

NON-CONVENTIONAL METHODS OF FINANCING HOUSING
FOR LOW INCOME URBAN HOUSEHOLDS IN PERU

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ABSTRACT

Two methods are described: 1) Modification of conventional methods in an established institution - the home improvement loan program of the savings and loan system. 2) Establishment of a new method in a new institution - the Construction Materials Bank. The descriptions are set in the context of how these methods address the limitations of conventional financing. The same procedures could be applied to financing adobe dwellings.

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Preface

In Peru, adobe construction is used primarily by low income families to construct simple and inexpensive shelter. In the rural setting both the preparation of the adobes and the actual construction using additional local materials is done by self-help labor provided by family members and/or neighbors of the community. This is done to minimize the cost of shelter. In urban areas, however, the preparation of the adobes is often contracted or the adobes are purchased ready made from a local producer. Sometimes the construction labor is contracted as well. Thus, in the urban setting adobe shelter is a potential client for medium and long term financing. In order to adequately serve low income households such financing must be non-conventional in that it must consider the constraints and needs specific to these households.

Currently in Peru, there are two non-conventional financing programs for low-income housing. Although to date these programs have financed only dwelling units using standard (i.e., non-adobe) materials and employing standard construction methods, they are presented to this workshop since these methods could also be applied to the construction of adobe housing for low-income households.*

* It should be noted that throughout this paper the term "household" is generally used instead of "family". A "family" - either nuclear or extended - consists of individuals biologically related. In contrast a "household" merely consists of a group of individuals living under the same roof either related or not. This latter is a broader term which more accurately reflects the current living situation of urban low income groups in Peru.

I. Introduction

A. Statement of the Problem

In Peru, as in most of Latin America, urbanization has been on a large scale and rapid in process. Urban population growth averaged 5.9% per annum from 1961 to 1972 as compared to only .7% p.a. for rural population and 2.9% p.a. for the total population(1). Of Peru's total population of 17.8 million in 1980, 12 million or 67.4% is urban (over 2,000 people). Population in urban areas is projected to double by the year 2000, when it will represent 78.5% of total population(2).

The main factor causing this urban explosion has been the rural to urban migration which involves a movement primarily from the highlands to the more developed coastal areas, an increasing concentration in larger cities, and the overwhelming primacy of the capital city, Lima. Although more than half of Peru's total urban population is found in Lima, medium sized cities are now growing at a faster rate.

The shelter institutions have been unable to provide the resources for this population influx and growth. As a result, there has been an increase in inner city slums (tugurios) and the invasion of uninhabited land on the outskirts of the cities. The effects of the current economic recession and "galloping" inflation (approximately 60% in 1980)(3) have been felt most severely by the population of these areas, which includes the poorest groups on the income scale. The bottom 50% of income earners received only 11.4% of total incomes in December 1978—one of the most unequal income distributions in the world(4). As a result, these households cannot afford any conventional housing in the formal sector due to the high interest rates (currently 58.5% for loans over one year) and high construction costs (which presently increase faster than the general inflation rate).

In the squatter settlements or "pueblos jovenes" (young towns) families attempt to solve their shelter problems outside the conventional scheme through a slow process of incremental upgrading. Initially, the invaders put up reed-mat (estera) huts, which they gradually transform over a long period of time to more permanent shelter. In fact, buying construction materials little by little when the household has a bit of extra income serves as a much better hedge against inflation than making savings deposits, the value of which is eroded by inflation. Unfortunately, due to the rapid increase in the cost of construction materials already mentioned, the time required to accumulate enough materials to complete an additional room, for example, may be several years since disposable real income buys progressively fewer materials.

B. Limitations of Conventional Financing

As indicated, in the current economic situation, conventional financing of housing is beyond the limited economic capacity of households with incomes below the median (estimated at \$330 per month as of 3/81 for Lima).* As can be noted in Table I, the monthly income required (\$588) for financing merely a

* Housing Bank of Peru estimate for 3/81.

minimal habitable structure (50m²) is nearly twice the median income.

In order to be successful non-conventional financing of low income housing must address not only economic constraints/needs, but also legal and procedural issues caused by the particular status and customs of the low income groups.

The divergence between criteria/terms of conventional financing and the constraints/needs of low income households are shown in Table 2. Particular aspects of the problem are shown in the left column and contrasted with the respective viewpoints of low income households in the right column.

TABLE 1
CONVENTIONAL FINANCING OF HOUSING
LIMA, PERU (3/81) (US\$)

Type House	Cost per ft ² (5)	Cost per m ² (5)	House Size = 50m ² Roofed Area			House Size = 65m ² Roofed Area		
			Total Cost/ Loan Amount	Monthly Payment	Monthly Income Required	Total Cost/ Loan Amount	Monthly Payment	Monthly Income Required
Habitable Structure	8.94*	96.25*	4,813	235	588	6,256	306	765
Minimal Finishing	11.02	118.75	5,938	290	726	7,720	378	944
Normal Finishing	13.35	143.75	7,190	352	879	9,343	457	1,143

Conventional Financing Terms (3/81):

- 1) Interest - 58.5% (56.5% + 2% commission)
- 2) Term - 10 years**
- 3) No down payment
- 4) Monthly payment cannot exceed 40% of monthly income

* S/.400=\$1

** S&Ls used to lend for 20 year terms, in which case the monthly payments would be somewhat lower. However, currently the few mortgage loans that are made are rarely longer than 10 years since at 20 years the real value of recovered funds is much lower.

TABLE 2

LIMITATIONS OF CONVENTIONAL FINANCING OF HOUSING* AS RELATED TO LOW INCOME HOUSEHOLDS (PERU) (-6)

A. High Eligibility Criteria	A. Constraints Inherent to Low Income Households
1. Income - an "adequate" income at a specified minimum - usually higher than the median**	1. Income below the median**
2. Saving - regular saving at a specified minimum rate and/or a certain minimum percentage of loan amount	2. Intermittent saving at a very low rate and often not deposited
3. Employment - regular	3. Intermittent employment
4. Collateral - in form of mortgage guarant	4. Lack of land title in many cases prevents mortgage - guarantee
5. Construction license - required	5. Lack of land title prevents obtention of construction license
B. Restrictive Loan Terms	B. Needs of Low Income Households
6. Purpose of loans - for completed dwellings	6. Loans for gradual improvement of dwelling
7. Loan size - minimum amount is large	7. Small loans
8. Interest - at market rate	8. Interest at below market rate targeted exclusively to these households
9. Monthly payment - equivalent to 40% of monthly income	9. Allocations of lower percentage (25-30%) of household income
10. Processing - complicated terms and conditions; lengthy procedures for application processing	10. Simple, easily understood terms and rapid processing of application

*As found at savings and loan associations and other institutions which finance housing.

**The income groups below the median are defined by USAID as the target group for Housing Guaranty financing. This is the group that receives only 11.4% of the income in Peru. Also see Section II.C.1.

This paper describes two financing programs currently operating in Peru which attempt to address and reduce this divergence so as to make financing more accessible to low income urban households.

II. Home Improvement Loan Program: MEVI

A. Purpose

The purpose of this program (Mejoramiento de Vivienda - MEVI) is to assist low income urban households finance improvements on their existing structures by making home improvement loans available, the amount of which is determined by their capacity to pay. This thereby reduces the time required to receive the benefits of such improvements. As noted above, improvements in pueblos jóvenes are normally made through an incremental building process by the investment of savings in building materials (rather than saving deposits), but that process is slow and difficult due to the rapid rise in construction costs. This program provides credit to households which could probably not obtain it otherwise and allows the materials for a specific improvement or improvements to be purchased all at once, thereby avoiding future cost increases.

This program is basically an experiment to determine if the loan recipients have the capacity to amortize relatively small loans with an interest rate below the rate for conventional housing loans.* Another objective is to determine if these loans will actually improve the living conditions in accord with the needs and desires of the borrowers. Apparently these objectives are being met and the Housing Bank of Peru (Banco de la Vivienda del Peru - BVP) is planning to expand the program.

B. Participating Institutions

The BVP was authorized by the U.S. Agency for International Development (AID) to borrow \$25 million under the Housing Guaranty Program (see description in Annex A). Of this amount \$1.5 million was designated for home improvement loans to low income households. The BVP lends these funds to the six participating savings and loan associations (S&Ls) in various parts of the country, which in turn make the individual sub-loans.

C. Program Design and Implementation as Related to Conventional Limitations

The following describes the program design and implementation problems in relation to the limitations of conventional financing indicated in Table 2 and how this program has attempted to deal with these limitations. MEVI has required some significant policy changes by the participating S&Ls and the BVP in an attempt to reach low income households in the context of the current economic situation.

It should be kept in mind that some of these aspects are parameters established by AID and/or the BVP for the sub-loans (See Annex B) and others are specific to each S&L in accordance with their own policies, but within the broad

* The interest rate for this program is currently 27.5 points below the conventional interest rate.

AID/BVP project parameters.

1. Income

In an effort to assure that these loans reach the poorest households, AID has required that borrowers must have "family incomes" below the median for the respective urban zone (based on a congressional mandate) and that they must live in pueblos juvenes or similar areas. That is, a maximum, rather than a minimum income level has been established by AID and in turn by the BVP. This has caused a problem in some areas where households with median incomes or below had little, if any, debt capacity. In this sense, then, there is a minimum income since the amount of disposable income must be equal to or greater than the monthly payment. This problem was alleviated somewhat by increasing the maximum loan term from 3 to 7 years. Also, the estimated median income is adjusted upward every three months by a rise in the consumer price index. However, this conflict of the "floor pushing against the ceiling" is always a potential problem. This is discussed further in Section II.C.9.

2. Saving

In none of the participating S&Ls is regular saving or percentage of the loan amount on deposit a requirement to obtain a MEVI loan. However, in virtually all participating S&Ls it is required that the borrower has opened a savings account with a small deposit. As mentioned, currently savings, which pay a negative rate ($50.5\% - 60\%^* = -9.5\%$), are not as desirable an investment as the purchase of building materials. However, it is hoped that once the inflation rate and the savings deposit rate are more in line that these borrowers will become accustomed to regular saving. At this time, however, requiring regular forced savings or a percentage of the loan amount as a condition for loans would be a disservice to low income borrowers, although some may already make voluntary deposits for short periods.

3. Employment

One study determined that approximately 40% of low income earners have unstable or intermittent incomes (e.g., street vendors)(7). Of the 1980 labor force 47.9% were independent workers (presumably intermittent income) (8). Thus none of the S&Ls have required stable incomes for MEVI borrowers; only that the income be verified by the employer or, in the case of self-employment, that the borrower signs a sworn statement as to the type of occupation and his/her average monthly income.

4. Collateral

Since many pueblos juvenes residents in certain areas (such as Lima) have not received titles to their lots, a mortgage guarantee is not a feasible requirement. Consequently, for the MEVI Program the S&Ls have tried to develop a set

* Inflation rate 1980.

of acceptable alternative guarantees such as:

- a. Employer's guarantee
- b. Commercial establishment guarantee
- c. Guarantee of solvent third person
- d. Time Deposits for maximum of one year (at which time they would be replaced with another guarantee)
- e. Salary deduction backed by up to 50% of the employee's indemnification fund.

In approximately 44% of the home improvement loans made to date, the participating S&Ls have accepted such non-mortgage guarantees as collateral.

Naturally, where the entitlement process is more advanced, the S&Ls prefer to have a mortgage guarantee when the borrower has title to his lot.

Some S&Ls have also accepted a global guarantee from housing cooperatives. This means that the total terrain of the cooperative is used to guarantee the loans of borrower members. Naturally, all cooperative members, both borrowers and non-borrowers, would have to approve this procedure in a general assembly to avoid potential future conflicts. This approach has the advantage that when a borrower becomes delinquent, other borrowers/members presumably would apply social pressure on him/her to pay so as to protect their own terrain against possible foreclosure.

Another S&L has used employer or commercial guarantees as transitory until land title is acquired, at which time the conversion is made to a mortgage guarantee.

Even though it does not serve as a guarantee, some S&Ls have required, in addition to the regular guarantee, that the borrower present documentation to prove he or she has a right to occupy the lot to assure that he or she will not be forced off the lot/relocated after the investment has been made in the construction.

5. Construction License

According to the law on construction licenses (building permits), all construction, including improvements such as finishing work, requires a construction license, which is issued by the local municipal government. Unfortunately, one of the requirements to obtain this license is that the applicant possess title to his land, an unrealistic condition for many pueblos juvenes residents. Also required are plans drawn by a professional engineer, an expensive proposition for low income households. In addition, the process is complicated and time consuming.

Consequently, for the MEVI Program some S&Ls have merely ignored this unrealistic (as relates to pueblos juvenes) law and not required the construction license of loan applicants. Others have required merely that the loan applicant show proof of having initiated the processing for the license when the applicant possesses a land title.

In the case of some housing cooperatives, where the house design as well as the improvements desired are basically the same for several members, it has been possible to obtain a single global construction license. One set of plans, the cost of which can be spread among members, and a global title are adequate to obtain such a license.

6. Purpose of Loans

Conventional loans are generally made only for completed units. However, MEVI resources are oriented exclusively towards gradually improving the existing unit. The program provides only partial solutions to the shelter needs of low income households, but it is in accord with the already existing incremental building approach described above. The possible uses for loans have been classified in eight categories of improvements. These are listed with the percentage of total improvements in each category.*

	Percentage of total home improvements as of 3/31/81.
a. Installations - placement of electric, water and sewage systems in the home.	12.4
b. Domestic connections - to the public service electric, water and sewage systems.	10.2
c. Finishing - includes interior carpentry, plastering, floors, etc.	34.8
d. Sanitary fixtures - such as placement or change of toilet, wash basin, shower, etc.	7.4
e. Renovations - partial or complete change of deteriorated elements without a design modification in the structure.	1.9
f. Conditioning - improvements that imply a structural design modification without expanding the roofed area.	2.1
g. Expansion - of the structure to produce one or more additional rooms for bedrooms, bathrooms, kitchen, etc.	9.1
h. Completion of structure - improvements such as columns, walls, beams, and roofs which complete the structure, including exterior carpentry,	22.1
	<u>100.0</u>

Most of the improvements have been for finishing work and for roofs to complete the structure.

7. Loan Size

Low income households do not have the debt capacity to amortize loans for completed dwellings. Consequently the program is designed to provide relatively small loans for "partial solutions".

* The total number of different improvements made is greater than the total number of loans since some borrowers made more than one type of improvement with the same loan.

The maximum loan amount established by AID and the BVP is the equivalent of \$2,500. The minimum loan size was established by each S&L depending on what was administratively feasible to process. In actual practice, the smallest loans made have been \$300-\$500 (depending on the exchange rate). However, very few loans have been made in this range. Originally nearly all the S&Ls established maximum loan amounts less than the permitted maximum in an effort to make loans to the largest number of households possible with the limited funds available. However, this has become extremely difficult. During the year and a half of program implementation an increasing number of loans have been made closer to the maximum amount simply because the rise in material costs has meant that smaller loan amounts do not permit improvements that are beneficial and adequate. Currently (4/30/81), the average loan amount is approximately \$1,900.

8. Interest

Even though the maximum interest rate which S&Ls are permitted to charge the borrowers for MEVI loans is 31% including 2% commission (some S&Ls are charging less), this is still 27.5 points below the rate (58.5%) for conventional mortgage loans. In addition, with an inflation rate of 60%, the borrower is actually paying a negative interest rate of 29%, which means that each monthly loan payment costs him successively 2.42% less in real terms. Nevertheless, within the context of economic recession and inflation such interest rates mean that this program cannot reach the "poorest of the poor" urban households. It can reach only those with incomes closer to the median (maximum qualifying income) which is periodically adjusted upward to accord with the rise in the consumer price index.

From the standpoint of the lender (the S&L) a negative interest rate means a decapitalization of the funds repaid by the borrowers. Consequently, the interest rate on this program should not be lowered. If anything it should be raised. If the rate were to be lowered this program would be even less commercially viable and would have to be subsidized further by the government.*

Unfortunately, due to the current interest rates, the demand for conventional financing of housing has virtually disappeared, which has meant that S&Ls must lend primarily for short term commercial purposes (not the purpose for which they were created) to maintain their existence during the current crisis.

The MEVI program is an attempt to allow the S&Ls to return to the financing of housing, but for small home improvement loans at less than the market interest rate. Funds are provided to the BVP at commercial U.S. rates, which are considerably lower than current local Peruvian rates for both savings and loans. The rate (17%) which the BVP lends to the S&Ls is 33.5 to 37 points less than what they must pay for savings deposits (50.5 to 54%), which is their main source of funds.

* The Government of Peru partially subsidizes this program by assuming the devaluation costs of repaying the AID HG loan in dollars at the current exchange rate (rather than at the rate originally received).

9. Monthly Payment

As mentioned, in some cases the loan terms were lengthened so as to provide lower monthly payments to borrowers. However, since loan amounts have increased in order to provide the same improvement, borrowers have had to accept a higher payment or a lesser improvement.* Thus the benefits of increasing the loan term have eroded. Also, there is a sharply diminishing benefit by increasing the loan term beyond 5 years as can be seen in Figure 1.

Most of the S&Ls in the MEVI Program have allowed the monthly payment to be a maximum of 40% of household income (limit established by the BVP for conventional loans). This limit should probably be much less (20 - 25%) for low income households. The higher this maximum, the lower the qualifying income, but it appears that those with lower incomes have less percentage of income available to amortize a loan for housing. If we assume for the sake of illustration (see Table 3) that as a household's income decreases, their disposable income as a percentage also decreases, we can see that, theoretically, only those with the higher incomes (required when the ratio of payment to income is lower) can afford to make the payments without creating a deficit. Such a deficit means reducing other living expenses (e.g., food, health) or becoming delinquent.

In any case, it seems obvious that applying an arbitrary percentage to income to determine what a family can afford has certain inherent dangers, particularly at lower income levels. For example, if a household is assigned a monthly payment equivalent to 40% of their income, but they can only in fact afford 15%, the loan is really creating rather than alleviating hardships. Therefore, it seems like a case specific analysis of income less average monthly expenses should be done to more closely determine the individual disposable income.

One way some institutions have recently tried to reduce monthly loan payments initially is to establish a system of gradually increasing (periodic increments) payments to correspond to the expected increase in household income. This system basically defers payment of part of principal along with the interest that corresponds to this part to the middle or end of the loan term. Obviously, this has certain risks in that household income may not increase as expected. This system of graduated payments has not yet been applied to the MEVI Program.

* As an example, one year ago a loan of \$1,500 may have provided a roof to cover 100m². Now to roof the same area may cost \$2,400 (60% inflation). Assuming the loan term were the same this would mean a higher monthly payment (e.g., \$103 per month for 3 years at 31% instead of \$64). If the loan term were increased to 5 years, the monthly payment for the larger loan would be \$79. If the borrower's income has gone up enough to cover this higher payment, he/she could still roof the same area. Otherwise the area to be roofed would have to be reduced so that the monthly payment would be equal to or less than his disposable income.

TABLE 3
ILLUSTRATIVE RELATION OF MONTHLY LOAN PAYMENT TO HOUSEHOLD INCOME

If monthly payment cannot exceed ____% of household income:	And the monthly payment is: (\$)	Then the required household income is: (\$)	Estimated disposable income available to make loan payment*		Excess/ (deficit)** after making loan payment (\$)
			%Household Income	Amount (\$)	
15%	120	800	40%	320	200
20	120	600	35	210	90
25	120	480	30	144	24
30	120	400	25	100	(20)
35	120	343	20	68	(52)
40	120	300 (median)	15	45	(75)

*These estimates are merely illustrative (not based on any specific study) to show how a family's disposable income decreases in relative terms (i.e., as a percentage of income) as well as in absolute terms in relation to total household income.

**Deficit means other living expenses (e.g., food, health) will have to be reduced to make payment or borrower will become delinquent.

Nevertheless, to date of the 456 loans (4/81) made in the MEVI program there have only been one or two delinquencies in repayments. This low rate of delinquency may be due to careful analysis of debt capacity or it may be that some borrowers have additional unreported income which allows adequate disposable income for making loan payments.

10. Processing

An objective of the participating S&Ls is the rapid processing and approval of loan applications to minimize the impact of material price increases. In addition, all have prepared simple and concise program descriptions to assist applicants in understanding the requirements and terms of the loans and to serve as a memory aid. The documentation required from the loan applicants has been reduced to the minimum.

Since the loan amount is relatively small and in nearly 44% of the cases the loans are without mortgage guarantee (which must be inscribed in the public register - a slow process at best) and often a construction license is not required, it has been possible to eliminate several steps from the normal application processing. Also, one S&L has established levels of approval authority, so that only the largest loans must go to the Credit Committee for approval. Loans of lesser amounts may be approved by the General Manager. In other S&Ls, the Credit Committee meets frequently (once a week), so that all qualified applications can be approved at this level without delay.

D. Other Aspects of Design & Implementation

1. Promotion

For program implementation all but two of the participating S&Ls have either hired or assigned personnel full time to the program. An important aspect of promotion/borrower orientation has been the personal contact between MEVI program personnel and the loan applicants, both in the office and in the field. In some S&Ls the technician/promoter visits the applicants in their homes in order to assist them to fill out the loan application and subsequently prepare the proposed project budget on which the loan amount is based. In one area the regional office of the Housing Ministry provided this service in coordination with the S&L.

The communities in which to promote and implement the program have generally been selected on the basis of pre-established criteria and in one case on a study of communities as well. In virtually all cases the S&L has initiated its contact with borrowers through local community leaders. Their support is important to program success, specifically in regard to acceptance by potential borrowers. These leaders often assist in program promotion by, for example, arranging community meetings where the S&L can explain the program. One S&L invited community leaders to make comments/suggestions after hearing the proposed program parameters. In this way the beneficiaries (i.e., their representatives) felt involved in the design process and that their needs were being taken into consideration. This resulted in still greater support during the promotion stage.

Working with communities and community leaders is more efficient and more positive than strictly advertising in local media and waiting for applicants to come to the S&L office. This "outreach" approach shows residents of these areas that the S&L really wishes to help them - an image contrary to that generally held of S&Ls by low income households. It also means that several applicants can be visited in their houses in a shorter period as opposed to dealing with applicants widely dispersed.

2. Construction

During the construction phase it is also obviously more efficient to visit several projects in the same area for inspections/technical assistance. One S&L has used an architecture student not only for these construction phase inspections, but also for promotion as well with very positive results. In addition, his student status means that his salary is much lower than a professional engineer or architect, which allows the S&L to provide this service to borrowers at no extra cost.

The following kinds of labor have been employed in the implementation of the home improvement projects:

- a. Contracted - the contractor/foreman is in charge of the contracting of labor as well as the purchase of materials for which he provides receipts to the borrower.
- b. Self-help - borrower and the members of his/her family provide the labor. Borrower buys materials himself with loan proceeds.
- c. Mutual-help - borrower and his neighbors provide the labor. Borrower, in turn, assists his neighbors on their projects. Borrower buys materials.
- d. Self-help, labor contracted - borrower contracts the labor which he directs himself. Borrower buys materials.
- e. Mixed - contractor/foreman directs borrower, and his/her family members and/or neighbors in unskilled labor. Contractor provides skilled labor. Contractor or borrower buys materials.

Although there are no statistics, the author has gotten the distinct impression from talking to several borrowers that a significant percentage of borrowers prefer to contract all the labor because they do not have either the time and/or the skill to do the home improvements themselves. However, nearly all borrowers probably help with some unskilled labor (e.g., carrying materials, mixing cement, etc.)

3. Program Status

As of April 30, 1981, the six participating S&Ls had approved a total of 456 loans representing an approximate dollar value of \$865,000 or 57.7% of the total \$1.5 million assigned to the program. The average loan size was \$1,896.