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**This is a family in the process of incrementally building their home with a loan from one financial institution that partnered with CISF.**

## ARTICLE 1:

# Opportunities and Constraints for Housing Microfinance

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Housing is proclaimed to be one of the "big three" priorities of low-income families around the world, along with food and children's education[1]. A 2005 U.N. report estimated that approximately 1.6 billion people worldwide suffer from inadequate shelter. Global housing conditions are being further stressed by rapid urbanization, particularly in the developing world, and the damage caused by natural and human disasters. These deficits paint a picture not only of tremendous human need, but also of a vast and largely untapped market of financing opportunities.

Interestingly, much of the housing demand is not for newly built, formally financed units, but rather for improvements and repairs to existing shelters. Low-income populations are frequently characterized by high rates of homeownership[2], but

1. "State of the Microcredit Summit Campaign Report," Jan Maes and Larry Reed, Microcredit Summit Campaign, 2012.
2. For example, declared homeownership rates in four of the countries included in this study are: Philippines – 80 percent; Peru – 72 percent; Uganda – 85 percent; India – 87 percent (see "Capitalizing Housing for the Poor: Findings from Five Focus Countries," C. Young, J. Hokans and B. Ahern, HFHI, December 2009, p. 47), while in the U.S., homeownership was reported at 65 percent at the end of 2012.

**Housing microfinance** refers to nonmortgage loans that are intended to finance home improvements, repairs and incremental building and are characterized by common elements of microfinance, such as:

- **Small loan amounts:** Financing a single improvement or step in a gradual construction process.
- **Short terms:** Generally between 12 and 36 months.
- **Market-based pricing:** Typically on par with other microfinance products.
- **Nonmortgage guarantees:** Such as co-guarantors or promissory notes, and accepting alternative proofs of land ownership from legal titles, such as purchase agreements or utility bills.

the quality of these homes is often deemed inadequate.[3] Around the world, the predominant pattern for building and improving homes is progressive, by means of small, incremental stages, in accordance with families' priorities and financing availabilities.[4]

Meanwhile, the supply of appropriate financing to support families' progressive construction is minimal. Conventional mortgage finance is not well matched with this population's financing needs and realities, and government housing programs are usually constrained by limited resources. Microfinance institutions have been somewhat hesitant to get involved in housing in recent years, as the pace of growth of housing portfolios has slowed in the face of the global economic crisis, the Andhra Pradesh microfinance debacle[5] and other more localized setbacks.[6] Moreover, until recently, microfinance institutions' interest in housing microfinance has been largely eclipsed by their historic focus on microenterprise lending.

As microfinance markets mature and increase in competitiveness, institutions are likely to reconsider housing microfinance as a compelling business opportunity. A 2010 report published by J.P. Morgan revealed that affordable urban housing represented the largest financial market opportunity for impact investors, measuring between US$214 billion and $786 billion.[7] The rise of nontraditional suppliers of housing microfinance from within the private sector gives evidence of the attractive business proposition this immense market represents. Latin America-based companies such as Promigas ("Brilla" program) and Corona ("Viste tu Casa"), along with housing finance veteran CEMEX ("Patrimonio Hoy"), attained a combined outreach of approximately 615,000 clients in Mexico and Colombia alone during 2011.[8] These are very low-income households, making up what is known as "the base of the pyramid."

When microfinance practitioners consider entering housing markets, they will likely be asking: What contextual factors particularly favor robust, high-performing housing microfinance portfolios? What factors constrain successful housing microfinance? Can steps be taken to mitigate these? The following article attempts to address these questions, using insights gained from studying a variety of microfinance institutions around the world that developed housing microfinance products in partnership with Habitat for Humanity in each of their countries.

## Housing microfinance: The industry's well-tailored response

Housing microfinance refers to a type of microfinance product that is directed toward financing the incremental repairs, improvements and progressive construction of housing. Housing microfinance is uniquely tailored to the needs and realities of the poor and is designed to match their specific building and financing patterns. For example:

- Improvements are undertaken in a series of small, incremental steps.
- Financing is determined based on clients' repayment capacities, pre-established loan terms, and the costs of an improvement "step."
- Guarantees are tied to alternatives that are within clients' reach (e.g., co-guarantors, promissory notes).
- Tenure security is confirmed via informal documentation vs. legal title (e.g., purchase agreements, utility bills).

3. UN-HABITAT defines adequate shelter as meeting a variety of criteria, including adequate space, security, durability, secure tenure, and access to basic services such as water and sanitation.
4. For example, researchers have estimated that 70 percent of housing investment in Mexico is for incremental construction; 98 percent of housing stock in urban areas of Tanzania is built incrementally; and 93 percent of owner-occupied homes in the Philippines were built incrementally. (See "Financing Urban Shelter," UN-HABITAT, 2005, p. 99).
5. The crisis of microcredit in the southern Indian state of Andhra Pradesh began in October 2010 with a suicide wave caused by widespread overindebtedness, badly tarnishing the sector's image in India and abroad.
6. See "Status Report: Housing Microfinance in Latin America," Habitat for Humanity International, Center for Innovation in Shelter and Finance, Nov. 9, 2011.
7. "Impact Investments: An Emerging Asset Class," J.P. Morgan Global Research, Nov. 29, 2010.
8. "Status Report: Housing Microfinance in Latin America."

- Financing is often accompanied by housing-related services[9] such as support to the family in planning and staging improvements, determining materials needed and associated budgets, providing technical advice, and offering recommendations about where to source materials and labor.

Within this category of housing microfinance loans exists a range of potentially differentiated and diversified offerings, such as loans tailored for common improvements (flooring, roofing) or distinct products (water cistern purchases, septic tank installations). Ultimately, a well-structured product development process has proved effective in helping a microfinance institution determine what specific housing microfinance products are best suited to particular target markets and contexts.[10]

This study's findings highlight specific opportunities and constraints to housing microfinance, organized below into five categories of contextual factors: land and location; sociopolitical factors; economic environment; microfinance markets and regulation; and government housing programs.

## Opportunities and constraints

### Land and location

Study results reveal that a favorable condition for housing microfinance is a setting in which land tenure is secure and homeowners feel confident of their property rights, even if they are not formally registered and titled. These factors feed vibrant housing markets and stimulate investment in improving homes, infrastructure and public services.

Conversely, contexts plagued by insecure tenure, land repossessions and government-sponsored relocations are less suitable for housing microfinance. Families are notably more reluctant to invest in tenuous housing circumstances, and lending risks are also heightened by clients' unreliable residence. Similarly, marginalized neighborhoods lacking basic infrastructure (e.g., roads and public services) tend to suffer from lower investment in private housing, as residents are forced to divert precious resources to purchase costly services from private suppliers, and property values often stagnate.

Zones at high risk of natural disasters are also difficult contexts for housing microfinance, given the associated lending risks. Nevertheless, the effects of natural disasters often present unique opportunities for housing microfinance. For example, migration to the Dominican Republic after the earthquake in Haiti catalyzed a surge in demand for housing finance, particularly in the areas where Haitians were settling.

When housing microfinance is offered in contexts that are particularly vulnerable to natural disasters (e.g., hurricanes, earthquakes, landslides, flooding), microfinance institutions tend to give special importance to pursuing qualified technical guidance. This advice might come in the form of neighborhood assessment and prequalification, whereby a civil engineer or architect approves of (or disqualifies) specific zones for housing finance, based on the perceived level of disaster-related risk. For example, in the Dominican Republic, certain marginalized communities were too close to precarious rivers to be deemed appropriate for financing. Technical support may also be provided directly to clients, assisting them in the construction of disaster-resistant homes. For example, a microfinance institution in the Philippines provided on-site technical advising to ensure that homes were built to withstand seasonal monsoons.

### Sociopolitical factors

Global urbanization presents a vast opportunity for housing microfinance, because urban areas experiencing significant growth and migration are often hosts to vibrant housing markets, where demand for financing far outstrips supply. Microfinance institutions operating in Lima, Peru, and Manila, Philippines, attested to the impressive markets for housing finance in low-income neighborhoods in those cities.

Another setting favoring housing microfinance is in areas facing reconstruction after wars have caused significant destruction to physical property. For example, a microfinance

9. Commonly referred to as "Housing Support Services," or HSS, and defined as nonfinancial support that is intended to equip families or the suppliers of housing materials or services with knowledge, connections or other resources that will improve the quality or reduce the cost of solutions built.

10. See "Housing Microfinance: Product Development Tool Kit," Habitat for Humanity International's Center for Innovation in Shelter and Finance, May 2012. habitat.org/cisf.

institution in Bosnia signaled the relevance of housing microfinance to post-war home rebuilding efforts.

Notably, areas that are facing substantial negative migration (e.g., war zones, or Mexican towns near the U.S. border) or that are highly populated by temporary residents (e.g., refugee communities) are considered less appropriate for housing microfinance. While these contexts present definite challenges for housing microfinance lending, specific product design features may be employed to partially mitigate obstacles faced. For example, by liaising with community-based organizations, a microfinance institution in the Dominican Republic was able to sufficiently diminish lending risks among communities heavily populated by Haitian refugees and temporary farm workers. The microfinance institution relied on these local entities to facilitate client prescreening, based on observed character traits and the stability of their permanence.

Microfinance institutions offering housing microfinance faced a particular challenge in settings where men were frequently absent, leaving women with the responsibility of overseeing any necessary home repairs or improvements. A microfinance institution in Tajikistan, for example, noted that while men were off working in Russia, the women remaining at home often felt less confident or equipped to take on construction projects. Hence the microfinance institution ensured that housing microfinance lending to this population was accompanied by necessary support in project planning and technical advising.

### Economic environments

Evidence confirms that an ideal condition for housing microfinance, and indeed any type of microfinance, is a macroeconomic environment that is conducive to business investment and growth. In other words, contexts experiencing stable economic growth and reasonable rates of inflation — and where investment is considered relatively secure — are generally considered favorable for housing microfinance.

On the other hand, high-risk markets, where capital is constrained and costly, are difficult contexts for growing housing microfinance. A microfinance institution in Uganda was feeling the consequences of high national inflation on its housing microfinance portfolio, as loan capital had become extremely expensive. Moreover, the price of construction materials was constantly on the rise, potentially outpacing its clients' borrowing capabilities. A microfinance institution in India was facing similar challenges, attempting to access needed loan capital in a highly constrained financing environment for microfinance institutions after the crisis in Andhra Pradesh.

A related challenge is the noted effect of struggling economies on clients' income, thereby compromising their borrowing capacity. A microfinance institution in Bosnia voiced this concern and ensured that its housing microfinance design was well-targeted, financing only small, incremental improvements, and that housing support service costs were kept low. Furthermore, it intentionally promoted via reduced interest rates a distinct housing microfinance product known as "energy-efficiency loans," targeting home improvements that resulted in energy cost-savings for families.

Microfinance institutions in India and Bosnia both raised concerns about clients' limited abilities to plan and budget for home improvements. In India, the microfinance institution discovered that 90 percent of its clients failed to properly determine needed loan amounts because they were unable to correctly calculate construction project costs on their own. In these contexts, the inclusion of support services to help clients plan and budget their home improvements appeared to be vital.

### Microfinance markets and regulation

The state of local microfinance markets can also have a significant impact on the performance of housing microfinance portfolios. In countries such as Peru and Bolivia, where microfinance institutions are relatively mature, the banking business is more sophisticated, and product diversification is commonplace, housing microfinance appears to be growing and diversifying in its offerings. Interestingly, in most countries (e.g., the Philippines, Bosnia, India) housing microfinance remains a relatively nascent product among microfinance institutions, creating a welcoming environment for strategic market positioning and housing microfinance portfolio growth.

In a few countries (e.g., the Philippines, Bolivia), banking regulators have recognized housing microfinance as a distinct product, and this will likely serve in encouraging product differentiation among lenders. Housing microfinance product differentiation, in turn, enables microfinance institutions to direct specialized services to these clients, undertake well-informed loan analysis, and verify loan usage. It also allows the microfinance institution to sell housing microfinance as a distinct product to specific target markets. Furthermore, the product's segregation within a microfinance institution's portfolio management system facilitates housing microfinance performance assessment.

Where microfinance markets (or credit markets in general) are saturated or burdened by over-indebtedness, predatory lending and other irresponsible lending practices, housing microfinance faces challenging prospects. Because housing microfinance loans are frequently repaid with existing income streams, when these are already overcommitted, repayments are likely to suffer. These types of environments signal the need for well-designed and highly targeted housing microfinance products. A microfinance institution in Peru addressed this issue by equipping loan officers to undertake particularly thorough credit analyses for housing microfinance loans. In India, where responsible lending practices are more critical than ever, a microfinance institution required that all potential housing microfinance clients attend orientation training that included home improvement guidance, loan terms and requirements, and basic financial education.

Unfortunately, in most countries, banking regulators have yet to recognize housing microfinance as a distinct product. As a result, regulated institutions find less reason to differentiate housing microfinance from existing products. Consequently, housing microfinance loans are often found embedded in the portfolios of consumer loans, fixed asset loans, or more broadly classified housing loans (possibly including mortgages). This presents a variety of challenges. For example, classifying housing microfinance as consumer loans may result in excessive provisioning requirements, given consumer lending's higher risk profile. In certain cases where housing microfinance is included within mortgage portfolios, specific regulations such as legal land title requirements or overly restrictive interest rate caps may stunt housing microfinance potential. Furthermore, overly regulated microfinance markets may impose restrictions that constrain housing microfinance success. For example, microfinance institutions in Brazil are not legally permitted to diversify microfinance lending for purposes outside of income-generating endeavors (termed "productive microcredit"), thereby discouraging the development of housing microfinance products among this sector.
A final constraint mentioned by housing microfinance lenders was related to industry concerns surrounding major shifts in microfinance regulatory bodies and their leadership. A microfinance institution in Bolivia, for example, mentioned how the announced changes to banking authorities and their perceived impact on regulatory requirements were fostering an environment of uncertainty. This, in turn, was dampening microfinance institutions' readiness to engage in further innovation and diversification.

### Government housing programs

Government programs targeting improved housing may also be perceived as opportunities or constraints to housing microfinance portfolios. Microfinance institutions have sometimes found that government-sponsored programs stimulate housing markets by helping families acquire land or build a portion of their homes. Consequently, families who have benefited frequently seek financing to continue with or complete their home-building aspirations. For example, the government of Tajikistan donated 50,000 plots of land for new construction, which has generated a substantial pool of clients for a local microfinance institution offering housing microfinance.

In some cases, an actual partnership may form between government entities and local microfinance institutions, whereby the latter offers financing to increase access to public services. For example, a microfinance institution in Peru collaborated with the municipality of Huachipa to finance connections to public water and sanitation services.

Unfortunately, in certain contexts, government housing programs — particularly subsidy-based initiatives — are perceived as having a negative effect on housing finance markets of low-income sectors. In Brazil, for example, the government development bank, CAIXA, has been criticized for creating unfair competition with suppliers of housing microfinance, offering home improvement loans at very low interest rates and with few restrictions. A microfinance institution in Peru expressed concerns that government housing entities were creating an expectation of widespread subsidies for housing construction, thereby tempering demand for housing microfinance.

## Conclusion

Housing microfinance is the microfinance industry's well-tailored response to the vast and relatively untapped housing finance market among low- and very low-income households (those earning less than US$2 per day). While housing microfinance tends to thrive in contexts where microfinance is generally prospering, certain factors need to be considered that are particular to housing microfinance lending. A study of experiences from around the world highlights the following observations:

- Land tenure security and access to basic infrastructure are factors that contribute to vibrant housing microfinance markets. Conversely, where these are lacking, housing finance demands tend to be diminished and are considered to be of higher risk.
- The threat of natural disasters may add to lending risk, but products may be designed in such a way as to help mitigate these risks for both microfinance institutions and their borrowers. Notably, reconstruction after human and natural disasters contributes to increased demand for housing microfinance.
- Global urbanization tends to contribute to urban housing markets' growth and vibrancy, fueling demand for housing microfinance.
- Struggling economies and high-inflation environments pose several direct threats to housing microfinance: increased construction costs, lower or less stable incomes among the poor, and the heightened cost of capital to microfinance institutions. Housing microfinance products need to be carefully designed to address these contextual challenges.
- Where microfinance markets are mature and lending is conducted responsibly, housing microfinance is prone to thrive. Similarly, where banking regulators permit good housing microfinance lending practices, even if not yet fully recognized and supported as a distinct loan product, there is greater potential for housing microfinance success.
- Finally, housing microfinance benefits when government housing programs stimulate healthy housing finance markets rather than compete with them.

In the coming decade, we are likely to see housing microfinance rising as a shining star among microfinance institutions, impact investors and the private sector, as contextual realities are leveraged for the benefit of the poor and their shelter needs.