creditworthiness²⁴.

²⁰ Renaud 1984

²¹ Vittas, 1997

²² Fabozzi

²³ Kwan (1996).

²⁴ Soukup (1996).

The simplest type of MBS is the pass-through security which is created by pooling traditional fixed-rate, level payment mortgages. Under the pass-through security, the payments made on the underlying mortgages are “passed through” unaltered to the security holders on a pro-rata basis. The amount and timing of cash flows of the pass through almost exactly match the amount and timing of cash flows of the underlying mortgages, after administrative costs, including prepayments. In this regard, pass through securities allow the securitization of mortgages but not necessarily allowing unbundling of risks²⁵.

The difficulty with pass-through securities though is the uncertainty of the amount and timing of the cash flow from the mortgages. This is caused by the prepayment risks that are associated with fixed-rate mortgage securities. If the market interest rates fall below the loan rate, the borrowers would have the incentive to prepay through refinancing. As an adverse consequence, the increase in the cash flow must be reinvested at a lower rate. This prepayment risk component is referred to as contraction risk. Conversely, if the market rates rise, slowdown in prepayments would cause the security holders to forego the prevailing profitable returns to investments. This risk is called extension risk.²⁶

To adjust the MBS to different risks and return preferences of investors, variations of security instruments were introduced. One is the collateralized mortgage obligations scheme. This redirects the cash flows to different bond classes and involves sequential pay and class tranches, as to create securities with different exposure to prepayment risks²⁷. For instance, a pass-through can be designed into a planned amortization class (PAC) and a non-PAC tranche, or support bonds. The principal prepayment schedule for the PAC is first satisfied. The resulting shortfall or excess of prepayments then is absorbed by the non-PAC tranche. This scheme does not eliminate prepayment risks; it merely categorizes who would sustain the least exposure²⁸.

Aside from the prepayment risks, mortgage-backed securities as with other instruments are subject to credit risks. To provide greater protection to investors, various credit enhancements have been developed in the market. Chief among them are third-party guarantees, reserve funds or cash collateral and

²⁵ Kwan (1996)

²⁶ Fabozzi ().

²⁷ Ibid.

²⁸ Other variations of the collateralized mortgage obligations is stripped mortgage-backed securities and floater. Discussion is outside the scope of the paper and the reader is referred to Kwan (1996).

senior/subordinated structure. A reserve fund is usually established by the issuer of MBS or ABS and it is used to make principal and interest payments when there are losses. Under the senior/subordinated structure, two classes of MBS or ABS are issued. The senior class has priority over the subordinated class with respect to the payment of principal and interest from the pool of assets²⁹.

In order to minimize credit risks, there should be effective credit-rating. This in turn relies on the development of a good data base on a large number of loan contracts.³⁰ Related to the screening of loans, efficient monitoring and loan collection schemes at the primary mortgage market should be ensured to minimize delays in repayments or eventual defaults. Of course, the legal and regulatory infrastructure for securitization should be properly defined to prevent market ambiguities and investor confusion.

Lessons for government's housing finance strategy

Three very important lessons that can inform the current housing finance strategy are: (a) the advantage of establishing a Contract Saving for Housing scheme between potential borrowers and banks; (b) linking primary lending institutions to the contractual savings institutions through asset securitization schemes; and (c) the necessity of having a legal, regulatory and institutional infrastructure that makes the housing finance market more efficient and minimizes risks for market participants, e.g. , primary lenders, investors in MBS, etc.

Contract Savings for Housing schemes create the equity base that potential borrowers can use as security for their home mortgages with banks. CSH also provides the lender important information on the borrowers' creditworthiness and financial discipline. This promotes the development of the primary housing finance market.

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

²⁹ Fabozzi ()

³⁰ Federal Reserve Bank of Minneapolis (1995).

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

Present government initiatives in housing finance

The present administration has launched a housing finance strategy that redefines government's role in the housing market. See **Box 1**. Overall, the housing finance strategy seems to be in the right direction. The major changes consist of using private mortgage market to finance the housing demand of low income groups and targeting housing subsidies to low income households. It is too early to assess the impact of the new housing finance strategy, but based on its components, it seems that the government is trying to establish the correct incentives and mechanisms for efficient participation of various market players.

There is an attempt to reduce the risk burden on the public sector by encouraging greater private sector participation. This rests on the premise that the private sector would significantly be enticed into the system. Risks of defaults are historically low under private contracts because of the more efficient selection, collection and monitoring schemes. However, it is also important to really work hard for the development of infrastructural support such as credit rating agencies, appraisers and private insurance that will minimize risk taking by various market players.

On the other hand, MBS which is currently being implemented by HDMF, holds the promise of improving access to mortgage financing by separating origination from funding. This is an important step toward the integration of home mortgage financing into the overall capital market.

Box 1. The Housing Finance Program of the Estrada Administration

Objectives

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

Strategies

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

Role of the Government

- Strengthen and define legal regulatory framework that will govern the housing finance system
- Provide adequate fund to the HAF and identified other welfare-enhancing programs
- Extend technical assistance to the LGUs in formulating proactive local planning

Role of the Key Housing Agencies

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

Role of the Private Sector

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

The Primary Mortgage Market

- ❑ The proposed *Plan for Shelter and Urban Development Sector* principally adopts the framework of previous primary mortgage programs of the National Shelter Program, e.g., resettlement, community-based lending, retail lending, guarantees, etc. except the ailing and structurally-flawed programs which will be discontinued.
- ❑ There will be an explicit prioritization in socialized housing e.g., 80%-20% allocation of aggregate public resources in favor of low-cost housing programs; specified target share of developmental lending including guarantee provisions
- ❑ An innovative “on-budget” subsidy (Housing Assistance Fund) will be established to complement the regular low-cost programs under the housing agencies and promote greater room for private bank low-cost

lending. Banks and other lending institutions are unable to compete under the former strategy because of the distortive interest subsidies of government loan offers.

- ❑ Moreover, under the HAF, the subsidization period of loan amortization of qualified borrowers will be reduced from 25 years to 10 years. This is due to the consideration of the rising capability of the borrowers to service their loans over time. That is, while amortization remains constant in nominal terms, nominal income increases due to inflation and income improvements. The problem of loan affordability then is re-assumed to exist only for a maximum of ten years.
- ❑ Effective implementation e.g., adequate fund releases and collection efficiency should, however, be installed to avoid the pitfalls of the previous programs
- ❑ Development of auxiliary infrastructure should also be achieved to help ensure the programs' success

Implementation strategy

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

The Secondary Mortgage Market

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

The initial experience with Pag-IBIG Securitization Program

Initially, the HDMF floated P500 million worth of mortgage-backed certificates (MBS) in 1994. The flotation is earmarked to lay the groundwork in eliciting investor awareness and gaining investor confidence in the profitability of mortgage-backed investment instruments. The certificates matured after a year and realized

a 17.5% rate of return for the investors. In February 1997, the HDMF launched its securitization program by issuing P430 million worth of mortgage-backed securities (MBS). The asset pool consists of 3,600 mortgage loans granted to Pag-IBIG members with loan value of not below P50,000 and with interests not below 6%. These loans are all current accounts and were pre-qualified based on their payment history.

The offered mortgage-backed securities are pass-through securities. Under this type, the payments made on the underlying mortgages are “passed through” unaltered to the security holders on a pro-rata basis. This means that the cash flow of the pass-through match the cash flow of the underlying mortgages almost exactly (after administrative expenses), including any prepayments.³¹

The securities are issued to public investors, with Citibank and the Philippine National Bank acting as the Fund’s financial advisors and underwriters. Trust certificates of Class A-1 and A-2 were successfully issued to the market, both representing senior direct ownership interest in the underlying assets. Class B and Residual certificates, subordinate to the Class A-1 & A-2, respectively in terms of payment rights, were retained by the HDMF. Class A will have a weighted average life of 1.5 to 2 years while Class B, 5.5 to 6 years.

The HDMF also provides the following credit support and enhancement to the issue:

- ◆ Senior-subordinated structure which provides the primary credit support wherein the subordinate Class B will be junior to the senior certificates with respect to payment of the principal and yield.
- ◆ Reserve fund that contains at least 6 months payment due to the holders of the senior tranches. The same will be used to cover any temporary shortfalls on collection for yield payments, as well as potential real property tax and documentary stamp tax liabilities.
- ◆ HIGC Guaranty program which will cover asset or mortgage-backed securities
- The certificates will also enjoy an 8.5% tax exemption for asset-backed securities

³¹ FRBSF, *ibid.*

Initial Results of the Securitization Effort

As of March 1999, only 3,199 accounts from the original asset pool remain as 405 accounts have been fully paid. Then as of May, the loan pool carried an outstanding balance of P330 million after full payment of some accounts. Since the securities are pass-through, the monthly payments to the investors depend on the actual remittance of the underlying mortgages. As reported, 93% of the total accounts are current while the rest are considered past due.

With the perceived relative success of the initial securitization attempt, the HDMF is on its way with the second tranche of MBS flotation. The amount of the issue will be the balance from the originally-planned P1 billion, that is, approximately P570 million.

V. CONCLUSION AND RECOMMENDATIONS TO IMPROVE HOUSING POLICY

There is a need to rationalize the government's housing programs and institutions.

There is a wide array of government intervention in the housing sector to make housing accessible to low and middle income households. It implements several housing loan programs all designed to make the cost of house acquisition affordable to target beneficiaries. However, the review of those housing programs indicates a need to rationalize and consolidate overlapping and duplicative programs. Most of the programs, if not all, extend subsidies either to the end borrower or the private developer or institution that participate in the housing program. The "subsidy" approach has discouraged effective participation of private banks in the housing markets for low-end clients.

On the other hand, the community-based housing program should be reviewed and improved. It has the advantage of catering directly to low income households who really are the ones needing subsidies. The same can be said of the resettlement programs.

In the rationalization, there is great sense in involving local governments in the design of a new housing program. Housing to some extent is a local problem and the situation varies from one area to another. The Local Government Code has vested authority on local governments to define land use policy which has a large impact on the availability of lands for housing.

Should a policy goal be funded by pension funds and fiscal resources?

The government has adopted the provision of economic and social housing as a policy goal. It has also determined that funding to attain this goal should come from both fiscal sources (budgetary appropriation) and the financial resources of the pension funds (contributions of members). However, the bulk of financing comes from the latter.

The NHMFC borrows from the GSIS, SSS and HDMF at about 12.75% rate of interest and uses the borrowed funds to take out mortgage loans originated by private developers and private banks under the so-

called "formula lending" approach³². Four programs are currently being administered by the NHMFC: (a) the Community Mortgage Program, (b) the Unified Home Lending Program (UHLP)³³, (c) Social Housing Development Loan Program and (d) the Abot Kaya Pabahay Fund. The GSIS, SSS and HDMF also provide housing loans directly to their respective members.

In 1995, legislators enacted RA 7742 that made mandatory membership in the HDMF, otherwise known as Pag-ibig Fund. HDMF with over P29 billion in total resources is a nationwide provident fund that pools employees' and employers' contributions to generate long-term housing funds. Pag-ibig Fund membership was mandatory in 1981 but became voluntary in 1987. In addition to providing funds for the UHLP, HDMF also has its own retail and institutional homelending programs.

To expand the pool of funds for the housing sector, Congress passed the Comprehensive and Integrated Shelter Finance Act (RA 7835) in 1994. This law provides an additional P38 billion funding allocation for housing over the next 5 years. It also allocates the largest funding to the Community Mortgage Program (P12.8 billion) and the NHA resettlement program (P5.2 billion). The Abot Kaya Pabahay Fund will get about P1.1 billion in the next 5 years. The law also increased the capitalization of NHMFC from P500 million to P5.5 billion and that of HIGC from P1.0 billion to P2.5 billion.

It is obvious that fiscal resources should be used to finance government expenditures. However, it is not immediately obvious why pension fund member contributions should be used to finance a government's policy goal. Pension funds are used for housing finance because these contractual savings are long term and are stable sources of funding. The problem though is that the government does not adequately compensate the use of member funds because the present housing finance is not a market-based housing finance. Member funds are paid a fixed rate of 12.75% regardless of movements in interest rates and other macroeconomic indicators. Adequate compensation is not possible because the members' fund contributions are on-lent at subsidized rates of interest to homebuyers.

³²Housing loans which are a certain multiple of monthly incomes are provided to those who have contributed to the pension funds.

³³ HDMF presently implements the UHLP because of the financial difficulties of NHMFC.

Government should change its assumption of the housing situation.

The prevailing bias for homeownership regardless of economic ability of the potential owner rests on the wrong assumption. Not everyone in society can afford to buy and own a house. There always will be a segment of society too poor and destitute to even think of purchasing a housing unit, but who need decent shelter. In fact, even in developed countries homeownership is available only to some 55% (Singapore) or at most, 65% (United States) of the population. The real problem is not how to provide everyone a house to own. Rather, it is how to provide access to decent shelter through several mechanisms: (i) renting, (ii) ownership through purchase or private transfer (e.g., through inheritance, donation) or (iii) public housing to certain sectors of society (e.g., the poorest of the poor). For this to happen, housing markets, including housing finance should work efficiently.

The trouble with the prevailing bias for homeownership and control of the rental market is that these invariably raises the cost of the National Shelter Program. The desire for to provide economic and social housing to the majority of the population raises expectations on the part of the public and motivates private economic agents who benefit from the subsidies to lobby for more funding to an unsustainable housing program.

Government should review its role in the housing market.

The housing market does not function efficiently because of heavy government intervention especially in housing finance. It also chose to control rents of private dwelling units. A disastrous result is the constriction of supply of apartment units and houses for rent and the heavier burden on homeownership as a mechanism to close the demand-supply gap in housing.

An important dimension is the neglected role of the private sector in moving resources to a potentially profitable economic and social housing market. The hard reality is that the government does not have the resources to finance a very costly homeownership program. Unless private resources are effectively harnessed, and unless the government directs its subsidies to those most in need and in the most transparent way, the huge demand for decent shelter will remain unsatisfied.

Given inappropriate policies and incentives, the private sector will avoid risking its own resources to the housing markets, but instead follow the line of least resistance: let government produce all the monies it can to build homes made available through subsidized loans originated for the government by private parties. The agency relationship between private parties and government effectively transfers the credit risk to the government and the taxpayers and generates huge profits to intermediate agents.

Government should focus on the provision of infrastructure to motivate development away from traditional urban centers. This will draw people away from the already congested major cities (e.g. Metro Manila, Metro Cebu) and provide for more affordable shelter in the newly developing areas. The government could also focus on reviewing the regulatory framework for housing to identify supply side bottlenecks, e.g., inappropriate zoning regulations, building standards, etc.

There is a need to promote a market-based housing finance system.

A market-based housing finance system is the only way to have a sustainable housing finance market that will make it possible for a greater number of low and middle income households to have decent shelter. Mixing long-term contractual savings with subsidy transfers sends the wrong signals. It also distorts the financial markets. This does not encourage the entry of private financial institutions into the low and middle income housing markets. All the private agents care is to originate as many loans as they can from “eligible” borrowers and to turn around and ask NHMFC or Pag-Ibig to take out the mortgages. Thus, no genuine home mortgage market for low income households ever develops.

Contractual savings could be the source of long-term funding for the housing sector but care should be given to make this sustainable. A market-based system of housing finance which compensates contractual savings with market rates of return and allows interest rate to play its major role of allocating credit should be considered. This means that private financial institutions should be able to offer adjustable mortgage loans to borrowers that consider the relative riskiness of clients.

There is a need to make subsidies transparent and well-directed.

First, there is a need to separate subsidy elements from financial credit and to make funding of the subsidy transparent.³⁴ Subsidies have mostly been hidden through the concessional interest rates of various loan packages. This has distorted the housing finance markets for low and middle income households where interest rates failed to play its role of allocating credit to creditworthy borrowers. The cost of the subsidies is not always transparent because of the major mechanism for giving them, that is, through the credit markets.

An example of a transparent approach is the Abot Kaya Pabahay Fund which provides loan amortization support to those with monthly income not exceeding P7,000.00. While this may not be the best way to provide a subsidy, its advantage lies in the transparency and certainty of the amount or size of the subsidy that Congress will deem proper.

Second, while a case may be made for providing direct or indirect subsidies to targeted beneficiaries, it is equally compelling to have the weakest groups enjoy the subsidies. This means that society knows who actually benefits from subsidies, who pays for them and the form the subsidies take, e.g., direct grants.

Protection of the weakest groups in society requires an efficient and well-targeted housing subsidy. The government can provide a one-time capital grant or allowance that will form part of a household's equity to a mortgage loan instead of interest rate subsidies. However, households could be required to put up its counterpart equity consisting of household savings. Matching the household's savings with a one-time capital allowance will encourage savings mobilization, instill financial discipline on potential borrowers and lower the cost of borrowing. Because there is mortgage finance available to middle and high income households, subsidies should be directed only to the low income households.

Third, the subsidy policy framework must also ensure that the subsidies provided must be fiscally sustainable in the sense that the opportunity costs of housing subsidies and the government's budgetary constraint are considered in the design of those subsidies. There is no sense in crafting unfunded subsidies. This only heightens expectations and eventual frustration on the part of the targeted households.

Government should address various supply side constraints that hamper the functioning of the housing market.

Escalating land prices drive up the production costs of housing units. This constrains the production of more affordable socialized housing units. It has been estimated that the cost of the housing lot constitutes more than 30% of the cost of the entire housing unit. Comparable figures in other countries show that lands for housing cost more in the Philippines. Part of the explanation for the rising land prices is the difficulty of releasing more lands for housing due to problems in establishing titles to raw land and assigning development rights over raw land owned by the government and the land conversion problems attendant to the agrarian reform program. The latter is supposed to be undertaken through a competitive bidding process. There is, however, a need for greater transparency over this bidding process.

Zoning regulations, building codes and infrastructure standards are at par with those of other countries in a similar level of development. However, overly strict standards could unwittingly restrict the supply of housing by increasing the costs of housing units. Similarly, inadequate infrastructure increases housing costs because the expenditure for on-site services, e.g., water supply, sewerage and power, would have to be recovered through price increases of housing units or the supply of units with smaller floor areas.

Unnecessary regulations increase transaction cost in the housing market. While the process of getting permits or approvals from the relevant government agencies may be necessary to ensure compliance with laws on the environment, agrarian reform, etc., it increases the transaction cost of developing raw lands for housing. The costs entailed eventually get passed on to the private buyers of privately developed lands. There is a need to review or streamline the process of providing development permits.

In view of the responsibilities given to them by the Local Government Code, local governments and local communities could work in the development of sites and services. This approach could provide appropriate development of local communities and save national government fiscal resources.

³⁴ See B. Renaud, "Housing Reform in Socialist Economies," World Bank Discussion Papers, 1991.

Recommendations

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