GOING TO SCALE WITH HOUSING MICROFINANCE: THE ROLE OF COMMERCIAL BANKS

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CONTENTS

EXECUTIVE SUMMARY III

I. THE RISE—AND COMMERCIALIZATION—OF HOUSING MICROFINANCE 1

II. COMMERCIAL BANKS AND GENERAL MICROFINANCE 3

III. HMF CHALLENGES FOR BANKS 5

- **THE HOUSING MARKET 5**
- **HMF PRODUCT METHODOLOGIES 6**
- **ORGANIZATIONAL STRUCTURE FOR HMF 7**
  - Model 1: Downscaling 8
  - Model 2: Upscaling 9
  - Model 3: Intermediaries or Service Companies 9
- **SCALING UP HOUSING MICROFINANCE–OPPORTUNITIES AND LIMITATIONS FOR THE FUTURE 10**

EXECUTIVE SUMMARY

Commercial banks globally have yet to demonstrate a comprehensive interest in developing the capacity to deliver housing microfinance (HMF) loans; indeed, of the estimated 200+ commercial banks currently offering microfinance products, perhaps only a dozen tender distinct housing or home improvement credits. [1] However, there has been significant interest among global financial markets, international development organizations and agencies, and housing advocates in the developing world to involve and expand banks' activities in this sector. In order for financial institutions to reach economies of scale in HMF, they must first have access to sophisticated physical, financial, and human resources – resources which MFIs typically do not have. Not only do banks have high levels of skilled human capital and sophisticated back-office operations, they also have access to capital markets and the capacity to provide a broad menu of financial services, including housing finance.

It is important to note, however, that the primary use of HMF provided by MFIs has been for progressive housing improvements, rather than for home purchase or whole home construction. It would seem misguided for policy makers and the development finance community to promote housing microfinance as it is currently practiced as the primary solution for filling the housing gap. Commercial banks have the potential to harness their comparative advantages to serve a broader range of housing needs for the poor. Bank's tremendous financial, operational and human resources enable them to take on new products with higher perceived risk, take the now-tested HMF sector to scale, and thus address the formidable quantitative housing demands of the less-developed world.

The few interested commercial banks have seen that housing microfinance constitutes a lucrative line of business. In Peru, we see how HMF offered by a variety of financial institutions can be successful. Large microfinance institutions that have "upscaled," or transformed themselves into commercial banks, like MiBanco, have even led the world in HMF best practices. At the same time, commercial banks that pre-date the microfinance revolution, like Banco de Crédito, have entered the sector. [2] In this context, commercial banks have proven that they can not only compete but also reach economies of scale with their HMF offerings.

However, the hesitancy of commercial banks in other countries towards developing HMF offerings leads us to seek patterns among current commercial bank HMF products to determine why, when, and how they decided to take the leap as well as what the outcomes have been. In this paper we consider the following hypotheses and observations about entering the market and the institutions' results:

- Commercial banks are wary of HMF because of the overall complexity of housing issues in developing countries, and the subsequent perception of risk. As such, even if they do enter the microfinance sector, they tend to stick with the "traditional," well-tested microenterprise products before developing HMF products.

[1] No full survey has been done to date to the best of the author's knowledge; as such, this number is based solely on applying the proportion of microfinance institutions with housing-specific products (approximately 5 percent) onto the population of commercial banks offering microfinance. It should be noted, though, that we could assume that many of the microenterprise products that are offered by banks are diverted to housing ends, which is similar to microfinance institution experience.

[2] Banco de Credito's microfinance portfolio is $267 million, and they are introducing an HMF product.

- Banks standardize products in order to scale them, so they prefer that HMF products adhere to traditional microenterprise product methodologies. They tend to avoid the provision of construction assistance, specialized loan officers, and other services that raise the costs and complexities of the business.
- When entering the MF market and developing HMF products, commercial banks often prefer to distance themselves from “boutique” products. This has led to experiments with several organizational structures and types, but it is too early to tell which works best and under which conditions.
- A strong commitment among bank management is critical to break traditional conceptions of both housing finance and microfinance, and the risk perception of both. An overview of current practice, however, suggests that the potential for HMF to become incorporated into the operations of non-microfinance banks is primarily a function of these banks’ interest in developing an overall microfinance portfolio, rather than a specific interest in HMF.
- While results from the pioneering HMF products offered by commercial banks appear promising, they have yet to: 1.) be adopted widely and globally; 2.) be viewed as a key area of growth on a par with other traditional banking products for any but a handful of banks; and 3.) meet any nation’s underserved housing demands.

The experiment, then, is still underway. In the foreseeable future, it seems reasonable to expect that housing will be part of the “second wave” of products commercial banks develop subsequent to their entry into the microfinance market, with microenterprise lending continuing to provide the entry point into the market. As such, donors and governments interested in promoting HMF as a banking product would be well-advised to focus their efforts on banks that have already become familiar with general microfinance methodologies. Similarly, those that advocate HMF as a solution to housing needs should view it as only one piece of a much larger and more comprehensive solution.

I. THE RISE—AND COMMERCIALIZATION—OF HOUSING MICROFINANCE

Until recently, access to housing-related finance has been extremely limited in the developing world. Its focus has been almost exclusively on home acquisition and mortgage-backed lending. Yet, mortgage lending and a supporting secondary mortgage market have rarely materialized as financially viable options in addressing the housing needs of the poor. This is due to three key barriers. First, few sources of funds exist that can match repayment periods spanning 10 to 30 years, creating a severe asset-liability mismatch for commercial institutions interested in housing finance. Second, when these sources do exist (government pension funds, for example), poor borrowers do not sustain repayments over long periods of time.[3] Third, the majority of the poor do not have clear title to the land they occupy for a variety of reasons, thereby prohibiting their access to mortgages. Because poor people cannot access mortgages, in short, they have been effectively shut out of all formal housing finance.

Recent developments in microfinance suggest a promising alternative. Microfinance institutions have long observed that clients use microenterprise loan proceeds to improve their living conditions.[4] Microfinance clients often make the economically rational choice to use business loans for housing needs in response to the lack of widespread access to housing finance (or to more flexible consumer finance, for that matter). A microenterprise loan offers much better repayment terms than informal sources of money lending, and such a loan can serve as a supplement or alternative to saving towards housing improvements. This suggests that microfinance has potential beyond income-generating uses (enterprise) and can apply to personal asset building activities such as investments in housing. This assumes that economically active poor people can finance their habitat needs in a manner that is incremental and affordable, and under conditions that allow the finance provider to cover all associated costs.

Typically, it has been microfinance institutions that have offered housing microfinance to their clients, as short-term cash-flow-based credit for renovation and incremental construction purposes. In this institutional context, the practices of housing microfinance as we generally recognize them have flourished.[5] Loan amounts have been modest, as have credit terms. Limited available data suggests that HMF services perform as well or better than traditional microenterprise lending from a credit risk standpoint, although the income profile of the clientele and the guarantee requirements are similar. Data also shows that HMF is usually priced marginally lower than microenterprise lending, perhaps reflecting the perceived reduction of risk.[6] Indeed, portfolio yield rates are often on par with or higher than the traditional banking sector.

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[3] Best practices have shown that repayments are not typically sustained for more than 3 years. See Franck Daphnis, "Housing Microfinance: Towards a Definition" in Daphnis and Ferguson (eds); Housing Microfinance: A Guide to Practice (Bloomfield, CT: Kumerian Press, 2004).

[4] Bruce Ferguson & Heider, E.; "Mainstreaming Microfinance of Housing." Housing Finance International (September 2000).

[5] See Daphnis (op cit) for additional elaboration of conventional practices and known advances in the field.

[6] Alejandro Escobar and Sally Roe Merrill, "Housing Microfinance: The State of the Practice" in Daphnis and Ferguson (op cit).

In short, HMF has proven itself to be a viable and growing product line for all kinds of MFIs. Historically, then, it has been the traditional MFIs that have led HMF (occasionally becoming HMF-specialized institutions), and their subsequent "upscaled" banks that have led bank-channeled HMF. It is the commercial bank HMF pilots of the last five years that have often led to further product diversification and a few cases of HMF scaling.

II. COMMERCIAL BANKS AND GENERAL MICROFINANCE

While MFIs have increasingly entered the housing microfinance market, commercial banks have also seen significant opportunities for expanding their market by moving downmarket. Spurred on by both the success of MFIs and the deregulation of the banking industries in various developing nations, banks have looked closely at developing a variety of microfinance products or working in the sector in more indirect ways (such as commercial lending to MFIs). These preliminary steps into the sector offered an opportunity to expand microfinance through every possible mechanism and explore the quality (the construction and design value of individual homes) and the quantity (the sheer number of occupied units) of housing, particularly housing for the poor. While MFIs could conceivably provide this through their existing services, the resources of commercial banks offer the potential for large-scale impact difficult for MFIs to achieve.

Looking at the entry of commercial banks into the broader (non-HMF) microfinance sector is revealing. The first entry of conventional commercial banks into the sector, along with the creation of specialized commercial banks that only offered microfinance products, occurred in the early- to mid-1990s. Generally, microenterprise lending was the entry point for both kinds of institutions but housing microfinance was introduced in almost all of these institutions fairly soon after entering the sector. [7]

Banco de Crédito de Perú

\An important development in commercial bank downscaling in HMF has been the strong recent involvement in the microfinance market of Peru's largest commercial bank, Banco de Crédito (BCP). With $267 million in uncollateralized microfinance and small business loans, BCP holds a larger share of the market than MiBanco while maintaining a low profile on the microfinance front actually. BCP's microfinance portfolio is growing at a fast pace, projected to be 30% a year for the next five years. BCP is in the process of introducing housing microfinance to its current product line and expects that the demand will be on par with what Mibanco has been able to achieve over the past five years. Even assuming a smaller percentage share of its microfinance portfolio over the next five years (for example assuming a 20% share) BCP is expected to become a major provider of HMF services over the next few years, with a portfolio that could reach $198 million by 2011.

Conventional banks were few and far between in the microfinance sector for some time; one pioneering study put that number at only a few dozen a decade ago.[8] The number appears to be hovering at over 200 now, though it is unclear how many of these are offering HMF. Motivated by stiffening competition in traditional banking activities, the desire to be perceived as philanthropic, or the simple profit possibilities from microfinance, traditional banks drew from donor-funded loan guarantees, central bank rediscount lines, and external technical assistance to fund their entries into the market. Among these transformed MFIs, the better known examples include BancoSol in Bolivia, MiBanco in Peru, and SEWA Bank in

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[7] See Liza Valenzuela, "Commercial Bank Downscalers in Latin America" A USAID Published Monograph: Microenterprise Development Brief No. 37(October 1998) and "Getting the Recipe Right: The Experiences and Challenges of Commercial Bank Downscalers" A USAID Published Monograph (October 2001); Robert Christen, "Commercialization and Mission Drift: The Transformation of Microfinance in Latin America;" A CGAP Published Monograph- Occasional Paper No. 5 (November 2001); and Robin Bell, Annie Harper and Dyson Mandivenga, "Can commercial banks do microfinance? Lessons from the Commercial Bank of Zimbabwe and the Co-operative Bank of Kenya" A DAI Published Monograph (December 2002), for examples of this process.

[8] Mayada Baydas et al., "Commercial Banks in Microfinance: New Actors in the Microfinance World;" A USAID Published Monograph (August 1997).

India; all of which have offered housing microfinance loans from a relatively early date and are now known as the leading purveyors of HMF globally.[9]

So, there have been successes. Yet, whether the faith in banks being the sole purveyors of scaling capacity is warranted in the case of HMF, and whether HMF offered by any kind of institution can address more than qualitative housing demands, has yet to be seen. Much research remains to be done to understand which organizational and governance structures are most appropriate to further scale up HMF products. The inability to develop the appropriate kind of organizational structure and processes for offering and testing HMF in commercial banks has been one of the main challenges in developing microfinance and housing products for the poor.

[9] See Greg Chen, "The Challenge of Growth for Microfinance Institutions: The BancoSol Experience;" A CGAP Published Monograph: Focus Note No. 6 (March 1997) for a description of how an NGO-seeded MFI scaled into a banking institution.

III. HMF CHALLENGES FOR BANKS

The emergence of housing microfinance and its limited rise and acceptance among MFIs has shown that new and innovative solutions can stretch traditional paradigms and offer effective alternatives to the poor in both housing and finance. Still, housing microfinance is only now coming into its own and much remains to be done to document its successes and shortfalls, standardize its methods, and ensure that tools and best practices are developed and disseminated. As of this writing, there has not been much rigorous investigation of the potential size of HMF markets. Beyond the high expectations that have been generated by early examples, important questions remain about the challenges of diving in. To answer these questions, some key factors that impede market entry include:

- the complexity of the housing market versus the conservative (risk averse) culture of banks;
- the differences between HMF and the traditional microfinance model; and
- the organizational and operational structure through which commercial banks pilot, launch, and scale HMF products.

THE HOUSING MARKET

Banks are conservative, risk averse institutions. As such, new products are often met with skepticism and the preferred course of action involves a healthy amount of risk assessment. When looking at HMF, there are two key obstacles to entry. The first is the previously described risk of microfinance products in general (that is, providing uncollateralized credit to poor people with irregular incomes). The second, and one worthy of further exploration, is the fear of financing the most precarious possession of a precarious population: homes.

Numerous housing advocates can attest to the fact that some of the most basic needs of a community include the provision of housing and urban services to its residents. [10] Most of the world's poor face an uncertain existence where many live without adequate access to water and sanitation, surrounded by uncollected garbage, subject to frequent violence, with limited access to education, and living in self-built homes on precarious land where they live in constant fear of eviction. Perhaps the most basic human service is the provision of housing. Adequate housing is considered so important that 75 percent of countries in the world have ensured this right in national constitutions or enacted legislation. Adequate housing is also critical to the social, economic, and political stability of a country. A viable housing sector can generate employment opportunities, improve public health, deepen the financial sector, provide a sense of ownership to the populace, and help develop complex institutions that provide benefits across many sectors of society. Housing is also typically the greatest source of wealth creation available to the poor. By investing in their individual homes, the poor accumulate equity which can then be used as collateral to start or expand a small business.

[10] See USAID's and the World Bank's urban and housing sector site for more examples of this situation: including, www.makingcitieswork.org and www.citiesalliance.org.

Unfortunately, in the absence of formal financial sector support, housing for most poor people has long been a progressive endeavor. The urban poor often live in informal settlements treated as illegal by municipal authorities. Poor households invade land or purchase a subplot in an informal subdivision, and then construct their homes incrementally, over a period of years or even decades. The lack of legal recognition and the corresponding lack of tenure rights by the inhabitants can be a major hurdle to securing access to improved services—including financial services. Without land security or title registration, traditional mortgage finance is difficult, if not impossible. Even when land tenure security exists, the legal framework for enforcing mortgage collateral can be problematic at best.

In addition to the complexity of land tenure and housing quality, housing is often the vehicle for providing subsidies across the globe. In fact, it is perceived as a critical economic development engine even when publicly provided. Unfortunately, subsidies are usually structured poorly, and often result not only in distortions in the market but in detrimental effects on poor citizens (such as relocation, displacement, or increased costs), thereby defeating the original intent of those subsidies. If the fear of working in poor communities was not enough, the sheer complexity associated with housing in this particular sector too often steers the conservative banking sector away.

TAMEER Bank of Pakistan: The Future of HMF "Upscaling"

The example of TAMEER Bank of Pakistan, a microfinance bank created in 2005, is enlightening. TAMEER projects that in five years, it will have 80,000 to 100,000 HMF clients, and up to 500,000 total clients, from the previously unbanked sector of the population. Various savings and insurance services will be systematically marketed to clients who come to the bank through the housing door, and the bank plans to open a separate mortgage finance company targeting its successful microfinance clientele.

As such, a significant dedication is required on the part of commercial banks to work with the poor, and to work with housing. The successful delivery of microfinance services cannot be improvised. It is dependent on a commitment to a "microfinance culture", and to methods for client origination, credit analysis, and follow up, line staff management, and field-based work that can differ significantly from the established practices of more traditional financial institutions. This required level of understanding and commitment to a different management culture and mode of operation explains, in large part, why commercial banks have yet to rush and embrace the microfinance world, despite the promise of high returns and expanding market share. In all of the examples we have documented, then, this commitment must be great enough to overcome perceived risk so that actual risks can be more fully understood and addressed. For this reason, MFIs are often the only purveyors of HMF.

HMF PRODUCT METHODOLOGIES

If banks are able to overcome these perceived risks, how do they then go about designing an HMF product? Does it differ markedly from other microfinance offerings? The short answer to this second question is "no," with a few exceptions. The majority of HMF products are seen in commercial banks after the bank has entered the microfinance market, and their housing products are structured similarly to their previously tested microfinance products.

In principle, many product methodology considerations like pricing, terms, and operational costs should be no different than for any other microfinance product. However, there are often few differences between an MFI's microenterprise loan and their HMF loan product. HMF products are often a reward for long-term, high-performing clients, and the HMF product is often simply an extension of the MFI's typical microenterprise loan, with a longer term and larger amount (and, sometimes a lower interest rate).

A distinct product development process for HMF, with a resulting clearly defined HMF product, remains a gap in many MFIs approach to HMF.

Within the broader spectrum of housing finance, the comparative advantage of housing microfinance consists of helping poor and low-income earning families to access home improvement funds. Provided these families possess a minimal capacity to repay a loan under microfinance conditions (including the absence of collateral or credit history), HMF potentially offers a reliable, if incremental path towards transforming a ramshackle dwelling into a livable home.

There are a few unique characteristics of HMF that could increase the perceived risk among commercial banks. These include the lack of formal land title or security; limited capacity of borrowers to correctly estimate loan amounts required for the home improvement task at hand (which could lead to an unfinished improvement, and unsatisfied client, and subsequent delinquency); and the ultimate quality of the improvement and the client's satisfaction with it (again, potentially leading to increased delinquency).

These particular risks of HMF are added to the general perceived risk of microfinance. Banks and other providers of formal financial services do not typically extend credit to individuals whose income cannot be documented or to individuals who have irregular or informal sources of income, even when that income can be documented. Further, the lack or the inadequacy of credit collateral (or of formal land or property title for housing loans) also constitute enormous hurdles for banks interested in financing economically active poor people. This is true for all microfinance clients, and is exacerbated for HMF. The operational costs associated with these hurdles seem to make the entire enterprise unfeasible: additional site inspections; specialized staff with construction knowledge; agreements with building material vendors or even contractors; etc.

These factors make commercial banks more reticent to offer housing microfinance, despite the fact that practical solutions are available. Microfinance best practices are based on non-collateralized loan methodologies. Mechanisms can be put into place at relatively low cost to reconcile home improvement estimates with the loan value, and to reinforce that the client is ultimately responsible for construction quality (unless the lender becomes involved in construction assistance, in building material provision, or in actual construction, as well). However, despite these available solutions, the perceived risk of the market, of the product methodology, and for the bank's operations continues to limit further commercial bank expansion into this product.

ORGANIZATIONAL STRUCTURE FOR HMF

In attempting to address these challenges, there has been no consistent or "best practice" institutional structure for banks developing HMF. When entering the HMF market, commercial banks often prefer to place firewalls and distance themselves from "boutique" products like HMF. This requires that they create an entirely unique staff and organization to develop and deliver the product—thereby adding costs and increasing risk. This has led to experiments with several organizational structures and types, but it is too early to tell which works best and under which conditions.

Interested banks have generally pursued three main avenues in developing broad microfinance windows that accommodate housing microfinance. [11] First is bank “downscaling,” whereby an established commercial bank sets up a microfinance unit within the bank itself to manage its microfinance portfolio (such as Banco de Crédito in Perú). Downscaling is also achieved through the creation of service companies or stand-alone subsidiaries , such as Sogesol and Microcredit National in Haiti, owned by SogeBank and UniBank, respectively. Second is the upscaling of microfinance institutions (MFIs), whether they have private or non-profit origins, into specialized banks that offer only microfinance products or even into full service banks that offer both microfinance and traditional financial products. MiBanco of Peru, BancoSol of Bolivia, and SEWA Bank of India are examples of this. Lastly, there are intermediary organizations or hybrids in which the bank utilizes an external company or service provider to originate and service its microfinance portfolio. ICICI Bank of India has formed partnerships with several MFIs for various specialized microfinance product lines, including HMF.

MiBanco of Perú: The Oldest Sibling in HMF

HMF has a recognized market leader in MiBanco, which has evolved from its non-profit roots to become a profitable commercial bank serving hundreds of thousands of clients. MiBanco began to offer housing microfinance services in the last few years and has seen large and rapid growth in housing loans. Peruvian government support of affordable housing finance subsidies linked to MiBanco products also suggests increasing awareness of the retail benefits of microfinance products. In Peru, if current trends continue, HMF could rise to represent 20% to 30% of all microfinance lending in the country. Microfinance is thriving, with Mibanco being by far the fastest growing bank in the country. Currently, HMF represents 15% of the bank’s $200 million total loan portfolio, and is expected to reach 25% in the next five years. Such growth indicates that the bank’s HMF portfolio could reach approximately $348 million by 2012. Interestingly, HMF represents a minimum of 10% of the lending done in the rest of the microfinance sector in Peru. Assuming the estimated current HMF portfolio share of 10% and a microfinance industry growth rate of 6% over the next 5 years, non-bank MFIs could potentially see their HMF portfolio rise to $214 million by 2011.

MODEL 1: DOWNSCALING

In commercial bank downscaling, we have seen that microfinance products have to be proven, through the success of other banks or high-performing MFIs, before a bank makes the decision to incorporate microfinance operations internally (and HMF, in particular). For some banks, governmental incentives have to be made to entice them yet, for the most part, the bottom line seems to be incentive enough if it has been demonstrated to be profitable by other local financial institutions. In these instances, we have seen that there is no clear difference in the motivations among the downscalers between HMF and non-HMF microfinance products, and virtually no difference in the actual internal operations; indeed, almost all of the downscalers (which are still few and far between) rely on traditional microfinance methodologies for loan origination. The advantage in this structure, of course, is that the bank leverages existing resources and systems without dramatically altering its processes. In those few circumstances in which this has occurred, we see that the only real concern is the client’s capacity to pay—whether it be used for housing or not is often less critical.

[11] See Jennifer Isern and David Porteous, “Commercial Banks and Microfinance: Evolving Models of Success;” A CGAP-Published Monograph—Focus Note No. 28 (June 2005); Matthew Brown et al, “Commercial Banks and Microfinance;” A CGAP Published Monograph (Undated); and Robin Young and Deborah Drake, “Banking at the Base of the Pyramid”, USAID MicroReport 22 (February 2005) for overviews of contemporary organizational structures in general microfinance.

MODEL 2: UPSCALING

Interestingly, many of the MFIs that choose to “upscale” adopt the same behaviors as downscaling traditional banks. Their motives are often the same, though usually described in more social terms, and they are restricted in their growth goals only by regulatory constraints. What is perhaps of most interest is the fact that many drop their concern for the physical housing results by limiting or restricting construction technical assistance, making the verification of the home improvement project with the requested loan value a perfunctory task, and focusing almost solely on the client capacity to repay. This is true of MiBanco and Tameer Bank in Pakistan. Aside from this key difference, the upscaled MFIs probably distinguish themselves most because they have had the expertise and experience of working with the local microfinance clientele for longer periods, and have undergone a variety of HMF product pilots before having selected the one that is most profitable and scaleable. Indeed, many downscaling banks simply copy the upscaled MFI HMF products—an important lesson not only for “upscaled” banks but for all of the HMF community.

MODEL 3: INTERMEDIARIES OR SERVICE COMPANIES

Lastly, there are intermediary organizations. Many forms exist in the microfinance industry of various partnerships and outsourcing arrangements between commercial banks and MFIs. But in housing microfinance we have only seen one kind: “servicing models”, whereby an MFI services the microfinance portfolios of established commercial banks. ICICI Bank of India has formed partnerships with several MFIs to service its various specialized microfinance product lines, including HMF. While the lines are sometimes blurred and largely dependent on regulatory environments, these are proving to be the testing grounds for HMF for commercial banks. This is due, it is believed, because they are the preferred venue for product experimentation and piloting and not because of an inherent characteristic of these institutions (unless there is a regulatory condition which requires housing finance to be performed by a certain kind of institution, as is often the case).

In a service company model, the bank forms a nonfinancial legal entity (the service company) to provide microloan origination and portfolio management services. As described in recent reviews, the service company usually undertakes more limited operations and is not regulated separately by the banking authorities. [12] In this model:

> “Loans and other financial service products (savings, transfers, payment services, etc.) offered to service company clients are registered on the books of the parent bank. The service company typically maintains separate corporate identity, governance, management, staff, and systems (although the information systems are usually linked directly with those of the bank). The service company may be wholly or partly owned by the bank. However, the service company structure offers the bank the ability to involve technical service providers with expertise in the delivery of microfinance and other interested investors as equity partners, which it cannot do with an internal unit. The service company may operate in designated areas within bank branches or in separate offices close to the bank.” [13]

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[12] See Isern and Porteous (op cit), as well as Matthew Brown et al, “Commercial Banks and Microfinance: The Service Company;” A CGAP Published Monograph (Undated), and “The Service Company Model: A New Strategy for Commercial Banks in Microfinance” An ACCIÓN Monograph—InSight No. 6 (September 2003); and Robin Young and Deborah Drake, “Banking at the Base of the Pyramid”, USAID MicroReport 22 (February 2005) for more non-HMF specific examples of this model.

[13] Ibid.

Indeed, this is the current model being employed by ICICI Bank in India with CapStone to demonstrate the scale of urban HMF in the country. As commercial banks become more interested in alternative microfinance products (particularly in one as complex as HMF), it is believed that this will be a common model for experimentation and, ultimately, future scaling.

SCALING UP HOUSING MICROFINANCE–OPPORTUNITIES AND LIMITATIONS FOR THE FUTURE

Despite the challenges discussed above - the complexity of the housing market, the unfamiliar product methodology, and the search for the right institutional structure - there are still high expectations of commercial banks entering the HMF market. Can HMF live up to the financial and housing-related expectations that many donors and development agencies have created? These interrelated expectations include the wide and global adoption of HMF; HMF leading to increased access to finance overall and an expansion of the financial markets to serve the poor; and HMF as a tool to address national housing shortages in poor countries.

Certainly, HMF often provides financial access to clients who do not formally own the land on which their dwelling is built. In most cases, land "security," rather than proper ownership is the operative criterion for approving an HMF loan. Practicality dictates flexibility on ownership criterion, as many poor clients do not actually own the land they occupy, often living in informal or precarious settlements.[14]

However, HMF products, to date, have had a limited impact on the overall expansion of financial markets and have not fulfilled the promises of global replication or the ability to address housing shortages. High interest rates and fees, coupled with short repayment periods and low client capacity to repay suggests that HMF loan sizes will remain relatively small. In Peru for instance, where a modest new home can cost a minimum of US$30,000 to acquire, HMF loans of $2,000 to $3,000 cannot substitute for or compete with a longer-term housing finance product, such as the Crédito MiVivienda mortgage subsidy products. The primary use of HMF is for progressive housing improvements, rather than for home purchase or whole home construction. It would seem misguided for policy makers and the development finance community to promote housing microfinance as the primary solution for filling the housing gap.

Even in the most favorable circumstances (such as those found in a country like Peru) it is difficult to envision that, in the foreseeable future, more than 10% of a country's households could access housing microfinance loans on a sustained basis. Of course, in large countries with significant housing finance shortages, this could amount to several million customers and could contribute to significant reductions in national qualitative housing deficits. Two important cautionary notes should accompany this observation.

First, as evidenced in the case of Peru, a number of prerequisites must be in place in order for such a level of market penetration to be possible. These prerequisites include: a large and profitable microfinance industry, a government that is engaged in developing social housing options, a potential for capital markets to finance the future growth of microfinance portfolios, a committed management and staff and a supportive regulatory environment. In countries where these conditions are currently met and where demand for incremental housing finance exists, it is reasonable to expect that as best practices spread, the examples of MiBanco and BancoSol have the potential of being emulated.

[14] By lending to such clients, though, HMF providers may play an inadvertent role in the entrenchment of informal housing. In some cases, such as with the Inter American Bank in Central America in the mid 1990s, donors have attempted to link HMF loans to land regularization programs.

Second, the relatively small size of housing microfinance loans probably implies that even with a market penetration as deep as 10% of a country's households, HMF loans as a percentage of GDP or total bank assets is likely to remain relatively low (at least, in the short term.) In the long run, as microfinance grows to become a more prominent feature of the financial landscapes in developing countries, so will the size of housing microfinance markets. At the present time, the projections for HMF in Peru (1% of GDP within five years) remain a goal that no other country, to the authors' knowledge, has come close to fulfilling.

The relative success of HMF among specialized banks should be tempered by the observation that its success has not yet been replicated at any significant scale beyond a few countries. While housing microfinance has the potential to reach a sizeable proportion of households in most countries with thriving microfinance industries, HMF portfolios worldwide remain small relative to GDPs or total bank assets. Despite the potential market, many banks seem wary about pursuing HMF products because of the dual complexity of serving the low-income and the housing markets. As a product primarily targeting progressive home improvement, HMF is not a suitable solution for financing large scale, non-subsidized new home constructions.

Thus, despite early hope, even commercialized HMF is not the "silver bullet" that will solve the challenge of universal access to home financing for the working poor. While HMF's potential impact could be substantial--perhaps offering financing to as much as 10% of household in a country such as Peru where favorable conditions prevail—its reach is limited to the financing of home improvements, or as an incremental or "gap" financing tool. HMF is not a substitute for affordable long-term mortgages, and the structures that support such mortgages at the private level including commercial retailing outlets, supportive regulatory authorities, and capital markets or other sources for refinancing. Rather, the specific promise of HMF is that it will provide reliable and affordable financing to those who do not qualify for a mortgage but are solvent enough to borrow in order to improve the quality of their existing dwelling; increase the size of that dwelling; or supplement a government –provided subsidy.

Despite this, it is important to note that MFIs and commercial bank HMF providers will continue to expand the methodological frontiers of microfinance and will likely discover new and innovative ways to deliver housing loans to clients over extended periods of time and under affordable conditions. As MFIs grow and become regulated, and housing microfinance develops into a mainstream microfinance service, it will become increasingly attractive to commercial banks interested in the microfinance market.

HMF's role in helping to house poor and middle income families is also becoming clearer. HMF should be the key product when poor and low-income families seek to improve the conditions of their homes. When subsidies are scarce or absent, HMF may also be the only viable option for economically active households employed through the informal sector and thus "unbankable" through traditional banking channels. This vital role is constrained, at least in the foreseeable future, by the limited capacity for most MFIs to scale up and become national players and by commercial banks' limited appetite for microfinance products. Currently, HMF appears best suited to be a lead response to qualitative housing deficits rather than quantitative housing shortages. Increased commercialization, however, holds promise for increasing qualitative impact as well as generating innovations to address quantitative housing shortages in the future.