

# IMPLEMENTING INDONESIA'S NEW HOUSING POLICY: THE WAY FORWARD

## Findings and Recommendations of the Technical Assistance Project “Policy Development for Enabling the Housing Market to Work in Indonesia”.

### *Executive Summary*

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## I Background

The Government of Indonesia (GOI) through the Ministry of Kimpraswil, Directorate General Housing and Human Settlement, launched a technical assistance project under the World Bank TAP4I project, to develop a new housing policy framework in line with the current development objectives for the country called “**Policy Development for Enabling the Housing Market to Work in Indonesia**” (abbreviated to HOMI). This report is a summary of the conclusions and recommendations of the main reports produced for the different components of the study by separate consulting teams.<sup>1</sup> It provides the team’s contribution to the development of a new housing policy and strategy for the country (Chapter 1,2), designed to improve the functioning of housing markets (Chapter 4) and the housing finance system (Chapter 3), create effective housing assistance programs (Chapter 5, 6) and more efficient government housing institutions (Chapter 7).

The report outlines the problems posed by the current housing institutions and policies and emphasizes the need for the development of an inter-connected process of policy transformation rather than a set of discrete reforms in particular sub-sectors. It is a long-term endeavor that involves many stakeholders, such as, DGHS/Kimpraswil, BPN, MOF, Bapanas and local governments, the financial sector, developers and contractors. International experience has shown that it is important to identify and prioritize the needed reforms and to establish an effective coordination and monitoring process to adjust the pace and content of the process as it unfolds over time. For that reason, the report takes a comprehensive approach to policy reform and discusses the urgent need to *rationalize institutional capacity* in the sector.

This executive summary will focus on four categories of **priority actions** the GOI should undertake, or initiate, over the next few years in order to move forward with the proposed reform agenda for the housing sector;

- Define the policy agenda and set up an institution to facilitate decision-making and coordinated implementation of projects.
- Initiate policies and regulations that improve the participation of the financial sector in housing finance and increase the timely supply of serviced land.
- Detail a set of complementary housing assistance programs.
- Decide on an effective implementation system for national housing assistance programs.

We summarize our recommendations for each of those action categories.

## II Main Findings and Recommendations

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<sup>1</sup> The authors of the different reports were: *Marja Hoek-Smit* on Housing Demand, *Sally Merrill and Erica Soeroto* for Housing Finance, *Michael Lee, Sally Merrill, Arie Hutagalung, Bob Sudjana Tantra* on Land and Housing Markets, *Marja Hoek-Smit* on Home-ownership Subsidy Programs and with *Douglas Whiteley* on Mortgage Insurance, *Jo Santoso, Dodo Juliman and Budi P. Iskandar* on Community-based Housing Programs. *Widiarto, Budi P. Iskander, Marja Hoek-Smit* worked on the overall Policy Framework and New Institutional Arrangements for the housing sector.

## A. Define The Policy Agenda And Move It Forward.

**Main Issues.** The housing and housing finance sectors in Indonesia are under-performing. **Demand for housing is constrained** by low and insecure incomes, a weak financial sector, high interest rates, the elimination of housing subsidies and high neighborhood risks which hinder investments in housing. There are also unnecessary **bottlenecks in the supply systems** for housing, particularly the supply of serviced land and a lack of private housing finance, that could be alleviated by well-designed and targeted government policies and program. However, the current institutional structure in which housing policies have to be developed impedes the design and implementation of effective policies and programs. Government housing functions are scattered throughout different ministries, agencies, and State Owned Enterprises, making coherent policy design nearly impossible. **The housing sector needs a “Champion”** --a coordinating, decision-making and implementing institution led by a Coordinating Minister (for example the Coordinating Minister for Economic Affairs) -- to be able to play its critical economic, financial and social roles in the recovery process of the country.

**Recommendations.** We recommend, as a matter of the highest urgency that:

- **The Inter-Ministerial Committee** will be re-activated as a permanent, and decision-making institution to steer the housing policy function –i.e., act as the **Champion** of the housing sector. Its permanent members would represent the main Ministries and Agencies involved in the housing sector (for example, the core members could be senior officials from Kimpraswil, MOF, BPN, Bapenas, Home Affairs and Local Governments). While the details of its institutional location and decision-making powers will need to be decided, it is essential that a process is developed for swift decision-making across Ministries and Agencies. A professional administrative unit would support the Committee.
- **Sub-committees** under the Inter- Ministerial Committee will be set up in high priority areas, such as housing finance policies and finance-linked subsidies, land management and land right policies, housing assistance programs for local governments. Sub-committees should have both permanent members and temporary members who are specialists in specific areas and can come from public, private or NGO sectors. These subcommittees prepare recommendations to the Inter-Ministerial Committee for actions. A clear agenda for implementation across different areas needs to be set.

## B. Improve Access To Credit And Serviced Land

While labor and construction markets work well and house prices are modest relative to incomes, housing finance and land markets are “incomplete”. We identified the following priorities in housing finance and land for policy action by the Interministerial Committee that would expand housing delivery for moderate and low income groups.

**B1 Main Issues in Housing Finance.** Banks, post-crisis, face a number of severe constraints that make them reluctant to expand mortgage lending. The Capital Adequacy Ratio (CAR) position of many banks is weak and mortgages have a high risk weighting (100 percent), credit risk in mortgage lending is high because of lack of credit information, titling and loan recovery problems, and there is a lack of access to medium and long-term funding options. Banks pay a premium to attract short-term deposits by long-term investors and rather invest in risk free, relatively liquid high yield government paper than making long-term mortgage loans.

Alternative sources of housing finance for low-income households are limited. Micro-finance is fairly accessible in urban areas, but savings and credit products are not suitable for housing credit and many micro-finance institutions lack technical skills and are operated on a non-commercial basis. Medium term funding is not available, and regulation of the non-bank micro-finance sector is scattered and weak.

**Recommendations to Expand Mortgage Lending.** Priority actions to be undertaken are:

- 1. Improve Asset-Liability Management.**
  - The new financial sector supervisory institutions should initiate prudential measures and training to induce banks to undertake prudent asset-liability management.
  - Access to funds from long-term investors should be facilitated, either directly or through the establishment of a Secondary Mortgage Refinancing Facility (SMF)<sup>2</sup>
    - Designate a special working group under the Interministerial (sub)committee to guide this policy initiative.
    - Commission a feasibility study for alternative refinancing structures (based on pre-crisis work by USAID).
    - Ministry of Finance (MOF) to change the regulations that limit pension funds and insurance companies to hold real estate assets to 10 percent of total assets.
    - Perbanas, in collaboration with the working group, to provide assistance to banks in setting up data-bases for analysis of mortgage portfolio characteristics.
  - Bank Indonesia should review regulatory risk weight for mortgage loans.
  
- 2. Improve Credit Risk Assessment and Management in Mortgage Lending.**
  - Bapenas or MOF to coordinate technical assistance to establish a credit bureau or registry for individuals; this should be linked with current efforts to set up a credit bureau for SME.
  - Standardize appraisal methods and improve supervision of the appraisal industry.
  - Improve foreclosure procedures and lower foreclosure costs:
    - Department of Justice to address the legal conflict between the mortgage law and the 1848 Dutch law to facilitate eviction in case of default/foreclosure.
    - The Supreme Court and Government Auction Agency to streamline the process to approve and execute auctions.
    - Department of Justice to cut informal foreclosure costs in the Court offices.
  - BPN and local land offices to improve titling and title registration (see below).
  - MOF to facilitate the establishment of private mortgage default insurance (MDI). Under current market conditions, MDI will only be feasible with government assistance in premium payment (see below under housing assistance programs).
  
- 3. Avoid Distortionary Housing Finance Subsidies and Institutional Arrangements in the Mortgage Industry**
  - Eliminate KPR interest rate subsidy system and replace with non-distortionary incentives.
  - Avoid special privileges and duties in down-market mortgage lending for BTN, in order to make moderate income lending a competitive area.

**Recommendations to Strengthen Micro-Finance for Housing.** Major banks will not make mortgage loans to households with incomes much below the 50<sup>th</sup> percentile, at least in the shorter term. Micro-finance institutions of all types (banks, credit unions, cooperatives, roscas) are needed to provide both a vehicle for savings and credit for housing. The following actions are proposed to prepare the MFI sector to play a role in housing:

- Build capacity through the micro-finance network (GEMA PKM) or a planned donor sponsored training center, with possible assistance from BRI.
- Change the way government and donors subsidize borrowers through micro-finance. Subsidize borrowers directly while strengthening the commercial base of MFIs.
- BI to develop a flexible, yet integrated, regulatory and supervision systems for MFIs that recognizes the large institutional and functional differences in the sector (ongoing).
- MOF and Kimpraswil to follow-up on the establishment of a liquidity window for housing micro-finance, initiated by the World Bank, and consolidate Cobild under this window.

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<sup>2</sup> A true secondary mortgage market conduit has far more complex legal and financial demands than an SMF. It would currently not be feasible nor desirable in Indonesia. However, efforts could continue to facilitate off-balance-sheet funding, including securitization, in the future.

**B2. Main Issues in Serviced Land Supply.** Despite recent positive changes several important constraints remain to the efficient functioning of the land market for housing: unnecessary complex and costly titling of land, inappropriate regulation, severely constrained supply of land because land is being held out of development. There are several positive actions by which the Government can make the land market more efficient.

**Recommendations To Improve The Efficiency Of Land Titling And Registration.**

- Land titles to be granted by Kab/Region, and in case land straddles several Kab/Regions by the governor upon local government recommendation. The National BPN office to become largely a policy-making body.
- Ministry of Home Affairs to declare housing developers as “permitted corporations” under the Basic Agrarian Law and thus allow them to hold Hak Milik in place of HGB rights.
- Revise PP24/1997 to achieve standardization of required documents for title registration and to strengthen the enforcement powers of the PPAT.

**Recommendations To Facilitate the Supply of Land.** Two main factors constrain the supply of land: large tracts of land around urban areas are held off the market, and cost and time to obtain the necessary permits is excessive. We recommend the following high priority actions:

- **Land held by IBRA should be sold by open and transparent auction, without restriction on the type of bidder, and within the time frames agreed within government and with the international community.** The larger holdings should preferably be disaggregated.
- **Public Sector Holdings** by different agencies should, under guidance from an Interministerial subcommittee, be reviewed and “surplus” land auctioned. Location Permits on these lands should be revoked where appropriate.
- **Large Private land holders** should develop land they own before being allowed to buy residual land under location permit, their unused location permits should be revoked and a higher Land and Building Tax (PBB) should be charged on vacant land. This issue should be taken up by the current review committee on PBB.
- **Pro-actively provide infrastructure** for moderate/low income housing developments, funded through National Housing Fund sources (see below) and/or revenues generated by the above mentioned land management measures.
- Ministry of Home Affairs to assist local governments in **simplifying permit processes.**
- **Improve the process of allocating and monitoring of the Location Permit,** enforce PP36/1998 and revoke expired permits for land not required in the near future.

Jointly, these priority changes in housing finance, land titling and land management procedures have the potential of dramatically improving the outputs of the housing market. Most of these measures can be implemented fairly speedily within the proposed structure of dedicated housing sub-committees under an effective Interministerial decision-making body. Other recommendations will require a national level subsidy or incentive program (e.g., improvements in land management and provision of infrastructure, establishment of a credit bureau, SMF or a mortgage insurance to extend down-market lending).

## **C. Design Complementary Housing Subsidy Programs**

**Main Issues.** GOI's housing programs are in disarray. *Without effective housing assistance systems, most of the housing requirements for the below median income groups (375,000 housing units per year) will be built in the illegal and non-authorized housing sectors.* Current access to land titles, sanitation, water, roads and transport is already inadequate. The main demand and supply constraints are:

- Housing finance is expensive because of macro-economic conditions and industry inefficiencies. Lenders do not extend moderate income lending.
- Unsecured lending for housing by MFIs is costly and MFIs are funding-constrained.
- Land and infrastructure markets for low-income housing do not work well.

- Current finance-linked subsidies are unsustainable, inefficient and market distorting.
- Rental housing for low-income workers is mostly available in the informal sector only. Current public rental programs require extremely high (and mostly hidden) subsidies, are poorly managed and serve a higher-than-intended income group.
- Capacity at the local government level to address low and moderate housing problems is exceedingly limited.

In the longer term, when interest rates continue to come down and the policy measures to improve the efficiency of housing finance and land supply will bear results, an increasing proportion of moderate and low income housing will be supplied through the market. But that will take time. Well-targeted subsidies are still urgently required, both for households at the margin of the market and for those for whom authorized housing markets do not work. The analysis suggests the following goals for housing subsidies:

- **Alleviating crisis related and longer-term poverty** concerns that can be addressed through housing programs.
- **Addressing new frontiers to improve the efficiency of and access to housing and housing finance markets.** Well-targeted incentives for mortgage lenders, investors in rental housing and households may expand the regulated housing market. *However, the land and finance sector inefficiencies that currently drive up prices of housing unnecessarily, should be addressed urgently. If these policy reforms are not implemented, the subsidies will merely pay for the continued inefficiencies.*
- **Enhancing local governments' abilities** to efficiently development and improve urban neighborhoods through housing assistance programs, both rental and ownership.

GOI faces the difficult task of developing new complementary housing assistance programs in the context of decentralization and the related budgetary changes that will allocate most of the development funds to the local government levels. *Given the limited fiscal resources, new national policy and programs need to focus on leveraging private sector, local government, NGO and household resources to increase authorized housing production.* Housing assistance programs should be transparent, well-targeted, on-budget, administered in an efficient and effective manner, provide incentives for the strengthening of market and public institutions, and be tailored to meet the varied needs of lower-income households in differing circumstances.

**Recommendations.** HOMI proposes three complementary housing assistance programs to address the identified goals.

1. **A national level home-ownership assistance program through the financial sector for those households who can, with a subsidy, use the regular housing market to obtain a house.** *The program should incentivize innovations and expand housing finance markets. Program parameters need regular adjustment in line with changing finance market conditions.*

- **Program components:**
  - A subsidy for households at the margin of the finance sector (the 55<sup>th</sup> to 40<sup>th</sup> percentile of the urban income distribution; Rp.900,000 to Rp.750,000/month).
  - Required first-time home-owner and borrower education.
  - A lender incentive system to induce participation by financial institutions.
  - An implementation system that facilitates developer participation.
- **Preferred instruments:**

We analyzed different subsidy instruments; upfront lumpsum, upfront buydowns, mortgage insurance and pledge accounts. Our preliminary recommendations are to:

  - Develop a **mortgage insurance** subsidy to extend mortgage finance for home-ownership and complement households savings. The subsidy program would pay the premium of commercial mortgage insurance. It has a relatively modest subsidy cost, addresses default risk and savings constraint, is transparent and easy to administer and strengthens standardization of lending procedures. Preliminary calculations show that subsidy costs on a Rp. 20 million house would

decrease from Rp.4.5 million under the current KPR subsidy to approximately Rp.1.6 million.

- Develop a **pledge account subsidy**, that complements household savings, for non-mortgage based lending (e.g., micro-finance and cooperative loans, lines of credit). The subsidy, a multiple of monthly payments on the loan, would be placed in an escrow account that can be accessed in case of default.
  - **Immediate steps**
    - The sub-committee and a special working group to study the alternative proposals for finance-linked subsidies. The working group should include specialists from the insurance industry and financial sector.
    - Once the decision is made on the types of subsidies to be develop, the working group should work with international and local experts to design a comprehensive subsidy system, including the household subsidy package, lender incentives and developer support measures.
- 2. A flexible neighborhood block grant program through local governments or NGOs, aimed at providing services and infrastructure to areas where unsupported land, infrastructure and housing markets do not yet function.** Two types of programs are envisioned, namely block-grants for **neighborhood/ home improvement programs**, and for **mixed new development** programs. The majority of beneficiary households would have incomes below the 50<sup>th</sup> percentile of the urban income distribution.
- **Program components**
    - Block grants to local authorities or CBOs/NGOs for varied supply side support (physical and social infrastructure, institutional development for community participation, legal and administrative support)
    - Capacity building for local governments and CBOs/NGOs.
    - Local government contributions (e.g., labor, land, services, infrastructure) and specific requirements (mostly related to the implementation of land titling and administration issues discussed above and the preparation of a simple housing plan for their jurisdiction). All costs and contributions should be calculated on the basis of opportunity costs (market value). Detailed costing will be worked out by an ADB pilot program.
- 3. Support to increase the availability of low-cost rental housing, preferably through the private sector.** Rental housing construction, particularly for migrant laborers, is a high priority. While the provision of rental housing is mostly a local government and private sector function, national incentives to private employers and capacity building support for local governments may facilitate the development of selected rental housing in strategic locations.

#### **D. Consolidate The Implementation Function of National Level Housing Assistance Programs in a National Housing Agency and Housing Fund**

**Main issues.** In a decentralized and market-oriented housing policy environment, the roles of the national government will change. Homi proposes respective housing functions for different levels of government in the report. There is one function -- **the implementation of housing assistance programs** -- that needs to be rethought fundamentally. Current subsidy/assistance projects are scattered, donor dependent and therefore discontinuous, not coordinated and lack a central home that can adjust programs to changing market conditions and changing institutional, regional or household needs.

The effective management of housing assistance programs requires highly specialized professional staff that understand the interface between the market and government policies and programs. Also, program adjustments will need some independence of legislative decision-

making. Lastly, close coordination of donor investments and technical assistance must occur to implement the menu of priority programs and institutional reforms.

**Recommendations.** We propose to establish a **Housing Assistance Agency and related Housing Fund** (NHA/HF) for the implementation of housing assistance programs.

- The NHA would administer a menu of programs, specified by government and approved by the Interministerial Committee. .
- The HF would pool funds for different housing programs and allocate these to trust funds for various programs. Funds should be set aside to cover all future flows of subsidies that are committed for.
- The NHA/HF would be under the supervision of the new Interministerial Committee. HOMI analyzed several legal models in the report.

A special working group under the Interministerial Committee should study Homi's proposals and, with the help of local institutional experts, define the new functional and legal details of a NHA/HF.

These combined actions for private and public sector improvements outlined in this four point strategic action plan, if implemented in a planned sequence, and assisted by donor funding, should begin to show early and positive effects in different parts of the housing sector and increase the overall production of low and moderate income housing.