Background paper UN Habitat and Human Settlement Foundation  
(UNHHSF)

1. The Challenge

It is estimated that some US$ 20 billion would be required annually during the period 2005 to 2020 to achieve MDG 7 Target 11 and to prevent the future formation of slums. The sheer scale of this challenge far outstrips the current levels of private and public investment in housing and infrastructure in most developing countries. The solution to this challenge lies in the successful mobilization of domestic capital and in leveraging the estimated US $5 billion provided annually by official development assistance to the urban sector. A related challenge is that of targeting. Current financing models and systems used by the commercial sector are designed to meet the needs of “middle-class” borrowers and are not accessible by the urban poor.1 New financial instruments, products and innovative packaging are required to make large-scale slum improvement and pro-poor housing and infrastructure projects “bankable”, i.e. attractive to domestic sources of capital.

2. The current architecture for housing finance

The current architecture for housing finance is comprised of a wide range of actors. These include government run or government-backed housing and municipal institutions, banks or funds; financing housing cooperatives; mortgage finance institutions and/or specialised branches of commercial banking; and micro-credit institutions. With the exception of micro-credit institutions, the majority of the existing financial instruments share the following characteristics and modus operandi:

- They require down-payments and/or guarantees
- They require a clear title deed
- They require that the borrower has a regular income or a proven track record in business
- They lend primarily to individuals rather than to groups and therefore involve high transaction costs
- They recognise a limited range of acceptable housing solutions and standards, often defined by insurance requirements and resale value, rather than client needs or widespread building practices.2 They do not, for example, cater to incremental building processes which are often the most viable solution for the urban poor.

In the case of micro-credit institutions, the long term nature of housing finance, typically ranging from 10 to 15 years, exceeds their cash flow capacities. They do however fulfil an important gap for short-term loans for incremental housing construction and the purchase of building materials.

In the case of municipal financing institutions, loans are mostly provided for conventional infrastructure development, which exclude slums and low-income neighbourhoods.

At the international level, sovereign and sub-sovereign credit facilities provided by IFIs and other Funds are limited largely to financing large infrastructure projects, providing credit lines to conventional banking and housing finance institutions, and to micro-credit institutions.

In summary, the current architecture for housing finance excludes the majority of the urban and rural populations in developing countries, all those who work in the informal sector of the economy, and especially single women and female-headed households.3 There is a vicious cycle consisting of a combination of “barriers” that prevents any single actor or stakeholder to make significant progress.

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1 Despite the fact that recent studies have shown that commercial banks in many developing countries have large amounts of liquidity
2 Mortgage finance practices, in many cases, have pre-determined housing standards that enable quick sale in cases of re-possession
3 Often in relation to land and property rights, inheritance rights and, in some cases, banking practices.
These “barriers” include security of tenure, risks perceived in lending to low-income individuals and groups, unrealistic housing “standards” used for loan approvals, high transaction costs, and the lack of an enabling environment. The latter has proven to be a major stumbling block as a more enabling environment would require simultaneous changes in policies, practices and cultural norms governing housing and urban development, land and property, banking and non-banking financial institutions, fiscal regimes, the insurance and the re-insurance industry, and building codes and standards.

3. Background

The General Assembly called for the revival of the UNHHSF as part of the overall strengthening of UN-HABITAT to enhance its contribution to the mobilisation of domestic resources for human settlements development in support of the coordinated implementation of the Habitat Agenda. The lack of pro-poor housing finance systems remains the greatest stumbling block to meeting the Habitat Agenda goal of “shelter for all” and to attaining the human settlements related targets of the Millennium Declaration. General Assembly resolution 56/206 of 2001 specifically entrusted the United Nations Human Settlements Programme with its revitalisation.

Subsequently the Secretary General promulgated the revised rules for the Foundation (August 2006) which together with General Assembly resolution 56/206 of 2001 provides the overall principles and framework for enhancing the effectiveness of system-wide response to the effective mobilisation of domestic resources for meeting the slum challenge.

4. Role and comparative advantages of UN-HABITAT

Since 2001 progress has been made with the creation of the UN-HABITAT Human Settlements Financing Division, the Slum Upgrading Facility conceived as a pilot methodology for the revitalised Foundation, and with the establishment of the Water and Sanitation Trust Fund. The experience of both the Slum Upgrading Facility and the Water and Sanitation Trust Fund has shown that UN-HABITAT’s comparative advantage lies in its ability to convene all spheres of government, associations of the urban poor, service providers and operators, micro-credit facilities, donors and IFIs to leverage their respective resources. It does so by playing a leadership role in policy setting and negotiations, and by providing pre-investment technical and advisory services for the scaling up community-led initiatives and pro-poor pilot projects and programmes in housing and basic services. The particular ability of UN-HABITAT to forge working relations between local authorities and urban poor communities has been widely recognised by the African and Asian Development Banks in their respective lending programmes in pro-poor water and sanitation.

In parallel, innovative practices in housing finance for low-income groups have been documented and analysed by UN-HABITAT and highlighted in its 2004 Global Report on Human Settlements. They include practices used in inter alia, India, Mexico, Peru, Philippines and South Africa for small-scale community shelter funds, and in the case of Chile, the application of targeted subsidies. Lessons learned from these practices include:

(i) The need to supplement micro-credit lending with instruments that can provide medium to long-term financing options, especially for organised groups and for the acquisition of land and the development of affordable basic infrastructure;
(ii) The need for appropriate mechanisms to bridge credit demand by the urban poor with formal sector lending requirements;
(iii) The need for a concerted approach to policy dialogue, institutional reform and the demonstration of innovative financial instruments to break the “impasse” of pro-poor housing credit and municipal finance.
5. **Rationale and role of a strengthened Foundation**

The long-term goal of the UNHHSF is to provide evidence based on what works to bring about changes in the policies and practices for financing affordable housing and urban development through the mobilisation of domestic resources and capital. The short-term objective is to introduce innovation in the market place by demonstrating how the “impasse” can be broken. The UNHHSF will rely on the comparative advantages of UN-HABITAT and its partners to:

- Provide technical advisory services combined with policy dialogue and the development of policy options;
- Engage relevant stakeholders in demonstration projects;
- Engage financial institutions in the practicalities of financial packaging for the poor.

In practical terms this entails:

- Developing and applying innovative approaches to pre-investment, pre-project and financing strategies for human settlement activities, related urban poverty reduction strategies and integrated city development strategies, while drawing on the accumulated experience of both the public and private sectors for the mobilisation of financial resources for human settlement projects through strategic partnerships;
- Promoting and facilitating the mobilisation of financial resources from domestic and international sources, including United Nations agencies, the World Bank, regional development banks and bilateral donors, for human settlement development in general and slum upgrading in particular, in accordance with the Cities Without Slums initiative endorsed in the Millennium Declaration;
- Providing pre-investment technical assistance services related to human settlement financing at national, municipal and community group levels;
- Facilitating the adaptation and transfer of appropriate scientific and technical knowledge on human settlement projects, with particular attention to poor and low-income populations.

6. **The new rules guiding the work of the Foundation**

The new Rules enable the Foundation to apply innovative and catalytic financing products at different levels including the municipality and community level for empowering the urban poor through improved availability of pro-poor housing and slum upgrading finance instruments. Three types of “lending products” are envisaged by the UNHHSF. All three are designed as pre-investment packages, including technical assistance and capacity and confidence building support, to mobilise domestic capital and private sector investment in pro-poor housing and urban development. They include:

- **Loan guarantees**: conceived as an instrument to reduce the level of perceived risk by private sector investors and financial institutions in broadening their client base to include low-income households, housing cooperatives and community groups;
- **Seed capital**: conceived as an instrument to reduce the burden of down-payments by the urban poor and to help overcome the start-up phase “hump” in pro-poor housing programmes and projects;
- **Equity share or stake**: a minority stake, typically ranging from 2 to 5% of project costs, conceived as a confidence-building measure through the direct participation of the UNHHSF or a designated credible third party, acting as a neutral advisor/mediator in the decision-making process of large scale pro-poor urban development projects or programmes.

The Foundation will not engage in fiduciary functions. Financial transactions will be conducted through established banks and financial institutions in line with the modus operandi of many Funds, such as the Common Fund for Commodities.

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4 The “hump” refers to the fact that many low-income households willing to engage in incremental housing construction would be obliged to pay for two “rents” during the construction phase of their new homes, lasting typically from 1 to 3 years.
7. **Relationship with the MTSIP**

The MTSIP, currently being refined both internally, with external partners and with the CPR, is designed to align the capacities of UN-HABITAT to fulfill a catalytic role in support of the attainment of the human settlements related targets of the MDGs. One of the five focus areas of the MTSIP pertains to pro-poor housing credit and finance systems. The MTSIP capitalizes on UN-HABITAT’s comparative advantages and experience in pro-poor housing, land and basic services; focuses on strengthening working relations with key partners including international financial institutions and the private sector; and packages its global and country-level activities for pre-investment.

8. **Conditions for a successful implementation of a strengthened Foundation**

*Funding prospects – different sources:* The major source of funds for the revitalised Foundation will remain, for its start-up period, on new commitments for specific voluntary contributions by Member States to the new Foundation. In due course (see ‘Timing’ below) there is scope within the Rules for a variety of ‘borrowing’ functions for the Foundation, to be sourced from ‘Governments, governmental agencies and intergovernmental organisations’ (Regulation 1.2).

*Staff capacity:* The initial staffing capacity for UNHHSF will be the responsibilities of the Executive Director and the Deputy Executive Director as Deputy Administrator of the Foundation together with UN-HABITAT Sub-Programme 4 (other than SUF). Staff will be recruited to fill existing posts to provide core expertise in the areas required by the Foundation. It is expected that highly specialised expertise will be subject to partnership arrangements with IFIs and other financial institutions.

*Organisational/governance structure:* An Advisory Board will be established to guide the Executive Director and Deputy Executive Director in the development of the Foundation, relating strongly to the responsibilities of the Governing Council. The revised Operational Procedures and Guidelines will propose a full organisational structure.

*Identification of strategic partnerships:* The key to the methodology of the Foundation will be the establishment of strategic partnerships with other financing institutions to seek complementarity in roles and operations. This will include new specific relationships built with the IFIs in general, the Bretton Woods Group, government finance institutions, as well as with private sector financial institutions, both internationally and within partnering countries.

*Revision of operational rules and guidelines:* New Operational Procedures and Guidelines are being developed to relate to the new Rules, including:

1. Definitions, purpose and primary objectives of the Foundation
2. Organizational structure of the Foundation
3. Resources of the Foundation
4. Resource Allocation
5. Lending Operations
6. Projects
7. Administration of the Foundation

9. **Relations to other activities of UN-Habitat**

*Water & Sanitation Trust Fund:* To ensure effective disbursement and utilization of financial resources provided by the UNHHSF, the Water, Sanitation and Infrastructure Branch (WSIB), based on its experience with the Water and Sanitation Trust Fund, proposes to develop methodologies, tools and guidelines in order to allow the Foundation to manage its operations. Key areas for consideration include providing technical assistance in setting up of revolving funds, partnership with water operators and community-based groups, public-private partnerships, and provision of
guarantees/bonds. Technical assistance can also be provided in monitoring and evaluation of the implementation of activities supported by the Foundation.

*The Slum Upgrading Facility:* The UN-HABITAT Slum Upgrading Facility (SUF) has established a Programme Management Unit within the Human Settlements Financing Division. The PMU has undertaken a SUF Design Phase to produce an agreed Operations Manual and to explore how this approach can work in ten countries in Africa and Asia. Four countries (Ghana, Indonesia, Sri Lanka and Tanzania) have been selected by the SUF Consultative Board, an advisory body to the Executive Director, for the 3 year SUF Pilot Programme supported by the UK, Sweden and Norway. The PMU has initiated project work in each of these countries. A mid-term review of the Pilot Programme will be undertaken in mid 2008.

The outcome of the Pilot Programme will be a series of projects in each country that can demonstrate the SUF methodology, and the processes by which in-country financial institutions and commercial banks are able to engage in providing a significant proportion of the finance for slum upgrading and new low income housing (thus also helping to prevent the formation of new slums), as part of the municipalities’ own programmes of upgrading and strategies for low income housing generally.

10. **Timing – a phased approach**

It is envisaged that Lending Operations as such will be introduced in a cautious phased approach:

(a) **Phase I (2007-2009):** Establishing the institutional framework and necessary capacity for the Foundation to undertake its roles and responsibilities with regard to the financing operations expected under the Rules. This will be undertaken within the two-year period between 2007 and 2008. In parallel, and building on the experience of the existing SUF Operations on the ground, run a programme of initial Foundation-type seeding operations to help refine the Operational Procedures and Guidelines, together with methodologies for dealing with problems that will inevitably occur during this period as may be determined by periodic performance reviews. The first phase will also be used to firmly establish partnership arrangements with financial institutions at the national and global levels, including IFIs, as well as an independent assessment and proposals for Phase II to be presented to GC22 in 2009.

(b) **Phase II (2009-2011):** Broader development of Foundation project utilising the experience of Phase I and building a portfolio of projects with Habitat Partners as a proving ground for the process. In parallel, to select a basket of projects to be considered for the Foundation to take to the Inter-Governmental Banking Community for re-financing under the New Rules of the Foundation for ‘Borrowings’, to test the processes and procedures that will be involved, reporting progress to GC 23 in 2011.

(c) **Phase III (2011-2013):** From the recommendations made by GC 23, to embark on the full mandate of the Foundation as envisaged by the new Rules and to scale up operations in view of the attainment of the human settlements related goals and targets of the Millennium Declaration.

The phased approach, together with the experience from SUF, will enable UN-HABITAT to fully develop its catalytic role within the wider finance community. The key aspect for the MTSIP will be the ways in which UN-HABITAT will bring the key messages and lessons learned of the new, broader availability of credit for slum upgrading and low-income housing to municipalities and community groups alike, preferably one in tandem with the other.