Sida

OCTOBER 2004 • FRANCK DAPHNIS AND INGRID FAULHABER

Policy Recommendations
for Sida's programs

Housing Microfinance

MAKING FINANCIAL MARKETS WORK FOR THE POOR

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Introduction and Executive Summary

Background

Since 1988, the Swedish International Development Cooperation Agency (Sida) has supported several programs that, in retrospect, provide a good fit with our current understanding of housing microfinance (HMF). In Costa Rica, Honduras, Guatemala, Nicaragua and El Salvador, Sida has helped public agencies as well as for-profit and not-for-profit institutions develop initiatives that extended credit to the working poor, under terms that deviate from more orthodox housing microfinance in the following ways:

1. Loans have often been for relatively small amounts;
2. Repayment periods are relatively short compared to traditional mortgage loans;
3. The programs are typically expected to contribute to the self-sufficiency of the financial providers;
4. Non-financial services in the form of construction assistance are often an integral part of the loan package.

As housing microfinance emerges from the shadows of micro enterprise lending and mortgage-based housing finance, Sida's work in Central America sheds a useful light on the promise —and current limitations— of the new practice. The following document, based on an independent review of Sida's housing microfinance programs in Central America and on subsequent policy recommendations presented to Sida in the fall of 2002, highlights elements of that promise and explores some of these limitations. This document does not purport to constitute a full-scale evaluation of Sida-supported HMF programs in Central America. It does, however, present a summary of facts and observations about these programs. Finally, this document includes policy recommendations the authors believe could assist Sida in developing and overseeing highly performing housing microfinance programs in the future.

Overview of Findings

The following is a synopsis of some of the key observations the consultants made during the rapid review of Sida-assisted housing microfinance programs in Central America. These observations, along with lessons

learned from the worldwide experience in housing microfinance, microfinance, and housing finance, inform the policy recommendations provided in Section 4 of this report.

Delivery Mechanisms

1 The variety of delivery mechanisms used by Sida for HMF has created a broad spectrum of initiatives and a rich source of experience, thereby establishing Sida as a trailblazer among donors for the emerging practice of housing microfinance.

  Specifically, Sida has favored three distinct methods for channeling housing microfinance resources to qualifying households:

  – Sida has supported second-tier (Apex) institutions directly. Second-tier institutions must in turn work with retailers in order to disburse the HMF funds to clients;
  – Sida has financed *first-tier institutions directly;*
  – Sida has established *trust funds* in order to finance first-tier or second-tier institutions.

2 The most efficient use of funds appear to have emerged in projects where Sida funds have been managed by retail organizations, irrespective of whether the funds have been placed in a trust fund or whether they have not.

3 The most challenging programs appear to have been those in which funds have been placed in a public sector entity. These programs have resulted in significant losses of capital.

Targeting

1 Sida typically establishes targeting criteria on the basis of income levels, geographic location, occupation and gender.

2 Sida-mandated income levels for HMF clients tend to be lower than those generally targeted by partner MFIs.

3 Methodologies used to determine household income levels vary dramatically across MFIs and do not always take into account family size.

4 Non-income-related poverty indicators are rarely used.

5 Wholesalers' geographic targets do not always match retailing MFIs' priority areas.

Wholesale financial products

1 The relationship between the second-tier and the first-tier institution can be through a loan, a line of credit or a management contract.

2 Where fund management contracts are in effect, second-tier institutions have had to refine the mechanisms through which they share both risks and rewards with partner MFIs (PRODEL, for instance.)

3 Second-tier financial products typically include targeting guidelines and other retail product parameters.

Retail financial products

- In many cases, loan pricing for housing finance programs differed from pricing for other microfinance products. In at least one case (FDL), this discrepancy could not be explained by the actual difference in cost and expected returns between the two products.
- Repayment periods were generally in line with the emerging experience in housing microfinance (1 to 5 year loans). FUNDEVI and FUPROVI were the notable exceptions with 10-year loans.
- Sida does not systematically reward MFIs or condition future support on the basis of portfolio performance.
- Sida-supported retailing MFIs have implemented a broad spectrum of housing initiatives. These initiatives notably include:
  1. Home improvement loans (FUSAI/Integral, FUNDEVI, FUPROVI, FDLG/Genesis, ACT, FENACOAC, HODE);
  2. Individual loans for new home construction on a previously-owned lot (FUPROVI, FDLG/HODE);
  3. Loan programs linked with government subsidy programs for new home construction (FUSAI/Integral, FUPROVI, FUNDEVI);
  4. New housing settlements (FUSAI/Integral, FUPROVI, FDLG/HODE);
  5. Lots with services (FUSAI/Integral).

Construction Assistance

1. Construction assistance is provided by all implementing MFIs.
2. Costs are often recovered via commissions charged up-front on the loan amount.
3. Second-tier lenders face difficulties in providing the MFIs with appropriate support to incorporate high quality and cost-effective construction assistance (FDLG).
4. Where the wholesaler has retained the function of providing construction assistance to clients (PRODEL), several strategies have been used with varying degrees of success. These strategies include:
   - Placing construction assistance personnel at the Municipal Government Offices;
   - Supporting construction assistance personnel within the MFI;
   - Encouraging MFIs to hire construction assistance personnel and retain part of the commissions charged;
   - Training new private sector consultants to serve as contracted staff to the MFI.

Relation with Subsidy Component

1. Where subsidies have been available, Sida-supported programs have essentially been structured to help low-income earning families access the subsidy and finance the cost differential of the home construction. Often, however, the subsidies dried up and the MFI has had to implement a credit-only program.

2 Structuring a program around government subsidies has proven risky in all cases given changes in policies that have altered the nature, availability, or amount of the subsidy.
3 Institutions whose strategies were based on the availability of subsidies have faced serious financial difficulties when the availability or policies governing the use of subsidies have changed. Most institutions have reacted by introducing new products that are viable without subsidies.
4 Performance, output or target-based incentives can provide a strong motivation for MFIs to introduce housing microfinance into their portfolios.

Linkages with Infrastructure and basic services

1 Generally, home improvement loans are available to clients who want to access or upgrade access to basic services.
2 New home construction and new housing settlements typically incorporate access to basic services in the design and costing of housing products. Housing finance programs designed to support such initiatives have proven costly (without a subsidy component) and repayment periods often exceed recommended limits for housing microfinance.
3 Experience of MFIs that are financing municipal basic services projects has not met with success

A Note on Credit for Housing vs. Housing Microfinance

It is important to note that not all credit initiatives designed to support the housing needs of poor people necessarily fall under the housing microfinance banner. If housing microfinance is understood to be the application of microfinance principles to the delivery of housing finance, a few basic conditions must exist in order for credit for housing to become housing microfinance.

Long-Term Financial Viability for the Provider. Operational and financial self-sufficiency are key elements in the long-term strategy of any institution engaging in microfinance. A microfinancial service focusing on demand for housing should work within a business strategy that calls for the long-term financial sustainability of the institution providing that service. HMF loan pricing (interest rate, commission and other fees) should therefore contribute to the long-term financial health of the organization, not be an impediment to it. This is an important point. Donors, managers of MFIs, and even housing professionals often make *a priori* assumptions assimilating housing finance to long-term, sometimes subsidized mortgage-type financing. This can lead to the belief that while MFIs may want to offer housing services to their clients, housing is a relatively unprofitable line of business, as compared to microenterprise lending.[1] The emerging lessons of the field of housing microfinance do not, however, support that belief. Organizations such as SEWA bank in India, MiBanco in Peru, FUNHAVI in Mexico, Card in the Philippines,

[1] This was notably the impression conveyed by the managers of FDLG in Nicaragua.

to name but a few, have demonstrated that HMF services can be delivered in a manner that is consistent with the microfinance vision for long term financial viability.

A Microfinance-Based Methodology. Another preconception is the belief that fundamental differences between housing lending and enterprise-focused lending necessarily translate into unbridgeable differences between housing microfinance and more traditional forms of microfinance. A key assumption in this document is that housing microfinance is a form of microfinance. By definition, it encompasses only those initiatives that adapt the lessons that have evolved from the larger microfinance revolution to housing. Housing microfinance should not be construed as a panacea for the full range of housing problems poor people face throughout the world. Rather, it offers a set of options available to microfinance and housing finance providers interested in exploring the intersections between housing finance and microfinance. For instance, a strict application of housing microfinance is likely to exclude the subsidy-based approaches and long term lending that are commonplace in housing finance but anathema to most successful applications of microfinance. From the point of view of a donor institution, this does not mean that subsidies or long term housing lending should never be an option. It does, however, mean that institutions that are encouraged to develop a microfinance approach for the delivery of housing should be allowed to maintain methodological integrity and should not be forced to become conduits for incompatible forms of housing assistance.

A Focus on Poor Clients with the Required Minimum Capability for Repayment. Not all poor people can take on a loan and repay it in a manner that is consistent with the expectation that housing microfinance will be financially viable for the provider. Invariably, some households will be too poor to have the minimum required capacity for repayment. Housing microfinance will not be able to provide successfully for the habitat needs of these households, and institutions supported by Sida should not be encouraged to take on these households as clients. Subsidies or other forms of assistance may be needed, should Sida determine that it still wants to provide for the needs of households that do not have the required capacity for repaying a housing microfinance loan.

1. Overview of Housing Microfinance Worldwide

Adapted with author's permission from: *Elements of Product Design* & *Housing Microfinance: Towards A Definition* By Franck Daphnis
To be published in the forthcoming anthology *Housing Microfinance: A Guide to Practice*, Kumarian Press, expected fall 2003

Introduction

Throughout the world, microfinance institutions (MFIs), NGOs and housing finance providers offer a variety of financial services that have come to be classified as housing microfinance. Housing microfinance can be linked to pre-existing credit and savings services, as is the case with the Grameen Bank in Bangladesh, SEWA Bank in India and CARD in the Philippines. Housing Microfinance also exists as stand-alone financial services that are independent of other product offerings. Organizations such as CHF International in the Middle East and Latin America, ADEMI Bank in the Dominican Republic, Bancosol in Bolivia, MiBanco in Peru and Financiera Calpia in El Salvador have successfully developed and offered stand-alone housing microfinance products.

Housing microfinance intersects both housing finance and microfinance. The emerging practice encompasses financial services that allow poor and low-income earning people to finance their habitat needs with methods adapted from the microfinance experience: (1) loans are for relatively small amounts and are based on clients' capacity to repay; (2) repayment periods are relatively short (especially in comparison to mortgage lending) and are on par with mid- to high-end microfinance individual loans; (3) loan pricing is expected to cover the real, long run costs – operational and financial – of providing the service; (4) loans are not heavily collateralized, if at all, and collateral substitutes are often used; (5) loans tend to finance habitat needs in an incremental manner, a function of the purchasing power of loans with short repayment periods and relatively low monthly payments; and (6) if the provider is an MFI, credit services for housing can be linked to prior participation in savings or more traditional microenterprise loan services.[i]

Demand Estimates for Housing Microfinance

MFIs attempting to estimate potential client demand and marketplace opportunities for housing microfinance – or for any proposed

microfinance service, for that matter – face a tenuous task. Presumably, a key purpose of demand studies is to generate information that will guide the product design process. Such information should notably include assessments of the potential market size and composition, client preferences, and competitive environment. In the case of housing microfinance, current experience suggests that demand studies will yield useful information only when the MFI already possesses a basic vision for the types of products and methodologies it plans to offer.[ii] It is almost a given that poor and low-income earning families the world over will express a *need* to improve their housing conditions. Client surveys that adopt an expansive, "scattershot" approach to understanding client preferences may highlight the extent of that need. These surveys, however, can fall short of reasonably projecting *demand* for a service provided under microfinance principles.

Demand assessments for housing microfinance are not alchemic exercises that deliver the ideal product, when no prior hypotheses for that product existed beforehand. Current experience suggests that MFIs interested in housing microfinance are well advised to consider a range of services they would be willing to offer their clients and to test client preferences within that range. Plan International's housing finance surveys showed that economically active but very poor PLAN families in nine countries around the world tended to consistently overstate housing needs and understate income. Only when PLAN asked clients about specific amount for affordable monthly payments and when it narrowed the types of housing intervention to home improvements, did it generate information that proved useful in the ultimate design of the housing loan. In those instances, PLAN had decided before conducting the surveys that it would offer some type of home improvement loans with a short repayment period, as opposed to the long-term, high-value loans its clients invariably wanted but could not realistically afford.

With the acknowledgment that assessments of potential demand are not perfect, client and marketplace surveys can still provide critical inputs into the design of financially viable housing microfinance services. Throughout this paper, we will work with the assumption that potential demand for housing microfinance stems from a positive determination that affordability, need, and willingness to borrow coexist within the marketplace.

Affordability is a function of a client's capacity to pay, the projected cost for a proposed housing intervention, and the loan terms. The MFI should also assess whether enough clients are willing to borrow funds (and under what conditions) in order to finance their housing needs. That *willingness to borrow* could eventually be expressed as a percentage of the total target clientele (e.g. 75% of clients surveyed say that they would take on a three year home improvement loan carrying a 35% interest rate). Finally, the MFI should identify the range of *housing needs* potential clients are interested in financing.

Clients' Capacity to Pay

Capacity to pay is an important component in the overall affordability analysis. For a housing microfinance loan, a client's capacity to pay

should always be a function of the client's income *before* the loan is issued. If the home is the place of business, housing improvements could increase business productivity and generate increased earnings. In many cases, however, housing microfinance loans help clients improve the condition of a personal asset, without necessarily improving short-term income prospects. This is a self-evident proposition if MFIs extend housing loans to salaried employees (who do not work inside the home). The eligibility criteria MFIs chose to qualify clients should therefore focus on current, rather than future, income.

MFIs currently rely on a wide range of strategies to determine client eligibility for a housing microfinance loan. The objective, however, is always the same: ensuring that clients will have a reasonable chance of meeting future periodic loan repayments based on their current financial profile. As for any other microfinance lending decision, the more relevant information the MFI has on the income and spending habits of a particular client, the more appropriate is the MFI's answer likely to be.

A key policy decision the MFI must make is determining what portion of a typical client's income should be earmarked for a housing loan payment. In many cases, the home is the most important asset poor people will ever own. Along with food, shelter is also one of the most fundamental human needs. It is reasonable to expect that poor families will spend a high percentage of their income on building, expanding and maintaining their homes. Many MFIs have already observed that clients use microenterprise loans precisely for these purposes.[iii] The question at hand is: if a microfinance loan is designed specifically with housing in mind, is there such a thing as an acceptable capacity to pay criterion, expressed as a percentage of periodic income?

Most institutions for which information on capacity to pay criteria is available recommend that 20% to 35% of either net or gross monthly income can be used to pay for a housing loan.[iv] A survey of practice and common sense also suggest that the percentage of disposable income clients can earmark for housing loans should be inversely related to their poverty level. Everything else being equal, a very poor person will spend a higher proportion of her take-home income on basic necessities, as compared with what a middle-income earning person will spend. For instance, a market vendor earning a net income of $50 a month in Port-au-Prince, Haiti may need a minimum of $42 to feed and clothe herself. A small shop owner working and living in the same neighborhood and earning $250 may only require $175 – a larger amount, but a lower percentage of monthly income.

Additional recurrent expenses, such as prior client debt, should also affect what percentage of a client's income can be applied to a periodic housing microfinance loan repayment. Suppose, for instance, that the market survey suggests most clients will be able to allocate 30% of their disposable monthly income towards the repayment of a housing loan. Suppose that the survey further shows that, on average, potential clients already use 20% of their monthly income for existing debt service.
The monthly debt burden (housing payment plus other payments) for an average potential client would be projected to be 50% of monthly income. If the MFI has good reasons to believe that future clients will have some form of prior indebtedness, the MFI should establish guide-

lines on the amount of total debt any client should be able to afford. CHF International, for instance, recommends that clients pay up to 25% of their disposable monthly income towards monthly loan repayment. However, CHF also believes that total debt burden should not exceed 40% of monthly income.[v]

For a specific housing microfinance loan delivered in a specific community and to a specific clientele, MFIs should think of the proportion of a client's income that can go towards loan payment as an acceptable range, rather than a set number. The MFI can assign a particular value within that range to a client based on what the MFI believes that client will be able to repay.

Table 6.1 Capacity to pay guidelines for six housing microfinance providers

Institution	Product Type	Eligibility Criteria Towards Loans
CHF/Gaza*	Stand Alone	Up to 25% of household income
Calpia	Stand Alone	Up to 25% of household income
FUNHAVI	Stand Alone	Up to 33% of household income
CARD	Linked	2 Loan Cycles; 1.5 year of savings; Bransch Manager recommendation
Grameen	Linked	2 Loan Cycles and recommendation from Group
SEWA	Linked	Up to 25% of household income

Source: IFC, HIID, Daphnis/CHF MFT Course Survey.

The challenge for the MFI is to determine the percentage of income that maximizes the periodic amount a client can repay, while also maximizing the likelihood that the client will be able to provide for her basic needs. This equilibrium point will vary from client to client and can have multiple determinants, including family size, consumption patterns, even inflation over the life of the loan. Organizations that offer linked housing microfinance products and can consult a client's individual repayment history on prior loans could peg the housing payment to the most recent periodic payment they know the client can honor. Organizations that offer stand-alone products and that do not have a prior relationship with the client will have to develop new criteria that correspond to the economic conditions of their target clientele.

Loan security requirements are another important factor that could affect capacity to pay. An MFI that has already collected one-year worth of savings from the client, as a guarantee prior to loan disbursement, does not face the same overall risk as an MFI with no prior relationship with that client. Similarly, a client that is able to secure her loan with two credit-worthy cosigners would seem to present a lower overall default risk than a client with no history with the MFI and no guarantors. An MFI could thus decide to tighten or relax its capacity to pay criteria based on the perception of default risks it associates with a client.

Current practice suggests that the periodic repayment for economically active poor clients interested in a housing microfinance loan can range from 20% to 35% of a client's income during that period. Also based on current practice, the total debt burden (housing loan plus other loan payments) can fluctuate from 30% to 40% of disposable income.

In addition to the debt burden, the MFIs should consider family size, predictable recurring expenses, and the rate of inflation as factors that can be expected to influence capacity to pay.

Repayment Period

Once an MFI has established a range for the estimated capacity to pay of its clientele, the next step in the affordability analysis is deciding on acceptable loan terms – notably on repayment period, pricing, and loan security. When the MFI has formulated policies on capacity to pay and on loan terms, it will be in a position to determine the loan amounts its clients are likely to afford.

Current practice indicates that repayment periods for housing microfinance loans range from one year to ten years, with the vast majority in the one- to five-year range. MFIs and traditional housing finance providers attempting to determine the optimal repayment period for a housing microfinance loan all face the same fundamental problem: What amount of time will enable a client to borrow enough funds for her housing needs, given: (1) the client's estimated current capacity to pay; (2) the pricing of the loan; and (3) the MFI's need to minimize the probability that the client will default on the loan? For MFIs, the answer is likely to involve repayment periods that are longer than what they allow for more typical microfinance loans. For traditional housing finance providers the repayment period will most likely be shorter than what they allow for more traditional (mortgage) housing loans.

In the case of established MFIs, demand for housing microfinance typically involves loan amounts – often in the $300 to $5,000 range – that are higher than the demand for low-end microfinance loans. Unless the provider has experience with high-value individual loans, fulfilling a demand for housing loans may entail altering the MFI's worldview on what constitutes an allowable repayment period. For instance, MFIs that target poor and very poor clients often develop group-based methods of lending that feature repayment periods of one year or less. The short repayment period is directly related to the default risk the MFI associates with its clients. The poorer the client, the more likely the MFI will attempt to manage default risks by reducing the time over which the client must repay the loan. As clients successfully complete lending cycles, loan amounts may increase and repayment periods may expand. MFIs that use a short repayment period to minimize credit risk may have to consider significant increases to the allowable repayment time for housing loans.

For traditional housing finance providers, the problem is reversed. Traditional housing loans typically carry very long repayment periods– sometimes up to 30 years. Until the recent emergence of housing microfinance, housing finance providers, governments and donors understood the housing microfinance problem as the need to finance a complete dwelling under terms that are affordable to poor families, attractive to the commercial sector, and on a scale large enough that it would have an impact on national housing shortages. Unfortunately, in most countries, mortgage lending and a supporting secondary mortgage market never materialized as financially viable options in addressing the housing needs of the poor. Poor people could not afford to borrow

enough money at real interest rates to finance a completed home, unless repayments were stretched over long periods of time. This created two problems: (1) few sources of funds existed that could match repayment periods spanning 10 to 30 years, creating a severe asset/liability mismatch for commercial institutions interested in housing finance; and (2) when these sources were found (government pension funds for example) poor borrowers could not sustain repayments over the term of the loans. As a result, investors were not willing to invest in securitized forms of these loans.[vi] Housing microfinance shows a way out of this cycle by redefining the *object* of housing finance. The unit financed need not always be a complete home, purchased from a previous owner or a commercial developer. Poor people around the world build incrementally. They finance their construction needs with their savings or with what they can borrow from relatives or informal sources.[vii] An incremental approach to financing housing needs significantly reduces the amount to be financed, thus eliminating the need for 10- to 30-year repayment periods.

Stand-alone Housing Microfinance

When the provider has no prior relationship with the client, a survey of existing practice suggests that MFIs allow poor people to repay a housing loan over periods that range from 12 months to five years[viii]. As a result, and given the limited capacity to pay, loans are likely to cover a basic home improvement rather than a substantial addition or a new home. The repayment period is longer than what an MFI engaging in group-based lending usually allows. This is within the range of (or slightly over) what many MFIs allow for individual loans

From a strictly financial standpoint, it would make sense that the repayment period for a stand-alone housing microfinance loan would be close to what MFIs allow for individual business loans. Whatever the housing need, MFIs with stand-alone housing microfinance products should not extend a loan to a client if they believe the client would be ineligible for an individual microfinance loan. (An important difference with a microenterprise loan being, of course, that a housing microfinance client can be a self-employed entrepreneur or a salaried worker.) CHF International, Calpia, ADEMI and other organizations have demonstrated that poor people with no prior links to the provider can take on such a loan and repay it over periods that extend for up to four years (the CHF maximum is three years). A safe recommendation would be to begin testing the product with an 18-month repayment period in cases where the MFI does not have experience with long repayment periods. The period could be expanded for subsequent loans.

Linked Housing Microfinance

Many MFIs link client eligibility for a housing loan to prior participation in a savings or lending program currently offered by the MFI. A survey of current practice shows that many of the MFIs offering linked housing microfinance products tend to work with poor or very poor clients. If they fulfill the eligibility requirement for a housing loan, the clients of these MFIs tend to be offered repayment periods that stretch far beyond what one would expect to see for individual microenterprise loans.

The poorer the clients, the longer the period they will require to be able to afford the sums that housing microfinance require. Because the expanded repayment periods can bring a higher default risk, MFIs, in effect, institute an internal credit bureau and only offer the service to clients that have demonstrated a discipline and track record such that they can be trusted with the larger amount. For instance the Grameen Bank requires two and a half years of participation in its loan program (in addition to clients' savings) as a pre-condition for offering a housing loan. CARD and SEWA Bank require clients to make regular savings payments before they are eligible for a housing loan.

Table 6.2 Repayment periods for 10 housing microfinance providers

Institution	Country	Product Type	Eligibility Criteria Towards Loans
ADEMI	Dominican Rep.	Stand Alone	16 to 36 Months
Calpia	El Salvador	Stand Alone	Up to 60 Months
Mi Banco	Peru	Stand Alone	Up to 120 Months
FUNHAVI	Mexico	Stand Alone	18 Months
CHF/Gaza*	Gaza	Stand Alone	36 Months
Genesis	Guatemala	Stand Alone	Average of 30 Months
Banco Sol	Bolivia	Stand Alone	Average of 80 Months
CARD	Philippines	Linked	12 Months
Grameen (basic)	Bangladesh	Linked	120 Months
SEWA	India	Linked	60 Months

Source: IFC, HIID, Daphnis/CHF MFT Course Survey.

Pricing

In principle, pricing a financially viable housing microfinance loan should be no different than pricing any other microfinance product. The effective annual interest rate a provider charges to its clients should reflect the competitive costs of providing the service to the clients, the financial costs of procuring funds for the housing loans, and the capitalization (including, as appropriate, profit) rate. The rate should also be offset by investment and other income generated outside of lending operations.

MFIs and NGOs pricing a housing microfinance service should use an advanced financial planning model such as Microfin[ix] to estimate the effective interest rate that will lead to financial viability. As Rosenberg demonstrated,[x] a simplified pricing formula for microfinance loans can be expressed as follows:

$$\mathbf{R} = \frac{\mathbf{AE + LL + CF + K^{xi} - II}}{1 - LL}$$

Where (R), "the annualized effective interest rate […] will be a function of five elements each expressed as a percentage of outstanding loan portfolio: administrative expenses (AE), loan losses (LL), the cost of funds (CF), the desired capitalization rate (K) and investment income (II)".

The resulting interest rate should allow the MFI to cover all operational and financial costs, capitalize its portfolio at the desired level and, if applicable, provide a return to its investors.

Administrative Expenses

Organizations planning to offer housing microfinance should spend time planning for the expenses they will allocate in support of that service. Assuming the housing loan will seek to be financially viable on its own and will not be subsidized by other products the provider offers, projected administrative expenses should reflect product-specific cost accounting. (All costs should be annualized and expressed as a percentage of the outstanding loan portfolio.)

- *"Line" Staff Costs.* What is the total cost of paying competitive salaries for program managers, loan supervisors, loan officers, promoters, and for any support staff working on ensuring successful delivery of the housing microfinance product. If the provider plans to offer construction assistance to its clients, what will be the costs of paying for staff architects/engineers and construction specialists, or what will be the cost for outsourcing these services?
- *Management and Overhead Costs.* If the organization is not built around housing microfinance, what is the estimated value of the senior staff time that will be spent working on the housing service? What is the estimated percentage of indirect costs (rent, accounting, equipment acquisition and depreciation) that is attributable to delivering the service?
- *Other Direct Costs.* Other important costs the provider should consider include staff training on the new methodology; transportation costs (which may be higher than for other products if the provider offers construction assistance involving frequent field visits); communications; supplies; equipment; outside consulting; and "bridge" cost of funds, if the provider is purchasing construction materials in bulk on behalf of clients.[xii]

Loan Loss

Setting up a loan loss reserve and provisioning for loan losses should be consistent with best practices in microfinance. At the onset of the program, the provider should set a loan loss reserve as a negative asset on its balance sheet. The amount in the reserve should reflect expectations for long-term losses. Current practice suggests that most successful providers of housing microfinance services have repayment rates of 97% or higher. Thus, if the provider has no methods of estimating its future long-term losses, the initial loan loss provision should be set at 3% of the outstanding loan portfolio. At regular intervals (for instance every three months) the provider can chose to make loan loss provisions to ensure that its reserve reflects the expected long-term losses. The annual total for these provisions should be expressed as an appropriate percentage of the portfolio at risk and incorporated into the pricing formula.

Cost of Funds

When pricing a housing microfinance loan, the cost of funds should reflect a realistic understanding of what the provider would have to pay for the required funds on a non-subsidized basis. As Rosenberg reminds us, "the figure computed here is not the MFI's actual cost of funds. Rather, it is a projection of the future "market" cost of funds as the MFI grows past dependence on subsidized donor finance, drawing ever-increasing portions of its funding from commercial sources."[xiii] Rosenberg goes on to suggest that an appropriate method of estimated cost of funds is to chose a point in the mid-term future of the institution and to estimate what a weighted average cost of fund will be at that point, taking into account the three most likely sources for these funds: (1) commercial loans; (2) client deposits; and (3) provider equity.

Estimated costs of funds for loans to outside parties should always reflect what the provider would have to pay to borrow funds from commercial sources—even when actual loans on the provider's balance sheet carry much lower interest rates. This ensures that the provider has incorporated in the interest rate it charges its clients what it will actually cost to raise funds in order to meet future growth. Rosenberg also recommends that the cost of funds on client deposits mirrors what commercial institutions offer their clients, even when the actual rate paid to current clients is lower. If the provider offers clients a higher interest rate than what commercial banks offer, the higher rate should be used to calculate the weighted cost of funds. Finally, the provider's financial assets net of its financial liabilities should be used to determine the equity to which a cost of funds should be applied.[xiv] For the purpose of calculating a weighted average, a reliable projection of the annual inflation rate should be applied as the cost of funds on this modified net financial equity, as inflation erodes the purchasing power of the organization's equity.

A formula for the weighted cost of funds (CF), calculated to reflect the MFI's market position and to allow for financial viability of the provider at a set point in the future, could be as follows:

$$CF = \frac{\left(\frac{L * i_1}{L/P}\right) + \left(\frac{D * i_2}{D/P}\right) + \left(\frac{E * i_3}{E/P}\right)}{P}$$

L is the total amount in annual loans that the provider estimates it will have to borrow to finance its total outstanding portfolio and i_1 is the interest rate it will have to pay to procure these funds commercially. D is the value of deposits the provider expects to attract at the time for which the cost of funds is calculated and i_2 is the higher of (1) the rate commercial institutions pay for client deposits or (2) what the provider thinks it will have to pay at that time. E is the provider's projected modified equity (as calculated in the preceding page) and i_3 is the annual inflation rate.

Note that this formula for calculating the cost of funds for a housing microfinance loan only works if the provider assigns the same cost of funds to its entire product line.

Capitalization and Profit

The provider should price its loans in such a way that it is in a position to retain some of its yearly earnings after all operational and financial costs have been paid, and after loan losses have been taken into account. The MFI can apply retained earnings to capitalize its portfolio in order to increase the nominal value of the portfolio—real value can also be maintained if the capitalization rate is higher than the rate of inflation. The MFI can also choose to distribute some of its retained earnings as profit to shareholders.

A survey of current practice shows that interest rates charged on housing microfinance loans are either on par with or lower than interest rates charged for other microfinance loans in the same markets. An important factor in pricing discrepancies between housing microfinance and microenterprise lending could reside in the fact that many MFIs view housing loans as less risky (thus requiring lower loan loss reserve provisions) if the loan is secured by the value of the home. MFIs that offer linked housing microfinance products may also feel that long-term default risk is less than it is for other products.

Table 6.3 Pricing for 10 housing microfinance providers

Institution	Product Type	Microenterprise Loan	Housing Loan
ADEMI	Stand Alone	18% to 24%	Not Applicable
Calpia	Stand Alone	32%	23%
Mi Banco	Stand Alone	30% + (MiCapital)	45% (Mi Casa)
FUNHAVI	Stand Alone	Not Applicable	58%
CHF/Gaza*	Stand Alone	11%	15%
Genesis	Stand Alone	35%	25%
Banco Sol	Stand Alone	32%	23%
CARD	Linked	20%	20%
Grameen (basic)	Linked	20%	8%
SEWA	Linked	17%	14%

*Average interest charged by partner banks

Affordability Analysis

The MFI is ready to look at affordability when it has acquired an understanding of capacity to pay, established a basic range for loan terms (including notably security requirements, repayment period, and interest rate), and assessed the costs for the housing interventions it believes clients will require. A housing microfinance loan is affordable when the MFI projects that clients will be able to finance their housing needs under terms that contribute to overall financial viability.

A successful outcome to the affordability analysis does not guarantee that the loan will be successful in the marketplace—demand is effective only when clients, in large numbers, actually access and repay housing loans. Still, the affordability test is an important part of the analysis an MFI should go through before it can launch a housing microfinance service.

The affordability framework presented in this paper assumes the MFI is interested in developing a financial service that matches a perceived demand for an established range of housing needs. As previously discussed, if the MFI's primary objective is to provide its clients with a consumer credit facility that uses housing for marketing purposes or as a touchstone for the loan amount, the affordability test will only be a function of the capacity to pay and of the loan terms—and not a function of the what types of housing interventions may actually be in demand.

For MFIs interested in assessing whether clients will be able to afford a range of housing interventions perceived to be in demand, the affordability of a loan will be a function of the following variables: (1) the clientele's estimated capacity to pay; (2) the loan repayment terms (including most notably repayment period and financially viable loan pricing); and (3) the costs of the housing solutions clients are likely to demand.

Determining product affordability is not a linear process. Rather, it should take the form of a sensitivity analysis examining the relationships among capacity to pay, loan terms and housing costs. Client capacity to pay (expressed as a percentage of household income, for instance) should be independent of loan terms and housing need—there is only so much a family can spend on a new loan that does not (necessarily) lead to additional income in the short term. The allowable loan repayment period is a function of the default risks the MFI associates with a particular client and of the MFI's overall worldview on microfinance or housing finance. Loan pricing is a function of variables that are internal (operational costs), external (commercial cost of funds, inflation rate), or a mixture of both (portfolio performance). The affordability analysis brings all these variables together by analyzing various scenarios under which the MFI could deliver the new product to eligible clients.

The process for the housing microfinance affordability analysis can be summarized as follows:[xv]

1 In a first phase, the MFI should conduct a sensitivity analysis for each proposed improvement, solving for the monthly loan amount, given a set interest rate. The repayment period will be the variable. Note that this assumes both loan amounts and repayment period can fluctuate within a range the MFI finds acceptable.

2 The MFI can introduce an additional dimension to the analysis by testing affordability for different interest rates. This is useful if the MFI wants to assess impact on affordability of construction assistance or of any other feature that will affect product pricing.

3 The MFI should compare resulting monthly loan payment amounts with the target clients' estimated capacity to repay.

4 From this analysis, the MFI will be able to determine, for each improvement, the percentage of potential clients who will be able to afford a loan, under what repayment period, and according to what interest rate.

Construction Assistance[xvi]

Many MFIs offer construction advice or supervision as an integral part of housing microfinance. Many more do not. The purpose of this section is to provide guidelines to MFIs that are considering developing this type of technical help for their clients.

If the MFI plans to offer no form of construction assistance, the housing microfinance loan is, in effect, a consumer loan whose declared purpose is housing but whose ultimate use is up to the client. The proposed construction project provides a rationale for estimating a required loan amount. In addition, calling the loan a housing loan may help the MFI market the new product to its clients. Ultimately, repayment performance determines the client's future standing with the institution—as opposed to whether or not the housing work has been completed in accordance with original loan documents.

When an MFI is considering whether to incorporate construction assistance into the design (and pricing) of a proposed loan, it may be useful to consider the MFI's attitude towards the familiar microfinance concepts of "due diligence" and "follow up". Some MFIs regularly conduct *pre-disbursement* due diligence on a microenterprise loan in order to determine whether the requested loan amount will provide a match for the intended purpose of the loan. In the case of housing microfinance, such pre-disbursement assistance can notably include the following activities:

- Basic construction design to ensure that the proposed intervention complies with basic safety and legal requirements;
- Budget verification to ensure that the proposed cost estimate for the intervention is appropriate and matches the client's loan request;
- Guidance on materials and labor procurement, tapping into the provider's knowledge of these markets to help clients make cost effective decisions; and
- Assistance with permits and other legal requirements.

Within the realm of microenterprise lending, some MFIs also follow up, *post-disbursement*, to ensure that clients fulfill the original purpose of the loan. In the case of housing microfinance, this could be translated into the following activities:

- Construction oversight to ensure that the builder/contractor faithfully executes the work for which he/she has been hired; and
- Verification that the construction has been completed in accordance with the MFI's agreement with the client or in compliance with applicable law.

From an organizational standpoint, an MFI can provide construction assistance to its clients in one of two ways. The MFI can build the capacity in-house by hiring, training and fielding the combination of professionals and skilled workers it believes will get the job done. Alternatively, the MFI may decide to outsource the work to a specialized firm, an NGO or a cadre of individuals.

Loan Security

MFIs use a variety of strategies to secure housing loans, including most notably co-signers. Traditional housing finance providers (including commercial banks), on the other hand, have typically relied on a mortgage (a lien against the actual property) as the main form of security for long term housing loans.

Many institutions do not believe that formally collateralizing a housing microfinance loan is necessary for the loan's success in the marketplace. CHF International, for instance, makes a strong case for using co-signers instead of actual collateral:

> "Co-signers provide the greatest security at the lowest cost [...] The challenge of using collateral is securing the asset, ensuring the right to seize it should the borrower default, and liquidating the asset to repay the remaining loan balance. Many countries do not have the legal system that supports the use of collateral to secure a loan. The lack of legal regulations can make it difficult to secure and seize collateral offered… Placing a lien or deed of trust on a home and, in the case of default, foreclosing on the house can be a costly and lengthy process. Additionally […] placing a lien on a home for a minimal loan amount also would over-collateralize the loan and under-utilize the borrower's financial asset, thereby putting an undue burden on the borrower.[xvii]

Co-signers should be adequate if the loan is small in relation to the market value of the home. Co-signers must pass the same eligibility tests as the actual borrower, and the MFI should establish a clear procedure to access the co-signer's resources in case the client defaults.

Land Issues

In many countries where MFIs operate, poor families cannot reliably produce formal proof of ownership for the land on which they live. Yet, for many of these families, that land and the dwelling built on it constitute the most important asset the family will ever own. Governments throughout Latin America, Africa, and Asia have enacted land reform and land regularization programs—but results have not always lived up to expectations. The need for shelter (and, thus, land) is a basic human need. When societies do not develop the legal, organizational and economic underpinnings to help people acquire land and conclusively document the exclusive right to ownership, people still find ways of procuring, investing in, and holding on to land. Unfortunately, whereas land acquisition can and does take place with varying degrees of legality, the acquired property (inclusive of the value of any investment to improve that property) often becomes a "locked" asset. The asset cannot be transferred to another party or used to secure a loan from a regulated financial institution because no formal documentation exists to evidence ownership. Some economists, including most notably Hernando de Sotto, argue that the lack of documented land tenure and the resulting lock on the asset is a major factor explaining economic under-development.[xviii]

In an ideal world, housing microfinance clients would live on land that is properly registered, they would pay taxes, and they would be able

to enjoy a full range of services resulting from legal ownership. In the real world where housing microfinance thrives, this is usually far from the norm. Land-related issues constitute one of the principal unknowns microenterprise-lending institutions face when they expand into housing finance. Similarly, the lack of land tenure has long been a source of frustration and a major impediment to scaling up existing services for housing finance institutions targeting the poor.

In the specific context of product design, land issues affect housing microfinance from a legal and from a risk standpoint. On the *legal* side, MFIs must determine whether they are able lend to a client without incontrovertible evidence that the client has a legal right to occupy the land. If relevant regulations stipulate that housing loans may not be extended without formal property titles, MFIs will not be legally able to develop a "housing" loan.[xix] In these cases, interested MFIs can still develop a multi-purpose consumer loan and tailor the loan amount and the repayment period to the desired level. ADEMI, for instance, currently offers such a loan – but it is not formally able to classify it as a housing product or track its true impact, as clients are free to use the money for purposes other than housing. If regulations do not explicitly require a linkage between loan eligibility and evidence of titling, MFIs have greater flexibility in addressing the land tenure issue. In such cases, the *financial* (repayment) risk MFIs associate with varying levels of land ownership – a function of the MFI's analysis of clients' land *security* status, as opposed to their land *tenure* status – should influence the MFI decision to finance a loan.

In the context of housing microfinance, a client enjoys land security when the following conditions exist: (1) she has the use of a property at the time the loan application is made; (2) the MFI determines that the client will not be forced to vacate the property during the time it takes to repay the loan; and (3) that determination is supported by usual and customary local practices.[xx] In other words, in the absence of legal proof of ownership, the MFI should satisfy itself that potential clients would not be forcibly evicted while the loan is still active. The underlying assumption is that repayment performance will be enhanced if the client has a vested long-term interest in the property being financed.

Criteria for land security should vary from country to country – and perhaps within a given country, from MFI to MFI based on the MFI's attitude towards risk. Some of these criteria, include notably:

- A written agreement between the buyer and seller of the land;
- A long-term rental agreement between the homeowner and government for use of public lands;
- The number of years during which a family has inhabited a property without paying rent and without due notice from the rightful owner; or
- Payment by the homeowner of taxes to the government.[xxi]

In addition to tenure, another important land-related risk factor the MFI should consider is whether the property can serve as collateral for the loan. In many countries, housing loans carry lower interest rates than business loans because the value of the property serves as an actionable guarantee against a potential delinquent loan. The guarantee can be

close to the assessed value of the property in the case of a home mortgage loan. It can also be equivalent to the assessed value of the property, clear of existing liens, for home equity loans. In the context of housing microfinance, however, using the property as collateral can be problematic for several reasons. If land tenure is uncertain or foreclosure laws are not well developed, it may be difficult for the MFI to foreclose on the property should a client default on a loan. Even when local laws allow the MFI to take over the property of a delinquent client, other barriers may prevent the MFI from finding a new owner for that property. A formal real estate "market" may not exist allowing for accurate valuation of the property; potential buyers may not have the financial resources (savings or financing) to purchase the property at the agreed upon value. Assuming all these barriers could be overcome, the MFI will have to decide whether it wants to be involved in the business of taking over and selling real estate—a new line of business for enterprise-focused MFIs. An equally important issue is that of the relationship between the value of the collateral and the value of the loan itself. In most cases, a housing microfinance loan amount will be far less than the value of the combined value of the home and the land. It is not given that clients will be willing to mortgage their entire property for a loan that may be worth a fifth (or less) of the value of that property.

In the end, MFIs must decide for themselves whether the property (including notably the land) is an adequate guarantee for a housing microfinance loan. In cases where the value of the loan approximates the value of the property, or when the relevant laws allow for foreclosure on and resale of that property, or when a real estate market actually exists for the type of property considered, this may be a viable option. In most other cases, collateral substitutes or non-property types of collateral are more realistic options.

2. Overview of Sida's Programs in Central America

Costa Rica

The Ministry of Housing and Human Settlements (MIVAH) is responsible for implementing Costa Rica's housing policy. The country's housing subsidy program has long been the principal instrument for providing access to housing for low-income populations, along with housing construction to stimulate the economy. The main institution involved in implementing the state housing policy and its programs other than MIVAH is the *Banco Nacional Hipotecario de la Vivienda* (BANHVI). Financial institutions authorized to intermediate subsidies do not include MFIs; only "mutuals", public and private banks and cooperatives have that authority.

Delivery Mechanisms (Program Structure) for Sida Assistance

FUPROVI, the Sida-supported institution in Costa Rica, was established as a non-profit organization in July of 1987. In 1988, Sida began to help FUPROVI provide financial and technical assistance to low-income families who did not have a home or whose homes required repairs or improvements. By 1996, Sida's support for FUPROVI had reached US$18.7 million. The following year, Sida established a trust fund to support future FUPROVI activities, rather than vesting the accumulated capital directly with that institution. As of December 2001, the net worth of the trust fund was US$18.83 million. The trust fund's balance sheet suggests that FUPROVI (who currently acts both as fund manager and program implementer) is investing a significant portion of the fund's assets (44%) in capital market instruments. Income from these investments helps cover the fund's operating costs.

Overview of FUPROVI

FUPROVI is a retail lender and offers lines of credit for three types of projects: (1) home construction on a lot owned by the borrower; (2) purchase of a lot and home construction; and (3) home improvements and repairs. FUPROVI operates both group and individual loans. Further, FUPROVI has entered into an agreement with Banco Popular that allows the bank to provide loan financing directly to FUPROVI clients. FUPROVI provides construction, administrative and legal assistance to borrowers and submits the loan applications to the Bank. Since 2001,

FUPROVI has presented 40 loans to Banco Popular totaling $61,500; of these, 39 had been approved as of the fall of 2002.

FUPROVI also uses the Trust Fund's resources to provide bridge financing for new construction projects. The December 2002 Balance Sheet shows $3.2 million invested in projects representing nearly 500 homes under construction. Once these homes are constructed, FUPROVI will work with purchasers to finalize individual loans. The sale of these homes is expected to generate a significant increase in the Trust Fund's loan portfolio over the coming year. Still, the Trust Fund has limited capacity to take on significant new long-term loans. FUPROVI expects to benefit in this regard from its relationship with Banco Popular, which as a private sector bank can access housing subsidies for clients and finance long-term loans.

FUPROVI's Housing Loan Portfolio[2]

Portfolio of Individual Loans	$4.9 million
Portfolio of Group Loans	$0.57 million
Total Housing Loan Portfolio	$5.47 million
Number of Housing Loans Outstanding	1746
Average Housing Loan Amount	$3,133
Average Housing Loan Term	10 years
Portfolio at Risk[3], December 2001	20.22%
Portfolio at Risk, June 2002	1.45%

Clientele

While FUPROVI works throughout Costa Rica, the organization gives priority to the metropolitan area surrounding the capital city of San Jose. FUPROVI also gives priority to families in the lowest income levels and to women-headed households. In December 2001, households earning no more than twice the country's minimum salary held 93% of the portfolio outstanding, while women accounted for 34% of that same portfolio.

Housing Loan Summary

FUPROVI is a retail lender. Among all of the Sida-supported institutions in Central America, FUPROVI comes closest to offering products that resemble a traditional mortgage loan. Repayment periods can reach 15 years and the loan can finance a new construction. The following table provides an overview of FUPROVI's housing loan.

[2] As of December 2001.

[3] For loans 60 days past due or greater.

Targeting:	a) Less than 6 minimum salaries, with emphasis on the lowest income families and women. b) Priority on sites in and around the capital city of San Jose.
Eligibility:	a) Form part of a nuclear family. b) Live in the home to be financed. c) The borrower contracts the labor required for construction or provides it himself or herself.
Affordability:	Up to 30% of the family's net income (Net income is considered to be gross income less taxes).
Loan Amounts:	Minimum: $800 Maximum: $22,000 – New construction on previously owned land: up to 100% of the budget according to the appraised value. – Purchase of lot and construction: up to 80% of the budget according to the appraised value. – Expansion, improvements and repairs: up to 80% of the budget. Minimum: $1951; Maximum: $13,196
Loan Term:	Up to 15 years for new constructionUp to 8 years for improvements and repairs
Interest Rate:	19% per year
Commission:	10% for construction assistance 2% for administrative fees 2.5% for legal costs

Construction Assistance

FUPROVI offers a comprehensive range of construction assistance services to its clients. These services notably include: research into the legal status of land ownership; property appraisal; construction design and planning; facilitation of construction permits; budgeting; construction oversight; assistance with the acquisition of necessary documents to facilitate a loan.

FUPROVI charges a 10% loan commission for construction assistance. Of this, 4% goes to cover the cost of design, 3% the cost of construction oversight, 2% the cost of financial oversight, and 1% covers budgeting services.

Subsidy Component

The national housing subsidy program requires that a housing solution for a low-income family contain three financial components: a contribution by the family, the subsidy and a loan. Families can contribute in various ways including providing land, self-help construction, savings, and materials. In order to apply for a subsidy, families must earn under four times the minimum salaries. Further, families cannot own other property, nor can they have benefited from a prior housing subsidy. Formal financial sector institutions typically process the application for a subsidy. If the applicant is selected for a subsidy by MIVAH, the funds are disbursed to BANHVI, and BANHVI pays FUPROVI. Families who receive a subsidy must live on the property, and are not permitted to sell, rent or mortgage the property.

Linkages with Infrastructure and Basic Services

All new construction is provided with complete basic services, including water and electricity. Clients can use home improvement loans to pay for accessing basic infrastructure services.

Guatemala

In 1996, the Guatemalan Congress passed a new housing and habitat law designed to foster the availability of affordable households for poor families. The new legal framework opened the path for increased mortgage lending by the private financial system and replaced the previous policy of subsidizing loans via *Banco Nacional de la Vivienda* (BANVI). The *Fondo Guatemalteco Para la Vivienda* (FOGUAVI), established in 1992 and restructured in 1995, became the main instrument for the government's affordable housing policy. FOGUAVI's main objective has been to offer up-front subsidies to low-income earning households and to facilitate access to loans via approved intermediaries. With a total of $60 million in loan from the Inter-American Development Bank and $49 million from the Government of Guatemala, 85% of FOGUAVI funds have been used as direct subsidies to poor households— families living in poverty or extreme poverty (living on less than US$2 or US$1 per day, respectively). This population totals six million people, or 56.7% of the Guatemalan population.

FOGUAVI subsidies can be used in one of four ways: purchase of a plot with basic services; construction or purchase of a home; home improvement or repairs; installation and/or access to basic services for the home;

At time of writing, FOGUAVI's activities are on hold, the result of widespread problems with the disbursement of prior subsidies. Although reliable information on the extent of these problems is hard to come by, FOGUAVI released a plan for fiscal year 2002 that estimated at $51 million FOGUAVI's liability for subsidies approved in previous years, but not yet paid. While the plan is unclear as to whether all subsidies approved in 2002 are included in this figure, FOGUAVI currently does not have the funds to offer additional subsidies.

Delivery Mechanisms (Program Structure) for Sida Assistance

The *Fideicomiso para el Desarrollo Local en Guatemala* (FDLG) began as a program concept in 1998. The program was based on a proposal from the Government of Guatemala to Sida and was initially set up as a trust fund housed in the *Banco del Café, S.A.* (Bancafe). FDLG's objective is to improve the living conditions of low-income families living in urban and peri-urban areas as well as in densely populated rural areas through

home improvement, infrastructure, basic services and microenterprise activities. As the fund manager, Bancafe is responsible for receiving, disbursing and accounting for all Sida financial resources earmarked for FDLG. The Trust Fund Committee includes one representative of Sida, one representative of the Planning and Programming Ministry, and three other members. A "Technical Unit" is responsible for program implementation, working with microfinance institutions and municipal governments. The Trust Fund Committee carries out all of the standard activities of a Board of Directors, including oversight of the fund manager and of the Technical Unit.

FDLG operates as a second-tier lender, providing capital both to MFIs for housing and microenterprise loans and to the *Instituto de Fomento Municipal* (INFOM) for on-lending to the municipalities. Housing microfinance loans are only offered via MFIs. FDLG currently has a lending relationship with five MFIs and one with the federation of cooperatives. Of these institutions, four engage in housing microfinance: *Genesis Empresarial*, *Hogar y Desarrollo* (HODE), *Asociacion de Cooperacion Tecnica* (ACT), and *Federacion Nacional de Cooperativas de Ahorro y Credito* (FENACOAC). In a recently produced document, FDLG is proposing a second phase of the program to consolidate its activities, develop a sustainability strategy, and assess the possibility of generating sources of funding that can complement those provided by Sida.

Overview of FDLG

With respect to housing, FDLG's strategy is to finance the construction of new homes as well as home improvement lending. New home constructions, based on the availability of subsidies from FOGUAVI, are currently on hold. With respect to home improvements, FDLG provides both loans and technical assistance to its borrowers.

The Housing Loan Portfolio

FDLG Housing Loans Committed	$2,652,030
FDLG Housing Loan Portfolio	$1,399,466
FDLG Number of MFI Housing Loans[4]	5
FDLG Average Loan Amount	$372,000
FDLG Average Loan Term[5]	59 months
MFI Active Housing Loan Portfolio	$814,568
Number of MFI Housing Loans Outstanding	938
Average MFI Housing Loan Amount	$1,037
Average MFI Housing Loan Term[6]	36 months
Portfolio at Risk	0

[4] Each of the four MFIs has taken on one loan each for housing; one of these, ACT, has taken on a second loan.

[5] Weighted average.

[6] FENACOAC cooperatives are the only exception, with average loan terms of 51 months.

Wholesale Financial Products

The following table provides an overview of the terms and conditions under which FDLG makes financing available to retailing organizations.

Eligible Institutions:	First and second-tier lenders, and housing and infrastructure organizations
Eligibility Criteria:	a) Eligible institution b) Operations (or interest in operating) in one of the five following departments: Quetzaltenango, Chimaltenango, Escuintla, Jalapa and/or Solola.
Evaluation Criteria:	a) Institutional strength b) Impact of existing programs c) Democratic and transparent governance structures d) Organizational autonomy e) Implementation capacity f) Favorable financial position and backing g) Successful and prolonged experience with credit programs h) Experience in participative community projects i) Ability to provide loan guarantees
Maximum Loan Amount:	First Loan: Up to 50% of active loan portfolio with zero delinquency Additional Loans: Up to 150% of the previous loan if: – 80% or more of previous loan has been placed – On-time repayment of any previous loan(s) – Portfolio at risk greater than 30 days no greater than 8%
Interest Rate:	8% (down from 12% in 2000)
Loan Term:	Up to six years
Repayment:	Quarterly payments with: a) One-year grace period on repayment of capital b) Two-month grace period on payment of interest
Credit Risk	Borne by MFI
Security	First Loan: 125% guarantee Additional Loans: 100% guarantee Guarantees can include the following: – Existing loan portfolio – Investments – Mortgageo Co-signer
Late payment charges:	5% per month on delinquent amount
Construction Assistance:	Provided by Borrowers in all cases

Retail Financial Products

The following table provides an overview of the key features for the housing microfinance loans extended by retailing MFIs working with FDLG and Sida funds.

Use of Home Improvement Funds:	As required by FDLG: a) Approved uses: – New home construction, enlargement, repairs or improvements – Protective constructions including retaining walls, drainage, reforestation, and land reclamation – Basic services including access to water and electricity – Land legalization All loans should strengthen community participation and where applicable assess the possibility of coordinating with State subsidy programs. b) Non-approved uses: – Land purchase, debt repayment, shares, general and administrative costs, loans to persons whose level of indebtedness is greater than their capacity to repay
Targeting:	As required by FDLG: a) Populations must reside in the urban and peri-urban areas of the departments of Quetzaltenango, Chimaltengango, Escuintla, Jalapa and Solola b) Beneficiaries of loans should be equally men and women, with an objective to strengthen the position of women c) Monthly family income less than $400 and 60% of families with monthly income less than $200
Eligibility:	HODE – At least 18 – Guatemalan citizen – At least one year employment in same activity – Income of at least one minimum salary and falling within established ranges for poverty and extreme poverty per capita differentiated for rural and urban areas.· Genesis Empresarial – Between the ages of 18 and 65 – Steady or seasonal employment or be self employed – Repayment capacity – Owner of the home and land – Good references – Willing to participate in training activities and receive technical assistance· ACT: – At least 18 – Fixed income – No other debt – 20% down payment on total cost of project – Property ownership· FENACOAC Cooperatives: – Cooperative member in good standing – On time with any other loans with the Cooperative – Good credit history – Repayment capacity – Good references

Affordability:	a) HODE: Capacity to pay is required, specific percentage not specified b) Genesis Empresarial: Up to 80% of monthly disposable income c) ACT: Capacity to pay is required, specific percentage is not specified d) FENACOAC Cooperatives: Capacity to pay is required, specific percentage not specified
Maximum Loan Amounts:	Maximum loan per FDLG: US$ 3,050 a) HODE: $1,250 (additional $2,500 for new home construction from HODE funds) b) Genesis Empresarial: $1,282 ($2,500 for non-FDLG housing loans) c) ACT: $3,750d) FENACOAC Cooperatives: $2,500
Loan Term:	a) HODE: 4 years (for new home construction) b) Genesis Empresarial: Up to 24 months (36 months for non-FDLG housing loans) c) ACT: 7 – 18 months for loans up to $1,250; up to 36 months for loans greater than $1,250. d) FENACOAC Cooperatives: up to 51 months
Interest Rate:	a) HODE: 25% b) Genesis Empresarial: 24% c) ACT: 25% d) FENACOAC: 11% to participating cooperatives; Cooperatives to Clients: 17% –18%
Commission:	a) HODE: 8% b) Genesis Empresarial: 3%, can be financed over 6 months c) ACT: Yes, amount charged not specified d) FENACOAC Cooperatives: Yes, amount charged not specified
Payments	Monthly in all cases
Security:	a) HODE: Co-signer; solidarity, mortgage, pawn b) Genesis Empresarial: Solidarity, lien, co-signer c) ACT: Co-signer, pawn, mortgage, other assets d) FENACOAC Cooperatives: Co-signer, mortgage, FENACOAC guarantee fund
Currency:	Quetzales

Construction Assistance

FDLG provides technical assistance to its borrowers in two areas: institutional strengthening and construction assistance. In general, this technical assistance is provided with the objective of improving institutional efficiency and increasing the organization's ability to expand its areas of work. With respect to construction assistance, the objective is to institutionalize that component within each MFI in order to ensure quality construction. All supported MFIs – ACT, HODE and Genesis Empresarial – have implemented similar methods for providing construction assistance. At the branch level, each MFI employs both credit advisors and construction assistance advisors. The credit and construction assistance advisors report to the branch manager and all have an indirect relationship with a national level staff person responsible for coordinating the MFI's construction assistance program. Only in the case of ACT are the credit and construction assistance functions carried out by the same person.

In order to apply for a home improvement loan, clients are provided with assistance in developing a construction plan and a budget. Modifications to the plan and budget are made by the construction assistance advisor based on the client's loan repayment capacity, as determined by the credit advisor. The services provided include a diagnostic of the home site and construction oversight through technical assistance provided to clients during site visits (up to three, depending on the situation.) Because HODE works with groups, its credit advisors perform additional functions related to group creation, organizing and training.

Subsidy Component

FDLG provides a subsidy component to borrowing institutions in the form of grant funding for training, marketing, (limited) equipment purchase, and program design. MFIs may not use funds to cover salaries, operating costs, debt payment, investments, or general and administrative costs.

Linkages with Infrastructure and Basic Services

FDLG provides loans to MFIs and municipalities for basic services and infrastructure projects. Of the MFIs, only Genesis experimented with a program to provide loans for basic services. FDLG has identified four projects for co-financing with municipalities. They include a solid waste plant, a municipal slaughterhouse, a bus terminal, a bridge, a shopping center and a health post. Anticipated loans for these projects in four municipalities total nearly $1 million.

El Salvador

El Salvador's housing finance system comprises government financing institutions, banks, NGOs and other housing finance institutions. The *Fondo Social para la Vivienda* (FONAVIPO), located within the Ministry of Housing and Urban Development, provides both lines of credit and subsidies to housing finance institutions targeting poor and middle income earning households. The subsidy program, designed to support new housing and not home improvements, has experienced severe difficulties due to low levels of funding.

Delivery Mechanisms (Program Structure) for Sida Assistance

FUSAI, a private non-profit organization created in 1994, entered into an agreement with Sida in 1999 to create a revolving loan fund for low-income housing construction and improvements. When it signed the agreement with Sida, FUSAI had already developed 25 housing projects, benefiting 3,000 families with the help of approximately $3.5 million in

state and municipal funding. Over the years, Sida's total contribution to FUSAI has reached $5 million. Approximately $3.8 million has been used in the revolving loan fund. Sida's support to FUSAI was initially designed to alleviate the country's need for home construction and improvements, a need that was significantly exacerbated by Hurricane Mitch. In addition to helping expand the scope of FUSAI's programs and contributing to that organization's financial self-sufficiency, Sida's funds also supported institutional strengthening, particularly in the areas of administrative systems, promotion and training.

Overview of FUSAI

FUSAI's goal is to be El Salvador's principal development finance organization. FUSAI's operations unfold along three major axes: (1) a Habitat program supported by Sida funding and FUSAI's own funds; (2) a newly created finance organization (*financiera*) called Integral, that is taking over all of FUSAI's lending activities; and (3) a training and capacity building unit. FUSAI's carries out its housing work both through Integral and through its FUSAI Habitat division.

FUSAI Habitat's mission is to promote and implement integrated housing solutions and to lower the deficit in housing and improve access to basic services among low-income populations (with incomes of less than four minimum salaries). FUSAI Habitat operates in ten of the country's fourteen departments, with the majority of its work concentrated in the six departments comprising and surrounding San Salvador. Habitat offers four products: (1) the development of new settlements – the *Nuevos Asentamientos Humanos* program (NAO); (2) housing lots with services; (3) new home construction, and (4) home improvement. The Habitat Program provides construction assistance, state subsidies where available, access to loans, and requires in-kind community participation. Loan fees completely cover the cost of technical assistance.

Habitat's NAO program is specifically designed to reach families in the two minimum wages and below category. The methodology is participatory and group-focused, first identifying populations interested and able to pay for a new home, identifying and purchasing a lot for the project, and constructing the homes along with the provision of basic services. Interested clients are prescreened to ensure that they are able to afford the home and are in fact interested in participating, and begin contributing monthly to a down payment throughout the construction phase. Once the construction is finalized, clients who have no delinquent payments qualify for an individual loan. The other three types of loan offered by FUSAI Habitat are individual in nature and are accessible to clients with average incomes of four minimum salaries or less.

In May of 2002 FUSAI, in partnership with the Duenas-Herrera Foundation, Accion International and the Inter-American Development Bank, established a new financial institution called *Apoyo Integral, S.A. de C.V.* Integral, as it is commonly known, is a for-profit financial organization whose objective is to manage FUSAI's $9 million loan portfolio. FUSAI and Integral signed a "fund administration" contract through which FUSAI contracted Integral to manage its Sida-funded revolving loan fund ($2,497,092.50 as of May 30, 2002).

Integral's Housing Loan Portfolio

Total Loan Portfolio	$8,701,970
Housing Loan Portfolio	$3,708,170
Individual Loans	$1,454,560
Community Loans (NAO)	$1,613,610
Number of Housing Loans Outstanding	3,259
Average Housing Loan Amount	$1,138
Individual Loans	$1,248
Community Loans	$771
Average Housing Loan Term[7]	2 – 5 years
Portfolio at Risk	9.2%

FUSAI maintains a separate accounting of the Sida-funded housing revolving fund. As of December 31, 2001, the total value of the Fund was $5.8 million. The difference between the amount under administration by Integral and the total amount of the Fund remains with FUSAI and is used for the Habitat program. The principal assets of the Fund in December 2002 (not including the housing loan portfolio) were: cash, accounts receivable, inventory and construction projects in process (FUSAI partly finances NAO projects and basic services projects from the Fund, essentially as bridge construction loans.)

Clientele

While FUSAI's Habitat Program targets families with four minimum salaries or less, Sida funds are available to those with three minimum salaries or less. Loan financing is available whether or not the families can benefit from state subsidies, although their ability to participate in any FUSAI program is always dependent on their capacity to pay.

Wholesale Financial Products

With the establishment of Integral, FUSAI now operates as a wholesale financial institution. Although Integral has the ability to raise funds on its own, particularly from El Salvador's financial system, its main source of financing is FUSAI itself. FUSAI provides funding through an equity investment (resulting mostly from the transfer of its original loan portfolio), debt and fund management contracts.

[7] Dependent on loan type.

Overview of FUSAI/Integral Fund Management Product for Sida Funds

Eligible Institution:	Integral
Contract Term:	One year with automatic renewal
Maximum of Funds under Management:	Established by contract: $2,497, 092.50
Management of Funds:	Funds to be managed by Integral in off-balance sheet accounts and kept in a separate banking account
Credit Risk	Carried by Integral. Portfolio at risk greater than thirty days no greater than 5%. In cases of loans for new home construction, any difference between 5% and a greater amount must be paid to FUSAI by Integral
Fees paid to intermediary	a) 50% of all interest and commissions collected (50% paid to FUSAI) b) 17% of all down payments collected c) $9.14 for each credit analysis d) 30% on extraordinary sales of assets
Construction Assistance:	Required and provided by FUSAI Habitat staff.

Overview of FUSAI/Integral Retail Products

MFI Intermediary:	Integral
Use of Home Loan Funds:	a) New housing settlements (NAO program) b) Individual loans: – Housing lots with services – New home construction including reconstruction – Home improvement
Targeting:	a) Departments of Sonsonante, La Libertad, Cuscatlan, San Salvador, La Paz, San Vicente, Usulutan, and the southern part of Chalatenango and Cabanas. b) New housing settlements: Income no greater than two min. salaries c) Individual loans: Income no greater than three minimum salaries
Eligibility:	a) NAO: No property and loan must be used for new home. b) Individual loans: loan must be used for new home. For reconstruction an appraisal of the damage must be provided.
Affordability:	Monthly payments no greater than 2/3 of disposable income, calculated as net income plus other income including remittances, spouse income etc. less family expenses including housing, food, transportation, school, etc. (Net income is considered to be salary income less taxes; or net income of self-employed person's business or microenterprise.)
Maximum Loan Amounts:	a) NAO program: $3,500; up to 80% of the cost (with Sida funds: 70%) b) Individual loans: $3,500 (with Sida funds: $5,714)
Loan Term:	Maximum: 7 years
Interest Rate:	23%
Commission:	2.5% per year charged on each payment for administration 2.5% on the total loan amount up front for transaction costs 1% per year charged on each payment for life insurance in the amount of the loan balance 1% up front for legal costs Mortgage fees
Security:	Mortgage

Currency:	Colones (at c8.75 per US$1)
Late payment charges:	3% per month

Construction Assistance

FUSAI's Habitat Program provides construction assistance for all its programs. That assistance notably includes:

e) Promotion, planning and project design for housing and community infrastructure projects;

f) Construction oversight and technical assistance;

g) Organizing the community or project participants in self-help and self-construction processes;

h) Financial administration;

i) Strengthening community organizations;

j) Applying for and channeling state subsidies;

k) Design of community participation plans;

l) Financing land purchases and the subsidy component.

The type of assistance varies depending on the program. For NAO projects, FUSAI supports members of vulnerable communities and who are not landowners through a combination of developer-type services, credit, and state subsidy facilitation. Once a community site has been chosen, FUSAI's Habitat staff works with Integral's credit analysts to ensure that clients can afford the proposed housing and infrastructure being developed. Once a critical mass of clients is pre-qualified, FUSAI purchases the land to be developed and pre-qualified clients begin servicing monthly payments toward the purchase of their home. (FUSAI calls this a progressive down payment.) Once infrastructure and housing work is completed, Integral extends a loan to all pre-qualified clients in "good standing". From the unit cost of the house, Integral deducts both the total amount accumulated as a down payment and any subsidies a client may have received in order to derive a final loan amount.

For Habitat's other home loan programs, including home improvements, FUSAI's construction assistance includes prioritizing construction needs, planning, budgeting and limited construction oversight. Staff coordinates with Integral credit analysts to ensure affordability of the project and to set up the loan required to finance it.

Subsidy Component

The availability of subsidies for FUSAI's programs has substantially diminished over the years. All of FUSAI Habitat's programs were designed as a complement to FONAVIPO's subsidy program. In 1999, expectations were that subsidies would amount to $1,584 for clients participating in the NAO program, and would reach $285 for clients interested in lots with basic services. No subsidies were expected for individual home construction where the client owns the land, or for home improvements. Currently, FUSAI does not access FONAVIPO subsidies. With its own financial viability in mind, FONAVIPO tends to markets its subsidy program as part of an integrated package with a loan (and thus income generating) component. FUSAI, which already has

access to a sizable loan portfolio, is not interested in the debt component of the FONAVIPO package. FUSAI is, however, hopeful that it may again access FONAVIPO subsidies in the future.

FUSAI has also received donations from many funders, including Sida. As of December 2002, FUSAI's revolving loan fund appeared to have become financially self-sustaining, generating $381,203 in profits for the year. Integral, as a young institution, is not yet self-sustaining, and posted accumulated losses of $11,338 after two months of operations. It should be noted, however, that Integral registered income of $236,380 in the month of June, and is on course to increase its loan portfolio and expand its client base within the short term.

Linkages with Infrastructure and Basic Services

With the exception of home improvement loans, all of FUSAI's housing programs incorporate access to basic services and seek government subsidies to cover these costs, whenever possible. The construction assistance provided by FUSAI Habitat offers clients advice to help them design an improvement or a new house, including advice on access to basic services, quality of construction, lighting and ventilation.

Honduras

The Ministry of Transport, Public Works and Housing (SOPTRAVI), created in 1996, is responsible for formulating and executing public policy in the area of housing. During the past two years, the Government had assigned $6 million for housing subsidies and focused its attention on three major challenges: regularizing land tenure; reducing the number of inhabitants per household through progressive housing construction; and providing access to basic services.

New housing legislation was recently developed and is ready for submission to the National Congress. The new laws seek to strengthen the capacity of SOPTRAVI in its policy function and to establish the National System for Housing Subsidy (SNSH), which will include a new program entitled Housing Program with Self-Effort (PROVICEP). Expectations are that this new law will be approved in 2003. Housing policies in Honduras have been in place since the late 1950s and implementation has been attempted through a series of ill-fated public entities including the National Institute for Housing (INVA) and the Social Fund for Housing (FOSOVI).

The housing finance sector includes two second-tier mortgage lenders: the National Fund for Production and Housing (FONAPROVI) with a portfolio of approximately $100 million, and the Private Contribution Regime (RAP) with a portfolio of about $68 million. The RAP is a

mandatory system of contributions by workers to a national fund for housing, based on a payroll deduction. Housing microfinance is not a well-developed sector in Honduras, though microfinance lenders (including CHF International) do operate in the country. The government requires that all microenterprise lenders – some of whom may be introducing housing in the future – become regulated financial institutions by February 2003.

Delivery Mechanisms (Program Structure) for Sida Assistance

Sida support of 25 MSEK[8] for housing in Honduras was first channeled through the Integrated Urban Housing Improvement Program (PRIMHUR) in response to Hurricane Mitch. A second phase of support has subsequently been approved by Sida for 52.5 MSEK over five years. Sida resources will leverage funds from the national subsidy program (financed in part by a loan from the Inter American Development Bank), and KfW, a German foreign assistance agency. This second phase of support is provided to the Foundation for Urban and Rural Housing Development (FUNDEVI). Sida's initial support enabled the construction of 873 homes and 12 infrastructure projects. Sida's Phase 2 support seeks to improve the living conditions of poor families, particularly in urban areas, and to strengthen the capacity of FUNDEVI. Sida funds will finance four program components: infrastructure and basic services, housing improvement, land legalization, and sector reforms.

Overview of FUNDEVI

FUNDEVI is currently the sole implementer of Sida-financed housing programs in Honduras. FUNDEVI was formally created as a public foundation in January of 2002, effectively fusing the programs, resources and staff of two government housing finance programs: PRIMHUR (an urban program) and PVMR (a rural program). Both programs incorporate three fundamental elements: self-help and client participation (savings or participation in the construction of the home); direct subsidies to borrowers; and mortgage-based financing at market rates. To date the subsidies have been primarily funded with public funds, whereas the source of long-term financing capital is from international sources—KfW and Sida.

The Housing Loan Portfolio

Total Loan Portfolio	$18.5 million
Number of Housing Loans Outstanding[9]	8,755
Average Housing Loan Amount	$2,113
Average Housing Loan Term	10 years
Portfolio at Risk:	
Greater than 1 day	62.5%
Greater than 30 days	41.4%
Greater than 90 days	29.1%

[8] One SEK (Swedish Krona) equaled 0.12 $US, as of January 23, 2003.

[9] Number of housing loans outstanding is an estimate calculated based on FUNDEVI's March – June Report showing that in June the average loan amount was $2,113. The same report shows that as of June, the cumulative number of projects and improvements financed was 12,543.

Targeting

Sida requires that FUNDEVI target low income-earning households, using the "basic nutritional basket" as the method of determining household income levels. Currently, one basic nutritional basket (BNB) is equivalent to approximately $200. While FUNDEVI as an institution can provide services to populations of up to four BNB, Sida funding is limited to financing loans for those in the 0.1 to 2.8 BNBs. Specifically, Sida expects the following distribution of loans among the different income ranges.

0.1 – 0.5 BNBs	Average Income: $61 per month	20% of loans
.51 – 1.5 BNBs	Average Income: $203 Per month	40% of loans
1.51 – 2.5 BNBs	Average Income: $406 per month	30% of loans
2.51 – 2.8 BNBs	Average Income: $537 per month	10% of loans

Sida requires that FUNDEVI allocate 50% of all loans to women and women-headed households. Lending activity is required in all geographic areas now covered by FUNDEVI, including Tegucigalpa, San Pedro Sula, La Ceiba and Choluteca. Lending activity will be extended to new areas as FUNDEVI expands its geographic coverage.

Construction Assistance

FUNDEVI staff includes both loan officers and construction assistance officers. The latter provide budgeting and design advice prior to disbursement as well as construction oversight. Loans are typically disbursed in two to three tranches and construction officers conduct a visit with each disbursement. They also carry out a post-loan site visit to certify that the project has been completed and funds have been appropriately expended.

Subsidy Component

FUNDEVI's housing finance programs are structured to work alongside government subsidies. Eligible families are those who do not own a home and/or those that are interested in improving the quality of their existing home. Subsidies work in tandem with a required savings component and a borrowing component. The proposed law for PROVICEP, the organization managing the government subsidy program, establishes the target population as households with incomes in the 0.5 to 4.0 minimum salaries range. The amount of the subsidy ranges from approximately $63 to $506, calculated as a percentage of the total cost of the housing solution, as follows:

0.5 Minimum salaries	68% of housing cost
1.6 Minimum salaries	46% of housing cost
2.4 Minimum salaries	30% of housing cost
3.2 Minimum salaries	14% of housing cost
4.0 Minimum salaries	0% of housing cost

Linkages with Infrastructure and Basic Services

Sida Phase 2 funding would provide financing for basic services and infrastructure benefiting FUNDEVI's target population. Two lines of credit are envisioned: (1) credit for infrastructure in new and emerging settlements; and (2) credit for infrastructure in established settlements. FUNDEVI plans to promote these lines of credit among municipalities and identify possible implementing partners. FUNDEVI expects to work with the Honduran Association of Municipalities (AMHON) and, when possible, also expects to involve implementing agencies such as the Municipal Development Foundation (FUNDAMUN) and the Center for Architectural Design and Construction (CEDAC).

A Note on FUNDEVI's Portfolio Performance

Although this document did not delve into detail concerning the issue of sustainability, FUNDEVI's portfolio at risk of more than 60% was extremely alarming. As a measure of comparison, the Central American Bank for Development will not fund any microfinance institution with a portfolio at risk over 10%. Sida's relevant country staff is fully aware of the situation and is diligently working with KfW and FUNDEVI staff to address these issues. Sida and KfW have invested significant resources in FUNDEVI and have indicated that they are likely to continue support to that institution. Nevertheless, should there be any additional support, Sida should seriously consider looking into what has gone wrong and into what structural, systemic and managerial changes are required (beyond the transformation into a public foundation) to bring FUNDEVI's performance back to more acceptable levels.

Nicaragua

Housing has experienced resurgence in interest among policy makers, donors and microfinance practitioners over the last year, largely due to the ongoing work of the Inter-American Development Bank (IDB).
As part of the liquidation of *Banco de la Vivienda de Nicaragua* (BAVINIC), a state-run development bank focused on housing, a new national housing institute was signed into law with the primary function of promoting housing solutions for the country's low-income populations. As part of its mission, the *Instituto de la Vivienda Urbana y Rural* (INVUR) will create a new fund, called *Fondo Social para la Vivienda* (FOSOVI), with the assets from the now defunct BAVINIC. As a result, the IDB has moved forward with a US$50 million project to provide direct subsidies to low-income families for home improvements. The project design stipulates that 70% of the expected 17,500 beneficiaries will earn monthly incomes of US$250 or less, with the remaining 30% having incomes of less than

US$350 per month. Subsidies will range from $600 to $1,300. The Government of Japan is providing direct support to INVUR to cover its first eight months of operations. The IDB expects that Nicaraguan MFIs and other financial services providers will finance the difference between the subsidy and the full cost of improvements or construction.

As promising as this scenario is, the Government of Nicaragua passed a law in mid-2001 that imposed a ceiling on the interest rates that MFIs could charge clients on their loans. The rate that MFIs must charge is determined monthly by the Central Bank, and is equivalent to the average rate set by the formal financial sector, excluding credit cards. The effect of this law was to paralyze MFI lending over a four-month period in order to adjust interest rates and commission policies. The maximum interest rate that MFIs can charge at the time of writing is 16%.

Delivery Mechanisms (Program Structure) for Sida Assistance

The Local Development Program (PRODEL) began its activities in 1994, working with five Nicaraguan municipalities in order to strengthen the work of these municipalities in the area of infrastructure development, and as a financial mechanism to channel housing and microenterprise loans. Based on a participatory method that links communities, local governments and a formal financial intermediary, PRODEL was funded for a second phase in 1998. Sida support for PRODEL's first and second phase totaled US$12 million, of which US$ 7.5 million supported phase two of the project. Its principal program objective is to improve the living and economic conditions of low-income families, especially female-headed households, living in marginal neighborhoods in eight municipalities.[10]

The executing agency for PRODEL is the *Instituto Nicaraguense de Fomento Municipal* (INIFOM), a government agency responsible for strengthening local government action at the municipal level. Based on an evaluation of PRODEL midway through phase two, external consultants determined that the institutionalization of PRODEL would benefit from its resources being transferred to a new non-profit foundation. Further, the recommendation was that PRODEL Foundation should operate independently of INIFOM as a second-tier financing institution and a provider of technical assistance and related services for the home construction and basic services project components. At the time of writing, the transformation into a Foundation is still in progress as the new PRODEL leadership has successfully moved forward on this proposal. In December of 2001, PRODEL submitted the necessary documents to the National Assembly, making it likely that the transformation will occur within the year.

Overview of PRODEL

In its 2002 Operating Plan, PRODEL set three priorities for itself: (1) promote local environmental and economic development initiatives in the areas of infrastructure, housing and microenterprise support; (2) enhance democratic processes and decentralization through the

[10] The eight municipalities include Leon, Chinandega, Esteli, Somoto, Ocotal, Matagalpa, Jinotega and Chichigalpa. The latter three were added in the second phase.

strengthening of local governments and citizen participation; and (3) increase women's participation and representation in project decision-making, planning, and resource and project management.

Since 1994, PRODEL has invested US$4.6 million, and leveraged an additional US$3.5 million from local governments and community participation, which has resulted in nearly 400 infrastructure and basic services projects reaching over 300 communities and 74,000 families. Additionally, PRODEL has disbursed nearly US$6 million in micro-enterprise loans and US$3.76 million in home improvement loans. PRODEL operates its credit program through existing microfinance institutions, and currently has fund management agreements with two MFIs: *Fondo de Desarrollo Local* (FDL) and *Fundacion Jose Nieborowski* (FJD). In both cases the MFIs manage the loan portfolio for both microenterprise and housing loans.

The Housing Loan Portfolio[11] (stated in US$)

PRODEL's Loan Portfolio (funds under management by MFIs)	$1,292,559
PRODEL's Total Loan Portfolio	$1,801,794
PRODEL Number of Fund Management Contracts with MFIs[12]	2
PRODEL Average Fund Management Contract Amount	$646,280
Number of Housing Loans Outstanding through MFIs	2,631
Average Housing Loan Amount	$492
Average Housing Loan Term	18 months
Portfolio at Risk[13]	17.7%

Targeting

PRODEL devised specific guidelines in order to ensure that its resources reach the target group. PRODEL defines its target group as families with monthly incomes of between US$100 and US$800; the average size of families is considered to be six members. Female-headed households are specifically prioritized, as are those at the lower end of the income ranges. PRODEL requires that its intermediaries target 30% of their lending to female-headed households, and 80% to households with an average monthly income of less than US$ 500. Loan interest rates vary between 12% and 18% (annual, on a declining basis) based on a family's income, and may even go higher, as permitted by the new law on interest rates.

In addition to targeting by income level and gender, PRODEL limits its services to populations residing in the areas surrounding the following cities: Leon, Esteli, Somoto, Ocotal, Matagalpa, Chinandega, Chichigalpa and Jinotega.

Wholesale Financial Products

The manner in which PRODEL makes its funds available to eligible MFIs has undergone important changes, and will evolve even further once the program is established as an independent foundation. PRODEL is technically unable to lend money due to the limitations on its activities,

[11] As of December 31, 2001

[12] Does not include the case of ACODEP.

[13] Does not include the case of ACODEP.

as prescribed by INIFOM's bylaws. As a result, PRODEL has devised methods allowing it to enter into contractual arrangements with eligible MFIs to hold and administer funds for on-lending on PRODEL's behalf. Currently PRODEL has two contracts in force with FDL and FJN, and is in the process of selling off a portion of its portfolio to a third – *Asociacion de Consultores para la Mediana, Pequena y Microempresa* (ACODEP).
The specifics of the ACODEP portfolio sell-off are thoroughly documented in a previous evaluation[14] and will not be dealt with in this report. However the terms and conditions of the funds under management by FDL and FJN are outlined below. It should be noted that, at the time of writing, the contract with FJN had only recently been signed, and the new agreement had not been fully operationalized.

Terms of Contract for Funds under Management[15]

Eligible Institutions:	Regulated and non-regulated MFIs with national, regional or specific coverage in one or more of the following municipalities: Esteli, Ocotal, Somoto, Matagalpa, Jinotega, Chanandega, Chichigalpa, Leon, Masaya, Rivas, Jinotepe, Masatepe, Boaco.
Eligibility Criteria:	a) At least five years of experience and demonstrated capacity in providing financial services to micro, small and medium-sized enterprises b) Operate as a legally-constituted institution c) Possess a computerized loan portfolio management information system d) Audited financial statements with no negative or outstanding opinions
Evaluation Criteria:	a) Delinquency rate of existing portfolio less than 7% b) Net worth greater than $250,000 c) Debt to capital ratio no greater than 7:1 d) Operational efficiency greater than 100% e) Financial self-sufficiency greater than 90%
Maximum of Funds under Management:	a) Category A MFIs: 30% of total loan portfolio, must demonstrate – Portfolio at risk greater than 30 days less than or equal to 4% – Portfolio at risk greater than 90 days less than or equal to 2.5% – Operational efficiency greater than or equal to 113% – Financial self-sufficiency greater than or equal to 110% – Debt to capital ratio no greater than 7:1 b) Category B MFIs: 25% of total loan portfolio, must demonstrate – Portfolio at risk greater than 30 days less than or equal to 7% – Portfolio at risk greater than 90 days less than or equal to 3% – Operational efficiency greater than or equal to 100.5% – Financial self-sufficiency greater than or equal to 90% – Debt to capital ratio no greater than 7:1

[14] Becerra, Norah et al., "Programa de Desarrollo Local (PRODEL) en Nicaragua – una Evaluacion," Sida Evaluation, 02/05.

[15] Extracted from PRODEL document entitled, "Requisitos de Elegibilidad de Intermediarias Micro Financieras Para Aplicar a Fondos en Administracion, March, 2002.

Management of Funds:	a) Establishment of separate bank account in the name of INIFOM-PRODEL and accounting for rotating fund separating the loan portfolio and cash reserve. Funds are not consolidated into intermediary's accounts, and reported as an off-balance sheet item. Separate accounting by municipality and use of funds b) Minimum cash reserve: 10% of loan portfolio; Maximum: 20% of the loan portfolio c) Requests for additional funds considered when cash reserve = 10% d) Disbursements for fresh funds between $20,000 and $50,000 given that the portfolio at risk is less than 10%, or 5% for portfolio at risk for payments past due of more than 30 days. e) Monthly reports
Credit Risk:	For funds under management: a) INIFOM-PRODEL assumes all risk on the credit operations For new Fund Management Contracts and/or Loaned Funds (once PRODEL Foundation is established):b) Intermediary assumes all risk on the credit operations and can establish a loan loss reserve of up to 3.5% of the loan portfolio.
Fees paid to intermediary:	For Funds under Management: a) 3% on total collections and b) 0.14% on the outstanding loan portfolio For new Fund Management Contracts and/or Loaned Funds (once PRODEL Foundation is established): a) 16% per year on the average loan portfolio discounting the loan loss reserve, payable monthly and b) 40% of the Intermediary's net profit on the management of the Rotating Fund
Construction Assistance:	For Funds under Management: Provided by INIFOM-PRODEL staff. For new Fund Management Contracts and/or Loaned Funds (once PRODEL Foundation is established): Provided by INIFOM-PRODEL through contracts with public or private institutions that can include the intermediary.

Retail Financial Products

MFI Intermediary:	Fondo de Desarrollo Local
Use of Home Improvement Funds:	a) Approved uses: Construction materials, securing land tenure, municipal construction permit. b) Non-approved uses: Land purchase, payment of personal debts, consumption, religious, political, illegal purposes, vehicles, business or commerce.
Targeting:	a) Populations must reside in surrounding areas of the following cities: Leon, Esteli, Somoto, Ocotal, Matagalpa, Chinandega, Chichigalpa or Jinotega. b) Average monthly family income greater than $100 and less than or equal to $800 for an average family size of five.

Eligibility:	a) Beneficiaries must form part of a nuclear family (defined as husband and wife who have children or as single-parent, male or female household with children). b) Age of debtor: between 21 and 60 years c) Live in location at least one year prior to receiving loan d) Own land and/or a home, may not own another home in an urban setting or a plot of land or farm e) Demonstrate employment or self-employment for at least six months prior f) Implement recommendations and agreements per the technical assistance and training components, and execute and administer the construction with support from the Technical Assistance Unit. g) Priority will be offered to families who are not eligible for loans from the formal financial system
Affordability:	Monthly payments will fall within the range of 15% to 20% of the average monthly family income.
Loan Amounts:	Between $100 and $3,000
Loan Term:	Maximum: four years
Interest Rate:	Rate set by Central Bank[16]
Commission for Technical Assistance:	For Funds under Management: 10% payable to PRODEL-INIFOM For new Fund Management Contracts and/or Loaned Funds (once PRODEL Foundation is established): 6% for the Intermediary and 4% payable to PRODEL-INIFOM Legal fees and paperwork: 1%
Security:	a) For loans up to $500, acceptable guarantees can include: – Solidarity, guarantor, pawnb) For loans between $501 and $1,500, guarantees include: – Solidarity, pawn, mortgage guarantee or guarantor – Establishment of a guarantee fund equal to 10–25% of a monthly payment c) For loans between $1,501 and $3,000, guarantee must include: – Mortgage guarantee – If mortgage guarantee is less than 1.5 times the value of the loan, also solidarity guarantee – Establishment of a guarantee fund equal to 10-25% of a monthly payment
Currency:	Loans are made in local currency (Córdobas), and monthly payments are adjusted to maintain value in US Dollars
Late payment charges:	Payments later than one day: 10% charge on late payment plus 1% on outstanding loan balance

Construction Assistance

While PRODEL manages the credit component of the home improvement program through MFIs, it directly manages and oversees the Construction Assistance component. PRODEL's vision for the construction assistance component was to house staff within the offices of each municipality in which it works. The home improvement lending program fully integrates construction assistance, and all clients who qualify for a loan must participate in and apply the recommendations made during the construction assistance phase.

[16] Given the interest rate cap, MFIs are obligated to charge the rate set by the Central Bank. At the time of writing, the rate was 16.5%.

By the end of 2001, four of eight municipalities had fully accommodated the technical staff within their structure. In order to strengthen the provision of construction assistance services, PRODEL's 2002 operating plan calls for more flexibility in creating local capacity to offer construction assistance to home improvement borrowers: (1) maintain the staff in municipal offices if staff are fully integrated into the organizational structure and if the municipalities view the construction assistance work as a potential source of revenue and as a tool for urban planning; (2) encourage the MFI intermediaries to incorporate the construction assistance component into their organizations; and (3) develop the capacity of independent professionals and technicians to offer construction assistance services, with a long-term view towards creating the opportunity for community residents to seek out construction assistance, whether or not they are in need of a loan. In all three scenarios, PRODEL views its role as strengthening the technical capacity of construction assistance providers, improving their ability to effectively coordinate their services with the loan process, and helping them to efficiently work with clients so that the construction assistance component is financially sustainable.

Construction assistance for PRODEL falls within one of three categories:

1. Repairs, small construction projects, maintenance and finishing;
2. Repairs, large construction projects and additions;
3. New construction of basic home unit.

PRODEL has developed a detailed manual on the content, process and desired outcomes of the construction assistance component. The manual describes a "good" progressive improvement as one that is of good architectural and technical quality and that is designed for the family according to its capacity to pay within a predetermined timeframe. Improvements in quality and hygiene are integrated into the planning phase with families and focus on six main areas: ventilation, lighting, hygiene, quality of construction, use of space, and location.

Subsidy Component

At the time of writing, there are no subsidies for individuals or the MFIs. The only subsidy is that provided by Sida to INIFOM-PRODEL. Sida subsidizes 100% of the program's costs.

Linkages with Infrastructure and Basic Services

There appear to be no linkages between PRODEL's home improvement program and infrastructure and basic services programs, as there are no direct programmatic components that link the two lending programs. One exception is that in some cases, the same personnel who provide borrowers with construction assistance may provide them with advice on priorities for improvements related to basic services. Also, in some cases, the providers of construction assistance are employees of the Municipalities who may be able to mobilize municipal resources for needed infrastructure and/or basic services.

3. Observations and Emerging Lessons

From Sida's Current Practice in Housing Microfinance in Central America

Policy Environment

Housing is on the national agenda of all of the Central American countries, and Sida-funded programs have sought to leverage that interest. Yet, changes in administrations, poorly run public sector housing subsidy schemes, and inadequate funding have proven troublesome in most cases, rendering most national housing programs nearly inoperable and inaccessible to Sida-funded programs. Even Costa Rica, which succeeded in developing a functioning subsidy program, has experienced significant decreases in volume over the years. At present, lack of funding hamstrings subsidy programs in El Salvador and Guatemala. Efforts in Honduras and Nicaragua depend heavily on governmental and international funding streams that are subject to change at short notice. Further, many second-tier lenders have been phased out, liquidated or have suspended key programs, resulting in a shortage of long-term financing for the housing sector overall.

Housing Finance Policy Context

Housing Finance Policy Environment		
National Housing Agency	**Mandate**	**National Second-Tier Housing Finance Institution**
A. Costa Rica		
MIVAH – Ministry of Housing and Human Settlements	Implements national housing policy and manages national subsidy program, channeling direct and construction subsidies through regulated financial institutions.	BANVIH – National Housing Mortgage Bank
El Salvador		
FONAVIPO – Social Housing Fund (within Ministry of Housing and Urban Development)	Provides lines of credit and subsidies to housing finance institutions. Subsidies are used by housing finance institutions to lower the final cost of housing solutions.	None

Guatemala		
FOGUAVI – Guatemalan Fund for Housing (within the Ministry of Economics)	Implements direct subsidy program for low-income households and facilitates access to home loans via approved intermediaries.	None (BANVI – National Housing Bank was restructured in 1995 and became part of the Ministry of Economics)
DAHVI – Office of Human Settlements	Implements infrastructure improvements in legalized settlements.	
SEPAZ – Peace Secretariat	Implements rural housing programs.	
Honduras		
SOPTRAVI – Ministry of Transportation, Public Works and Housing through: SNSH – National System for Housing Subsidy; and PROVICEP – Housing Program with Self-Effort	Formulates and executes housing public policy. Manages SNSH and PROVICEP direct subsidy programs.	FONAPROVI – National Fund for Production and HousingRAP – Private Contribution Regime (FOSOVI – Social Fund for Housing is suspended and its assets under litigation)
Nicaragua		
INVUR – Institute for Urban and Rural Housing and FOSOVI, a new fund to be created by the INVUR.	Promotes housing solutions for low-income populations, and implements direct subsidies for low-income populations through FOSOVI.	None (BAVINIC – Housing Bank of Nicaragua is being liquidated and its assets transferred to FOSOVI.)

The regulatory environment for housing finance and microfinance in Central America is also is in a state of flux, as governments and banking authorities grapple with the proliferation of financial institutions catering to the working poor. In the case of Nicaragua, MFIs must contend with a ceiling on interest rates; in Honduras, all MFIs have been required to become regulated financial institutions in order to continue to operate; in Costa Rica capitalization requirements for non-bank financial institutions has nearly doubled; and in El Salvador, the now-dollarized economy has had the short term effect of transferring to borrowers any currency risk an MFI may be facing. To be sure, democratic regimes, now more common in the region, do tend to be more responsive to public needs. However, government transitions often wreak havoc on public sector programs and priorities, including housing finance and subsidy programs. Incoming administrations often roll out new priorities and re-staff key positions within already weak public institutions, resulting in a lack of continuity in and ownership of programs targeting the housing microfinance clientele (FOGUAVI, in Guatemala, being a notable example).

Natural disasters have also significantly affected the funding and impact of housing microfinance programs. Hurricane Mitch in 1998, the earthquakes that struck Nicaragua in 2000, and the 2001 earthquake in El Salvador have been the most notable among such disasters. Governments, funders and local institutions have had to respond to the need for

emergency shelter. As a result, the influx of foreign aid—while often generous and welcomed—has had the corollary effect of temporarily dampening demand for housing loans by raising the expectation that housing needs would be addressed through donations.

Emerging Lessons

Programs that offer lending alongside other non-financial initiatives tend to perform below expectations. Yet, Sida funding for housing microfinance has tended to be imbedded in programs (often government-sponsored) that pursued a diverse agenda. These programs have notably included:

a) Initiatives designed to strengthen and/or create public sector capacity in support of low-income housing and infrastructure development;

b) Municipal/local development strengthening; and

c) Credit/subsidy schemes that were highly dependent on public sector funding priorities for housing.

While working within the context of national priorities makes sense for Sida-funded housing programs in Central America, the governments themselves have not proven to be optimal implementing partners. Further, when the goal of strengthening long-term financial self-sufficiency is not explicit from the onset, the long-term viability of the housing microfinance program can become compromised as a result of high delinquency, portfolio erosion and high cost/portfolio ratios (in the case of PRODEL and PRIMUR, for instance.)

Private sector financial institutions (such as FUSAI, GENESIS and FUPROVI), working in coordination with (but independently from) government agencies and with a long term vision for financial sustainability have been Sida's most reliable partners in developing successful housing finance programs in Central America.

Delivery Mechanisms (Program Structure) for Sida Assistance

The variety of delivery mechanisms funded by Sida in Central America has generated a broad spectrum of institutions, financial services and strategies in support of housing microfinance in Central America. However plentiful a fount of experience, this variety does bring forth many challenges when comparing outcomes across countries and when extracting lessons learned. The chart below highlights the status of each country program, at the time of writing, and highlights the heterogeneity of approaches. While most programs have been designed to complement public sector housing subsidy programs, it is startling to observe that no program is currently accessing actual housing subsidies for the poor.

Sida Delivery Mechanisms for Housing Finance		
Institutional Form	**Financial Functions**	**Links with Public Sector Housing Subsidy Program**
(1) Costa Rica – FUPROVI		
Non-profit housing retail lender and construction organization that operates a trust fund (Sida funds)	– Retail lender – Bridge financing for new home construction – Underwriter for loans passed on to commercial bank	No Subsidy programs very limited and no longer available through NGOs
(2) El Salvador – FUSAI and Integral		
Non-profit housing wholesale lender and construction organization and principal investor in Integral, a for-profit financial intermediary	– Principle equity holder in Integral – Wholesale lender via Integral – Retail lender for loan funds under management by Integral – Bridge financing for new settlements construction	No Subsidy payments due FUSAI since 2001 have not been paid due to lack of funds.Interest rate charged by program for wholesale funds for on-lending higher than other alternatives.
(3) Guatemala – FDLG		
Trust fund set up within a commercial bank operating as the trustee, with oversight provided by a Trust Fund Committee, and operations carried out by a Technical Unit.	– Wholesale lender to MFIs	No Subsidy program unfounded.
(4) Honduras – FUNDEVI		
Public foundation set up as a fusion of two public-sector housing programs.	– Retail lender – Retail lender for loans funds under management by Integral – Underwriter for loans passed on to commercial bank	No New funding contemplated by Sida based on vision of a direct link with public subsidies.
(5) Nicaragua – PRODEL		
Program of a governmental agency responsible for strengthening municipal governments.	– Wholesale lender to MFIs	No Subsidy program under consideration by IDB. No links currently.

Sida-supported housing microfinance delivery mechanisms assume a wide range of institutional forms and have generated an equally diverse variety of financial and non-financial services. So far, the empirical evidence suggests that program design has had no impact in ensuring continuity in the delivery of subsidies to the target population. Designing programs in such a way that they depend for their long term success on the availability of government housing subsidies has not yielded the expected results, and Sida-supported institutions have had to develop a credit-only alternative to the original credit/subsidy hybrids.

Emerging Lessons

The cases of FUPROVI and FUSAI suggest that non-governmental retail lenders have had the most success with respect to program scale

and sustainability. These institutions have also shown themselves to be the most apt at constructively adjusting their strategies in light of a diminishing supply of housing subsidies.

The cases of FUNDEVI and PRODEL suggest that programs housed within public sector institutions face significant challenges with respect to scale and sustainability, with subsequent Sida funding dependent upon the creation of new foundations (both private and public) to manage the programs.

The cases of FDLG and PRODEL suggest that reaching scale and sustainability proves challenging for wholesale finance institutions—at least when there is no pre-existing housing microfinance retailers' network as was the case in Guatemala and Nicaragua.

Strategic Vision

In the last couple of years, all Sida-supported housing microfinance programs in Central America have undergone significant structural changes. FUPROVI was required to transfer its Sida funds into an external trust fund. FUPROVI will continue to enjoy access to (but not ownership of) these funds. FUNDEVI and PRODEL have evolved into independent foundations from their roots as government-housed housing finance initiatives. In the case of FDLG, Sida is currently reviewing the structure and mandate of the trust fund and considering significant changes in the way the program is implemented. Finally, FUSAI, on its own initiative, has created and invested its funds into INTEGRAL, a new for-profit financial intermediary—effectively altering its identity from that of a financial services retailer to that of a wholesaler. Sida is currently negotiating with FUSAI to ensure that Sida funds (already granted to FUSAI) remain outside of the INTEGRAL equity structure.

Strategic Vision for Sida programs

Entry point into housing finance / Major Challenge	Significant shifts in strategic vision/ Strategy to address major challenge
(1) Costa Rica – FUPROVI	
1988: Non-governmental organization designed to complement the national housing subsidy program with the establishment of a rotating loan fund.	Sida required that a Trust Fund be established with Sida funds after 10 years of operation/ support.
Major Challenge: Near elimination and non-direct access to public subsidies. Access to long-term capital. Reliance on investment income from a substantial portion of the Sida-funded trust fund for financial sustainability.	Establishment of lending relationship with Banco Popular as loan underwriter, and as a mechanism for a limited number of clients to access state subsidies.
(2) El Salvador – FUSAI and Integral	
1999: Non-governmental organization. Sida support was for the creation of a revolving loan fund for low-income housing construction and improvements, and the provision of technical assistance, complementing public subsidy programs.	Sida is holding discussions with FUSAI to create a new foundation with Sida funds as patrimony after four years of operation.
Major challenge: access to sufficient long-term capital.	Establishment of formal financial intermediary, Integral, able to access capital markets.

(3) Guatemala – FDLG	
2000: Commercial bank as trustee of FDLG, constituted as a temporary funding mechanism to improve housing and local infrastructure; improve microenterprise, community organizations and municipality access to credit; provide technical assistance and training in community participation and planning; promote new home construction in coordination with public subsidy program.	Sida is currently evaluating FDLG and reassessing its vision, scope and structure after 2 years of operation.
Major challenge: Low disbursement, un-sustainable model.	Sida-mandated evaluation, various strategies under consideration.
(4) Honduras – FUNDEVI	
2002/3: Transformed national program into a public foundation to complement public subsidy program by providing financing and technical assistance for progressive infrastructure, delivery of housing micro-loans. Improve the capacity of municipal governments in the area of land tenure, and strengthening national housing policies and institutions.	Sida support is based on the establishment of the Public Foundation.
Major challenge: institutional transformation from public sector programs to public foundation, sustainability, delinquency, management of credit risk, uncertainties regarding new public subsidy program.	Ability to successfully transform the institution and its culture. Implement new housing finance models to be evaluated based on new Sida-support.
(5) Nicaragua – PRODEL	
1994: Municipal governmental agency to co-finance local infrastructure project, provide funds under management to financial intermediaries for small housing and microenterprise loans; technical assistance in housing design and construction; technical assistance to municipalities in management and information systems.	Sida is requiring that a new non-profit foundation be established with Sida funds as patrimony after 8 years of operation.
Major challenge: institutional transformation to private foundation, sustainability, liquidating partial portfolio sell-off, sustainability, delinquency, scale, management of credit risk.	Transform the program into a new institution, professionalization of its culture, ability to diversify number of eligible institutions, transform financial model and financial products to increase sustainability, reduce delinquency, increase scale and reduce exposure to credit risk to be evaluated by Sida.

FUPROVI and FUSAI, designed as non-profit retail lenders, have shown their capacity for innovation and change in response to their need for long-term sources of capital. FUPROVI is forging relationships with commercial banks, acting as an originator of loans to a previously untapped clientele. With the creation of INTEGRAL, FUSAI can now tap into a broader array of funding sources, including private capital.

Sida has required that FUPROVI and FUSAI clearly separate Sida funds from other funds managed by these institutions. This requirement has brought about a certain level of transparency in the institutional accounting of the use of Sida funds. It has also created an "opportunity loss" for these institutions, as they had to forgo the possibility of using Sida's grants as equity.

New rounds of Sida funding to FUNDEVI and PRODEL (two institutions designed originally as programs within public sector institutions) have been linked to these institutions' transformation into independent foundations. Past uneven performance appears to be, at least in part, a function of the well-known difficulty public sector institutions face when managing lending programs directly. The multi-tiered agenda often pursued by Sida has also proven challenging for these government-run organizations.

As providers of wholesale finance and of technical assistance, FDLG and PRODEL appear to have suffered from a mandate that was overly broad and multi-sectoral. That mandate included:

a) Lending to multiple sectors including housing, microenterprise, community banks and infrastructure;

b) Lending to a variety of entities including MFIs, cooperatives, municipalities and other community-based organizations;

c) Providing technical assistance in the form of training, institutional support, and programmatic strengthening;

d) Advocating for improved policy and performance in local governance, local infrastructure, low-income housing finance, microenterprise and community banking finance, national housing policy, and MFI institutional strengthening.

Emerging Lessons

The cases of FUPROVI and FUSAI suggest that direct and flexible support for specialized non-profit housing finance retailers is the most effective intervention where scale, institutional sustainability and targeting certain populations are high programmatic priorities. Additionally, financial performance, at the institutional level does not appear to be dependent upon mechanisms that segregate Sida funds from those of the implementing institution. Indeed, in those cases where Sida is providing support to programs or institutions that also rely on other funding sources, Sida may want to consider relaxing the requirement that its funds be administrated through a separate administrative set up—as long as the partner institution fulfills the objectives Sida sets for the program and can track and report on the funds separately.

Government agencies, irrespective of type, are not effective vehicles for the direct implementation of financially viable housing microfinance operations. Political considerations, bureaucracy, and poor loan recovery history seem to be the most important inhibitors. The cases of FDLG and FUPROVI also suggest that "trust fund" arrangements create a leadership and accountability vacuum that the institution may (FUPROVI) or may not (FDLG) fill, based on experience and internal capacity.

Targeting

All Sida-funded housing microfinance programs prescribe targeting criteria as part of their program design. At the retail level, these criteria can apply to any of four variables: household income levels, geographic location, occupation, and gender.

Targeting Criteria – Retail lender	Targeting Criteria – Wholesale lender	Major Challenges
(1) Costa Rica – FUPROVI		
Household Income < 2 minimum salaries ($288–$1,400/month) – (7%–36% of GNP per capita for 93% of borrowers) National, with metropolitan area surrounding capital prioritizedWomen borrowers prioritized (= 34%)	Rather than act as a wholesaler, FUPROVI looks toward the commercial banking sector to take over FUPROVI loans in order to access subsidies and access long-term capital.	FUPROVI's flexible targeting strategy and retail product design allows for efficient responses to markets and policy environment. FUPROVI's priority on families with income of 2 minimum salaries allows for eligible households with incomes of up to 35% of GNP per capita.
(2) El Salvador – FUSAI and Integral		
Household Income < 4 minimum salaries ($576) Nine specific departments affected by earthquakes Women borrowers: no target	Funds placed as equity, loans and funds under management with Financiera Integral for on-lending.	Income target is low at 28% of GNP per capita, where even 4 minimum salaries can be considered a poverty wage. Focus on lending in earthquake affected areas difficult in an environment of significant aid for fully subsidized housing.
(3) Guatemala – FDLG		
Household Income < $400 for 40% of borrowers Household Income < $200 for 60% of borrowers Women = 50% Urban, peri-urban and "concentrated rural populations in 5 departments	Eligible microfinance institution with operations targeted areas, a strong track record, financial health and ability to guarantee loans at 120%.	Income target is low at 12% of GNP per capita for 60% of borrowers and 23% of GNP per capita for 40% of retail borrowers. Difficulty in matching retailers' lending needs with FDLG geographic targets because their geographic priorities are not the same.
(4) Honduras – FUNDEVI		
Household Income < 2.66 basic nutritional baskets ($538) Women borrowers = 50% Urban and rural populations in four regions	Funds placed under management with commercial bank, Banco del Occidente.	Income target is high at allowing for loans to families with up to 63% of GNP per capita.

(5) Nicaragua – PRODEL		
Household income < $800 for 20% of borrowers Household income < $500 for 80% of borrowers Women borrowers: 30% Urban and peri-urban areas surrounding 8 cities	Eligible MFIs with operations in targeted areas, a strong track record, and financial health. No guarantees required for funds under management.	Income targets appear to be extraordinarily high, at 190% of GNP per capita for 20% of borrowers and 120% for 80% of borrowers. This may be adequate for a post-disaster strategy, though less so once disaster relief is no longer the objective. Difficulty in matching retailers' lending needs with FDLG geographic targets because their geographic priorities are not the same.

As retail lenders with access to significant non-Sida loan capital, FUPROVI and FUSAI have had sufficient flexibility and resources to develop products that reach the populations targeted by Sida. These institutions' scale, the variety of their financial products and related services, and a clientele that extended well beyond Sida's targets helped ensure continued financial performance.

Wholesalers, created exclusively to manage Sida-funded activities, have not fared as well. FDLG has experienced limited demand for its funds, with commitments for new lending and disbursements of negotiated loans failing to live up to expectations. Retail lending targeting criteria imposed by FDLG on its borrowing institutions appeared to have deviated significantly from the prior practices of these institutions. On the positive side, this may have spurred Sida-supported MFIs to expand their original clientele to include lower income-earning groups, or to lend to more women or within more geographic areas than they otherwise might have. Further, both PRODEL and FDLG have experienced significant difficulties in ensuring that their retail lenders meet Sida-mandated targeting criteria— particularly income level criteria. As retailers have established differing methodologies for estimating household income, the application of uniform targeting requirements may have had the effect of creating perverse incentives for both the potential borrower and the retailer to under-report household income in order to qualify for the loan. These incentives appear to be particularly powerful when the income criteria established by the wholesaler are significantly lower than the average population served by the retailer.

Geographic targets are easier to monitor; but they also place significant constraints on the wholesaler's ability to find qualified retailers. If wholesale financial resources are not significantly discounted or subsidized in some way or another, there may be little incentive or ability for retailers to expand their operations into new regions. Limited resources also constrain investment in new product development to tailor financial products and technical assistance to the newly targeted population.

Emerging Lessons

Targeting criteria are more easily implemented when program support goes directly to a housing finance retailer.

While targeting is a desirable donor objective, it comes at a cost in the context of housing microfinance. In the past, subsidy programs supplementing an institution's budget have been required to create the necessary incentives and products to achieve Sida targets. Because of the short-term attraction of these subsidies, supported institutions may also be getting into lines of businesses, acquiring new clients, or working in geographic locations that do not necessarily match their own long-term financial and institutional interests.

Targeting based on income level is difficult to monitor and can create an unintended incentive for both the client and the institution to lower their estimate of a client's income. As a result, it may be useful to consider criteria other than household income estimates to increase outreach to poorer clients. Possible proxies for income levels include desired loan sizes households may wish to access, loan purpose, and existing quality of the dwelling to be improved. If a reliable baseline client survey exists, focusing on specific sections of a community where the retailer already operates may provide a good indication of the likelihood that a certain income level will be represented in the client pool.

Geographic targeting may be a necessary input given national priorities; however, what is gained in increased directed impact can be offset by a financial performance cost to the MFI, if the targeted region does not have a critical mass of clients to sustain demand for the product, or if costs to maintain an operation in that region are prohibitive once Sida subsidies dry up.

Wholesale Financial Products

Sida-supported housing microfinance wholesalers in Central America use two financing mechanisms for passing on Sida funds to retailers: (1) fund management contracts and (2) loans.

Wholesale Financial Products

Wholesale Product	Strengths	Weaknesses
(1) Costa Rica – FUPROVI		
None	Allows for maximum flexibility in retail product design.	Shortage of long-term financing places cap on amount of retail lending. Need to reach sustainability reduces amount of funds in trust fund to be loaned out (higher return on investments than on lending activity.
(2) El Salvador – FUSAI and Integral		
– Funds Under management With Non-Sida funds: – Equity – Debt	– Shareholder in for-profit financial intermediary. – Passes on retail credit risk to financial intermediary. – Carries funds on FUSAI's books – improving financial position and holds closer reigns on retail product design and targeting criteria.	– Returns on equity dependent on performance, limited ability to take-out equity. – Returns on debt limited to wholesale lending rate – lower than retail rate. – Returns limited by payment of service fees, carries portion of retail credit risk.

(3) Guatemala – FDLG		
Debt	Passes on retail risk to MFIs and small portfolio of loans to manage. Ability to work with a broad spectrum on MFI types.	High cost model for determining eligibility and providing technical assistance and monitoring. Limited ability to ensure that retail loans are made. Wholesale interest rates charged limited by weak demand.
(4) Honduras – FUNDEVI		
Funds under Management	Carries funds on FUNDEVI's books – improving financial position and holds closer reins on retail product design and targeting criteria.	Returns limited by payment of service fees, carries portion of retail credit risk; difficulty in monitoring retail loan performance and delinquency.
(5) Nicaragua – PRODEL		
Funds under Management	Carries funds on PRODEL's books – improving financial position and holds closer reins on retail product design and targeting criteria.	Returns limited by payment of service fees, carries portion of retail credit risk; difficulty in monitoring retail loan performance and delinquency.

The experience of FUNDEVI's predecessors (PRIMHUR and PVMR) and PRODEL with fund management has been plagued by high rates of delinquency and loan losses. Typically the wholesaler has assumed most of the credit risks whereas the responsibility for portfolio management is delegated to the fund manager. Fund management arrangements tend to be costly and have not always incorporated adequate mechanisms to encourage and reward good performance.

FDLG's wholesale loan product has yet to live up to its promise and appears ill-suited to the financing of on-going and growing retailer loan portfolios. FDLG loans to retailers allow a limited grace period for the repayment of interest and capital. Once the grace period has elapsed, the MFIs must repay the loan through quarterly payments over a number of years. Given the objective of fostering a functioning housing microfinance sector in the country, wholesale loans that must be repaid based on a strict schedule can hamper the ability of a retailer (especially one relying exclusively on Sida funds) to remain liquid in the face of potentially expanding demand. Further, the potential for asset/liability term mismatch (the relative discrepancy between the repayment period the retailer negotiates with FDLG and the average repayment period for the housing microfinance loan to households) can exacerbate the retailer's liquidity problems. Given the fact that FDLG has encountered problems disbursing funds already at its disposal, loan repayments from retailers should not be a priority, and a fund management contract may have been preferable.

Emerging Lessons

Wholesale or second-tier programs should ensure that financial flows to participating MFIs match retail-lending flows in order to avoid potential liquidity crunches. Wholesalers should also devise incentives that help

nurture both retail portfolio growth and quality. Converting fund management contracts or balloon payment loans into grants (whole or partial) based on a high loan volume and a low portfolio at risk could constitute the foundations for such an incentive program.

The ability of wholesale funds or institutions to reach financial self-sufficiency depends on their ability to minimize cost, reach a large enough scale, and maintain portfolio quality. However, financial self-sufficiency need not be a *sine qua non* for Sida-supported wholesale housing microfinance programs. The option that a successful wholesale operation could include a "sunset clause" calling for the portfolio to be transferred to high performing retailers at the end of a certain period could prove to be a valuable tool in Sida's arsenal (and that of other donors).

Retail Financial Products

Retail lending programs, including those run by retailers financed through Sida-supported wholesale lenders, typically offer home improvement lending. However, such lending often is not the single focus for Sida support. Lending for new home construction and for infrastructure as complements to government subsidy programs, also receive priority.

Retail Financial Products

Retail Product	Strengths	Weaknesses
(1) Costa Rica – FUPROVI		
New home construction. Lot and new home construction. Home improvement/ Basic services.	Market-driven products. Flexibility in loan amounts. Financially sustainable product pricing.	Shortage of long-term financing options poses limitation on scale.
(2) El Salvador – FUSAI and Integral		
New housing settlements. Individual home construction. Individual lot and home construction. Home improvement/ Basic services.	Market-driven products – with separation of financial services underwriting performed by Integral, and community organizing performed by FUSAI. Financially sustainable product pricing.	Potential conflicts of interest to arise from tensions in FUSAI and Integral priorities, creating the potential for increased delinquency.
(3) Guatemala – FDLG		
New home construction. Home improvement/ Basic services. Land tenure legalization.	Technical assistance component to MFIs has improved quality and quantity of home improvement loans.	Inability to operate loans for new home construction due to limitations in public subsidy program and on loan amounts. Ability to increase retail-lending dependent upon MFI performance.

(4) Honduras – FUNDEVI		
Urban infrastructure projects in new settlements. Urban infrastructure projects in established settlements. Home improvement micro-loans.	High subsidy component, especially for lower-income ranges and reasonable down payment required by borrowers. Potential for scale and national scope.	Project expectations are that 50% of loans will not be recovered in new settlements. Loan recovery method to be established by municipal governments. Separate rate not set for construction assistance. Supply-driven project methodology. Interest rate appears low given that no additional fees or commissions are charged to cover construction assistance, monitoring, etc.
(5) Nicaragua – PRODEL		
Home improvement/ Basic services. Land tenure legalization.	Technical assistance component to MFIs has improved quality and quantity of home improvement loans.	Variable loan repayments due to indexation to the dollar. Interest rate ceiling creates challenges for MFIs. Ability to increase retail-lending dependent upon MFI performance.

Emerging Lessons

If the retailer is an MFI with a pre-existing track record for designing successful financial housing or microfinance products, it should have the flexibility of using Sida funds in a way that fits its product design strategy. Sida, either as itself or through a wholesaler, should resist the temptation of imposing specific interest rates and fees. Funding agreements should allow the retailer to redesign products or incorporate new ones in response to changes in its operating environment.

Retail products should never be launched if expectations for HMF portfolio performance do not meet basic industry-accepted standards (long run losses of no less than 3%, and portfolio at risk of no more than 10%, for instance).

In cases where retailers have a shortage of long-term capital, housing finance products with relatively short repayment periods should reside at the core of lending operations. Policy advocacy should focus on creating long-term financing options available through private or public sector financial institutions. Non-financial institutions should not be designed to carry long-term debt.

Construction Assistance

All retailers, whether directly or indirectly supported by Sida, provide some form of construction assistance to their clients. The content and quality of the construction assistance varies significantly. As a general rule, when Sida support has gone directly to non-profit housing finance retailers, the construction assistance programs appear to work well in terms of quality and cost recovery. However, when support has been channeled through a public sector program, results have been mixed.

Construction Assistance Mode	Strengths	Weaknesses
(1) Costa Rica – FUPROVI		
Direct assistance.	Full cost recovery via appropriate mechanisms.	None detected
(2) El Salvador – FUSAI and Integral		
Direct assistance provided by FUSAI, Habitat staff.	Full cost recovery via appropriate mechanisms.	None detected
(3) Guatemala – FDLG		
Loan agreements with MFIs require the provision of construction assistance.	Technical assistance provided to MFIs to develop/improve construction assistance.	Variable performance among MFIs. Weak mechanisms to ensure adequate MFI performance. Inadequate cost recovery mechanisms for FDLG – technical assistance is grant-based.
(4) Honduras – FUNDEVI		
Direct construction assistance.	Insufficient information.	Inadequate cost recovery mechanism – construction assistance costs imbedded in the interest rate charged on loans.
(5) Nicaragua – PRODEL		
Direct construction assistance with view to transfer function to MFIs and develop new private sector construction assistance consultants as contracted staff to MFIs.	Move away from direct construction assistance, which is incompatible with wholesale finance function.	Inefficiencies in original design to have municipalities develop construction assistance programs. Inadequate cost recovery mechanisms.

Wholesale lenders face significant obstacles in providing retailers, especially those that are new to housing microfinance, with appropriate support to develop high quality and cost-effective construction assistance services. Strategies now in place include:

- The wholesaler providing direct construction assistance to clients;
- Placing construction assistance personnel at the municipal government offices;
- Supporting construction assistance personnel within the MFI;
- Encouraging MFIs to hire construction assistance personnel and retain part of the commissions charged;
- Training new private sector consultants to serve as contracted staff to the MFI;
- Grants and training to borrowers to develop and/or improve their construction skills;

Emerging Lessons

Retailers that include housing finance as an integral part of their core mission (HODE, Genesis, FUSAI) are more likely to develop adequate construction assistance services. Wholesale finance institutions face significant difficulties in ensuring quality and cost-effective construction assistance delivery by retailers.

Where funding guidelines require that a retailer provide construction assistance, the assistance must be priced into the HMF loan and must be of a high enough quality that borrowers see a value added in the service being provided.

Construction assistance is most appropriate in situations where local laws governing a household's ability to undertake a construction project do not guarantee the soundness of the resulting construction work. In cases where such laws do exist and are likely to lead to decent results, construction assistance may not bring significant value added to the client – unless it is designed to help comply with the laws.

Construction assistance can be particularly useful in locations that are at high risk of natural disasters, to ensure safety and to help borrowers prioritize construction activities.

Subsidy Component

Direct subsidies form part of the housing policy agenda in all Central American countries with Sida HMF support. However, the actual implementation of transparent and continuous subsidy programs has been problematic.

When subsidies have been available, Sida-supported programs have been structured to help low-income families access the subsidy and finance the cost differential of the home construction. Often, however, the subsidies have dried up and the MFI has had to implement a credit-only program. Lenders whose strategies were based on the availability of subsidies have faced serious financial difficulties when the availability or policies governing the use of subsidies have changed. Most institutions have reacted by introducing new products that are viable without subsidies.

Emerging Lessons

In cases where public subsidy programs are operating, housing finance programs can be designed to complement them. However, institutional sustainability should not be dependent on this portfolio because of the volatile nature of the policy environment.

Subsidies are not a required component of a housing program focusing on poor households. The experience in El Salvador and Costa Rica (and the emerging worldwide track record) shows that stand-alone housing microfinance lending can lead to an MFI's self sufficiency and contribute significantly to the quality of life of borrowers.

The same organization should not manage subsidies to borrowers (whether to individuals or local governments) and housing loans. MFIs should focus on understanding, finding and qualifying potential *clients* with a sufficient enough income to afford a housing microfinance loan. Subsidy providers should focus on understanding, finding and qualifying potential *beneficiaries* whose income or economic and social circumstances

are such that they would qualify for a subsidy. If one organization finds itself in a position to administer both credit and subsidies, it should "firewall" the two programs and avoid packaging credit and subsidy as one product. Households may very well qualify for both a credit and a subsidy, based on criteria for credit underwriting and eligibility requirements for the subsidy program. Nevertheless, loan eligibility should not depend on the availability of a future subsidy that may or may not be available in the long term.

Linkages with Infrastructure and Basic Services

Home improvement loans for Sida-supported programs often allow clients to obtain or upgrade access to basic services. Financing for new home construction and new housing settlement also typically incorporates access to basic services in the design and costing of housing products. Upon review, programs incorporating financing for basic infrastructure services have proven costly and challenging to maintain when subsidies are not available. Further, these loans generally require repayment periods that exceed recommended limits for housing microfinance.

PRODEL's experience illustrates the challenges of working with municipal governments as borrowers. Still, municipal governments in Nicaragua have shown on occasion that they are capable of improving community infrastructure where funds have been channeled as subsidies. In the case of FDLG, a similar mechanism proved to be the bottleneck to project financing, as municipal governments can be, sometimes understandably, reluctant to take on debt.

Emerging Lessons

Retailers with sufficient capital have the ability to implement new home construction lending programs. As FUSAI has demonstrated, such programs can be designed to incorporate basic infrastructure services if the retailer understands its clientele and is skilled at product design.

In an ideal situation, subsidies should help local authorities provide a community with basic infrastructure (roads, water, electricity, sewer), and loan funds should help households pay for their individual housing needs. In the end, because of the high costs associated with infrastructure projects and given the limited repayment period and the financial viability considerations involved in housing microfinance, a HMF loan is not usually an adequate tool for financing public infrastructure projects in their entirety.

4. Policy Recommendations

Delivery Mechanisms (Program Structure) for Sida Support

Type of Institution: The type of "delivery" mechanism for Sida funding should reflect whether Sida sets out to foster housing microfinance (or housing finance for that matter) as an "industry"; to support the strongest institutions already operating in the housing finance market rather than the "industry" itself; or to have an immediate impact on housing production (in the wake of a natural disaster, for instance.) A survey of Sida's current programs suggests two preferred modes of operation for housing microfinance service delivery.

- Direct funding for retail or "first-tier" microfinance institutions (FUSAI in El Salvador, FUDEHVI in Honduras, FUPROVI in Costa Rica);
- Funding for Apex or "second-tier" institutions (PRODEL in Nicaragua, FDLG in Guatemala);

Sida also uses a trust fund mechanism, a.k.a. fideicomiso in Latin America (Guatemala, Costa Rica), to finance its wholesale and retail programs.

Policy recommendations for this section focus on the two main delivery mechanisms currently favored by Sida and present a third alternative (management contract with expert outside agencies) that would bring Sida in line with the *modus operandi* of other major bilateral aid agencies working in development finance. Policy recommendations also address the use of trust funds in the context of housing microfinance delivery.

Recommendation: Guidelines for Deciding Whether to Support Second-Tier (Apex) Institutions.

1. Sida should give priority consideration to supporting apex or "second-tier" institutions if *developing the capacity of the financial/housing sector to deliver HMF services* is a desired outcome. The following conditions reinforce the desirability of the "sector development" approach as a strategy for HMF delivery:

   – *Scale and Availability of Significant Financial Resources.* Long-term funding for the HMF program should be sufficient to ensure that the Apex institutions as well as eventual retail institutions will be able to provide the HMF service in a manner that contributes to the financial viability of these institutions.

   – *Limited Implementing Retail Capacity.* At the onset, no existing retail institution appears capable of implementing a HMF program without long-term technical and financial support. The second-tier institution should seek to facilitate the creation of that retail capacity in the long term.

2. **Public vs. Private.** If a choice exists between setting up an apex institution as a private entity or setting it up as part of a government institution, and with everything else being equal, a private institution offers better long-term prospects for transparency, independence and management efficacy.

3. **Permanent vs. Temporary.** The appropriate "institutionalization" strategy for the HMF program—whether or not HMF will remain as a financially viable function within the apex institution after the end of Sida funding, or whether that function will be phased out and potentially transferred to retailers— should be an explicit part of the decision of whether or not to set up a second-tier institution.

   – *Apex institution as an Intermediate Strategy.* If at the outset, the apex institution is viewed merely as a mechanism to channel funds and technical assistance to retail institutions on a temporary basis, the apex does not require a permanent institutionalization strategy. Operating efficiency, technical assistance capacity, and outcomes at the retail provider level, rather than the financial self-sufficiency of the apex institution, should be the paramount program objectives. Wholesale financial products should assist retailers in building capacity and, eventually, in capitalizing their HMF programs.

   – *Apex institutions as a Permanent Strategy.* If the apex institution is conceived of as a permanent entity, the range of financial instruments that it can offer its retail partners should allow for the apex institution's long-term financial self-sufficiency. The instruments must also be appropriate to the needs of the retail partner. It is likely that higher amounts and periods of subsidy will be required to simultaneously build capacity at the retail and wholesale levels.

Recommendation: Guidelines for Supporting First-Tier Institutions Directly.

All things being equal, Sida's experience with HMF suggests that direct support for retail institutions leads to better program performance than support for second tier institutions.

Sida should give priority consideration to supporting retail or "first-tier" institutions if one or a combination of the following conditions is present:

1. *Limited Financial Resources.* Available resources are such that only one or a predictably small number of institution(s) can be supported in a way that will support the objective of making the HMF service financially viable for the financing institution.

2. *Concentrated Existing Capacity.* The objective of providing HMF services to the target population is best served by selecting one institution or a very small group of institutions already showing a strong promise of developing or expanding housing microfinance services.

3. *Emergency Situation.* If HMF is used to helping within an emergency or post-emergency situation (reconstruction after an earthquake or a hurricane, for instance), and if time is of the essence, channeling resources directly to a first-tier institution or a group of such institutions should be strongly considered.

4 *Private Sector.* Sida should only support first-tier institutions that operate in the private sector, whether as for profit or not for profit institutions.

Additional Observations on Delivery Mechanisms for HMF Initiatives

Management Expert. When Sida seeks to foster the HMF industry in a given country or area, entering into a temporary management agreement with an institution with the appropriate expertise to nurture the growth of that industry can serve as an alternative to working through an existing local apex institution.

Divestment of Public Programs: Transforming existing Sida-supported government programs or funds into private, independent institutions will shield the programs from political pressure and administrative inefficiencies and is likely to result in better services to the targeted clientele.

Institutionalization of Programs as Trust Funds. Accounting principles require that the accounts of a trust fund be administered outside of the institution that is benefiting from the fund. For these reasons, a trust fund does not contribute to the capitalization of the entity that it supports. Sida funds segregated into a Trust Fund do not build institutional capital; rather they build capital in the trust fund and thus do not contribute to the strength of the institution's balance sheet.

Recommendation: Guidelines for Deciding Whether to Set Up a Trust Fund in support of HMF initiatives

Trust funds can support the operations of both retail and apex institutions. All things being equal, vesting Sida funds directly within the supported institutions will strengthen the institutions' financial position and should allow them to enjoy a more flexible use of the funds.

A trust fund may be appropriate in the context of HMF if one or a combination of the following conditions is present:

1. *Legal or Bilateral Restrictions.* Legal or government-to-government requirements prevent Sida from directly funding otherwise acceptable retail or second-tier institutions.
2. *Strong Existing and Widespread Implementation Capability.* Many institutions already operating in the targeted areas already posses the capacity to implement successful HMF initiatives without extensive long-term technical support. In this case, the trust fund fulfills a financial "apex-type" role, but without the need for an actual institutional industry-building function.
3. *Temporary Situation.* The existence of the trust fund is expected to be temporary, and will last until Sida can identify suitable institutional fund managers.

Targeting

Within the field of microfinance, the issue of targeting—the extent to which MFIs should be able to focus on clients with certain desirable characteristics such as income, gender, and geographic locations—is the subject of an ongoing, sometimes intense, debate. To be sure, microfinance, by definition, pursues a form of targeting as a business strategy. Microfinance emerged as an alternative (or a complement) to more mainstream means of financing, and its clientele comprises, in principle, those who do not enjoy access to the formal banking sector—that is, for the most part, the economically active middle income, poor and very poor people living in developing economies.

For the purpose of this document, targeting will be framed within the context of Sida's potential wish to provide economic assistance on the basis of income, gender, geographic location and occupation. The policy recommendations in this section build on the underlying assumption that, as a bilateral development cooperation agency, Sida may want to extend that strategy to housing microfinance. The recommendations provide some guidelines as to the appropriateness, or inappropriateness, of these forms of targeting within the specific context of housing microfinance.

Assumption. As a bilateral donor, Sida often seeks to extend its development assistance on the basis of beneficiaries' income, gender, geographic location and occupation. In the context of housing microfinance, where a key goal is the long term financial viability of the implementing institution, Sida's desire for targeting should be balanced against the need to ensure that Sida funds do not provide short-term incentives that are detrimental to a MFI's long term financial viability.

Recommendation: Guidelines for Targeting Based on Income.

As a general rule, Sida should avoid prescribing specific income thresholds for potential clients, unless those thresholds are already explicitly or implicitly incorporated into the MFI's client eligibility criteria. Thus, if Sida wants to reach a population within a given income range, the preferable option is for Sida to select an implementing organization already working within that range, and to provide that organization with financial incentives to remain within the range. In principle, if an MFI, with no prior support from Sida, already serves a desirable income group and does so in a manner that contributes to the organization's financial viability, Sida's support would only reinforce the organization's existing strategy.

Sida-supported programs may seek to reach the poorest households able to participate in a financially viable HMF program—but should be very careful not to finance households that fall beyond that point. The objective for Sida programs will be to go as low on the income ladder as feasible, given the objective of offering the lowest-cost HMF product for which there is demand, in a manner that is financially viable. There will be a point on that income ladder, based on households' capacity to pay a HMF loan, where the households will not be able to afford that loan. HMF programs cannot reach such households: clients will default and the programs will not be financially viable. Non-eligible households should be assisted through independent subsidy or grants programs, if available.

Thus, before Sida can prescribe a lower limit on income for its HMF programs, it is important that Sida and its implementing partners determine how far down on the income latter they can reach while still allowing the household to repay a loan comfortably.

The lower limit on income in any given market can be defined as the income of the poorest household that fulfills the following conditions: The household reasonably can be expected to afford a HMF loan, given (1) the household's estimated capacity to repay taking into account estimated recurring expenses and debt burden; (2) the expected minimum loan amount in demand; (3) the "market" effective interest rate for the loan; and (4) the maximum allowed repayment period for that household.

Recommendation: Guidelines for Targeting Based on Gender

No gender-based targets should be required. The unit of analysis (household) for determining HMF loan eligibility typically, if not always, includes women. It is reasonable to expect that women will benefit from a HMF loan whether or not their names appear on the loan documents. In order to monitor the impact of HMF programs on women, loan applications should include the total number and the gender of household members who benefit from the housing loan. In cases where a detailed client baseline survey preceded program design, and everything else being equal, Sida could use the proportion of female headed-households as a recommended (not a required) benchmark for the proportion of loans that should go to women.

Recommendation: Guidelines for Targeting Based on Geographic location

Targeting potential HMF clients living in specific geographic areas is acceptable when the MFI is confident that the client pool is large enough to support a branch office or a network of branch offices in a manner that contributes to long-term financial viability.

Targeting potential HMF clients based on their geographic location should not be pursued when servicing these areas is cost-prohibitive as a result of the following: (a) insufficient client base, (b) insufficient capacity to pay from potential clients; (3) or other forms of lack of demand for housing microfinance in the targeted areas.

Recommendation: Guidelines for Targeting Based on Occupation.

Clients should never be targeted based on their employment or occupation.

Product Design

Sida should encourage the institutions it supports to develop and offer housing services that build on emerging lessons learned from the field of housing microfinance. As an overarching guiding principle, Sida should encourage the institutions it supports to design housing microfinance products in such a way that an *equilibrium point* is reached between Sida's developmental objectives and the institutions' financial interests. Rather than require specific mechanisms to "firewall" Sida's funding from the institutions' ongoing initiatives, Sida should strive to make HMF attractive to the MFIs by allowing the MFIs to integrate HMF alongside other product offerings. Sida should also encourage the MFIs to earn the Return on Assets (RoA) they expect to generate on other products (as a consequence, Sida should refrain from imposing artificially low interest on supported MFIs).

Wholesale Products

In the context of this document, the term "wholesale product" encompasses the package of financial and non-financial features an apex (second-tier) institution makes available to potential retail institutions. Sida should encourage the apex institutions it supports to develop a range of wholesale products that strike a balance between the donor's developmental incentive and retailers' financial interests. This should help create potentially favorable conditions for a retailer to keep housing microfinance in its product line, even after Sida's support has been phased out.

Retail Products

In the context of this document, retail products refer to the product a retailing MFI makes available to its clients. Sida should encourage MFIs to develop a range of retail products that strike a balance between the donor's developmental incentive and retailers' financial interests.
This should help create potentially favorable conditions for the MFI to maintain housing microfinance in its product line even after Sida's assistance has subsided.

Construction Assistance[17]

Many MFIs offer construction advice or supervision as an integral part of housing microfinance. Many more do not. If the MFI plans to offer no form of construction assistance, the housing microfinance loan is, in effect, a consumer loan whose declared purpose is housing but whose ultimate use is up to the client. The proposed construction project provides a rationale for estimating a required loan amount. In addition, calling the loan a housing loan may help the MFI market the new product to its clients. Ultimately, repayment performance determines the client's future standing with the institution—as opposed to whether or not the housing work has been completed in accordance with original loan documents.

When an MFI is considering whether to incorporate construction assistance into the design (and pricing) of a proposed loan, it may be useful to consider the MFI's attitude towards the familiar microfinance concepts of "due diligence" and "follow up". Some MFIs regularly conduct *pre-disbursement* due diligence on a microenterprise loan in order to determine whether the requested loan amount will provide a match for the intended purpose for the loan. In the case of housing microfinance, such pre-disbursement assistance can notably include the following activities:

- Basic construction design to ensure that the proposed intervention complies with basic safety and legal requirements;
- Budget verification to ensure that the proposed cost estimate for the intervention is appropriate and matches the client's loan request;
- Guidance on materials and labor procurement, tapping into the provider's knowledge of these markets to help clients make cost effective decisions;
- Assistance with permits and other legal requirements;
- Construction oversight to ensure that the builder/contractor faithfully executes the work for which he/she has been hired; and
- Verification that the construction has been completed in accordance with the MFI's agreement with the client or in compliance with applicable law.

From an organizational standpoint, an MFI can provide construction assistance to its clients in one of two ways. The MFI can build the capacity in-house by hiring, training and fielding the combination of professionals and skilled workers it believes will get the job done. Alternatively, the MFI may decide to outsource the work to a specialized firm, an NGO or a cadre of individuals.

[17] This section is from Elements of Product Design (draft of chapter from the forthcoming book Housing Microfinance: A Guide to Practice)

Recommendation: Guidelines for Designing Wholesale Products

1. *Portfolio Support.* Loans, lines of credit, fund management contracts, and equity participation are acceptable methods of financing the HMF portfolio of retailing MFIs. Grants should be provided as portfolio support only when the apex institution does not have to rely on the cost of funds it receives from the retailing MFIs to support its ongoing operations. This may be the case where the apex is designed to be a temporary initiative, and not an ongoing second-tier financing institution.

2. *Operational Support.* Outright grants, equity participation and performance incentives are acceptable methods of financing the HMF-related administrative costs of MFIs.

3. *Pricing for Wholesale Loans and Lines of Credit.* The effective annual interest rate (the annualized interest rate on a declining basis, including all interest charged on a loan plus all other fees and commissions) apex institutions charge to retailing MFIs should not exceed the average cost of capital retailing MFIs are expected to incur in a given market.
   If the apex institution is not designed to be a permanent institution, fund management arrangements are preferable to loan agreements.
   Setting Retail Interest Rates. Apex institutions should not require retailing MFIs to lend at a preset interest rate. Rather, apex institutions should provide clear retail pricing guidelines that ensure the HMF product can be attractive to the retailer from a financial viability perspective. Guidelines should also maximize the possibility that clients will be able to afford the loan.
   Apex institutions and MFIs pricing a housing microfinance service should use an advanced financial planning model, such as MicroFin, to estimate the annual effective interest rate that will lead to financial viability.
   A recommended pricing formula is as follows: (See Appendix A for a fuller discussion)

$$R = \frac{AE + LL + CF + K^{1} - II}{1 - LL}$$

   Where (R), the annualized effective interest rate is a function of five elements, each expressed as a percentage of the outstanding loan portfolio:

   – AE: administrative expenses;

   – LL: loan losses;

   – CC: cost of funds;

   – K: desired capitalization rate including any profit or capital to be reinvested into the loan portfolio;

   – II: investment income.

4. *Construction Assistance.*
   – If desirable, apex institutions can set basic standards for construction quality by requiring the retail institution to procure construction assistance for its clients.

   – Construction assistance is most appropriate in situations where local laws governing a household's ability to undertake a construction project do not guarantee the soundness of the resulting construction work. In cases where such laws do exist and are likely to lead to decent results, construction assistance may not bring any value added to the client.

– When required, construction assistance can apply to design; budgeting; assistance with the selection of a contractor; and construction oversight.

– Construction assistance should always be included in the pricing for the HMF loan.

Recommendation: Guidelines for Designing Retail Products

1. *Loan Use.* HMF loans can be used for a full range of habitat needs, including but not restricted to home improvement, core home construction, water and sanitation improvement, land acquisition, and physical infrastructure.

2. *Repayment Period.* If the MFI does not have a prior relationship with the HMF clientele and has not established a risk adjusted repayment period for its HMF product, Sida strongly recommends that the loan repayment period should vary from 12 months to 36 months, with 60 months as an absolute maximum for repeat clients. These recommended limits should only be exceeded in cases where the MFI can demonstrate that the clientele does have a history of repayment with HMF or similarly structured loans over longer periods of time.

3. *Repayment Performance.* Sida-supported MFIs should manage loan portfolios that meet basic performance standards reflecting Sida's general microfinance standards. At minimum, these standards should include: Portfolio at Risk guidelines (10% or less); Arrears over 30 Days Guidelines (7% or less); Repayment rate guidelines (95% or more).

4. *Write Offs.* In order to accurately reflect the value of performing financial assets, MFIs should adopt clear policies to write off bad loans. Sida recommends writing off loans that are more than 180 in arrears at least twice a year.

5. *Pricing for Wholesale Loans and Lines of Credit.* The effective annual interest rate (nominal loan interest rate, plus all other fees and commissions) apex institutions charge to retailing MFIs should not exceed the average cost of capital MFIs are expected to incur in a given market.

6. *Pricing.* Sida-supported MFIs should lend to their clients at rates that allow the MFIs to reach financial self-sufficiency in the long term. MFIs pricing a housing microfinance service should use an advanced financial planning model such as MicroFin to estimate the annual effective interest rate that will lead to financial viability.

   A recommended pricing formula is as follows:

$$R = \frac{AE + LL + CF + K - II}{1 - LL}$$

   Where (R), the annualized effective interest rate is a function of five elements each expressed as a percentage of the outstanding loan portfolio:

   a. AE: administrative expenses;

   b. LL: loan losses;

   c. CC: cost of funds;

d. K: desired capitalization rate including any profit or capital to be reinvested into the loan portfolio;

e. II: investment income.

7. *Construction Assistance.*

– If desirable, retailing MFIs should set basic standards for construction quality by requiring procuring construction assistance for their clients.

– Construction assistance is most appropriate in situations where local laws governing a household's ability to undertake a construction project do not guarantee the soundness of the resulting construction work. In cases where such laws do exist and are likely to lead to decent results, construction assistance may not bring any value added to the client.

– When appropriate, construction assistance can apply to design; budgeting; assistance with the selection of a contractor; and construction oversight.

– Construction assistance should always be included in the pricing for the HMF loan.

Relationship Between HMF and Housing Subsidies to Client

Structuring a program around government subsidies can be a risky proposition, as Sida's recent experience in Central America has demonstrated. Political considerations, bureaucratic inefficiencies and financial mismanagement have contributed to the fact that no current Sida program is able to access the subsidies with which they were designed to work. As a result, supported MFIs have had to adjust their program design to offer their clients pure credit programs in lieu of the credit/subsidy mix several of these programs initially envisioned.

Worldwide experience of credit and subsidy suggest that, while they can coexist alongside one another, two basic rules should apply:

8. *The credit provider and the subsidy provider should be two different organizations.* MFIs should focus on understanding, finding and qualifying potential *clients* with a sufficient enough income to afford a housing microfinance loan. Subsidy providers should focus on understanding, finding and qualifying potential *beneficiaries* whose income or economic and social circumstances are such that they would qualify for a subsidy.

9. *Subsidy and credit should not be mixed as part of a single package.* This is not to say that one household could not be the benefit of a subsidy at one point in time and of a loan at another. It means that loan eligibility should be independent from the availability of a subsidy (in case, as is unfortunately often the case, the subsidy does not materialize or dries up over time).

Recommendation: Guidelines for Subsidies:

Combining HMF with Direct subsidies to clients

– HMF programs can be designed to work alongside subsidies programs, so long as loan disbursements are not dependent on subsidies disbursements.

– It is not advisable for the HMF retailer to also be the organization making the decisions on loan subsidies.

Institutional Subsidies to Wholesalers and Retailers

– Sida can provide fixed, pre-agreed upon institutional subsidies as operational support. Subsidies should be contingent on performance targets and all parties should agree upfront on a phase-out strategy for the institutional subsidy.

– Institutional subsidies can be variable and provided under the form of performance incentive.

– Institutional subsidies can be under the form of "targeting" incentives.

– Institutional subsidies should never take place at the level of the interest rate charged to clients; wholesalers supported by Sida can however charge a cost of funds to retailers that is below "market" rate.

Endnotes

[i] This paragraph is adapted from Franck Daphnis, *Housing Microfinance: Towards a Definition,* in this volume.

[ii] Including notably the experience of PLAN International. PLAN conducted nine such studies around the world with CHF's help between 1996 and 1999.

[iii] As much as 20% of MFI business lending goes "de facto" for housing, according to an estimate by Ferguson and Heider (*Mainstreaming*, page 9). SEWA Bank estimates that more than 40% of its business loans were used for housing purposes before it started offering a specific housing product in the mid-70s.

[iv] Genesis in Guatemala, Bancosol in Bolivia, SEWA Bank in India, FUNHAVI in Mexico, for instance all fall within that range.

[v] Daphnis and Tilock, 10.

[vi] This paragraph is adapted from Daphnis, *Housing Microfinance: Towards A Definition,* in this volume.

[vii] Daphnis and Tilock, 5.

[viii] Repayment periods may stretch beyond that if target clients are middle-income earners.

[ix] Available from the Consultative Group To Assist the Poorest (CGAP) at www.cgap.org.

[x] See *Microenterprise Interest Rates*. CGAP Occasional Paper No 1 (Revised); August 1996.

[xi] Includes both capitalization and profit.

[xii] As FUNHAVI, for example, currently does.

[xiii] Rosenberg, 2.

[xiv] In other words, this represents the amount owned by the provider that is in excess of what the provider owes to outside parties as loans or client deposits.

[xv] From notes distributed as a part of the Housing Microfinance Course, Microfinance Training Program, July 2000 and 2001. Also based on Daphnis and Tilock.

[xvi] This section draws from Daphnis, *Towards A Definition* in this volume.

[xvii] Daphnis and Tilock, 14.

[xviii] See notably the work of Hernando de Sotto, including *The Other Path* and *The Mystery of Capital.*

[xix] This is for example the case in the Dominican Republic.

[xx] Adapted from Daphnis and Tilock, 17.

[xxi] Ibid.

Halving poverty by 2015 is one of the greatest challenges of our time, requiring cooperation and sustainability. The partner countries are responsible for their own development. Sida provides resources and develops knowledge and expertise, making the world a richer place.

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