

Developing Kenya's Mortgage Market

May 2011



THE WORLD BANK

Report No. 63391-KE

©2011 The International Bank for Reconstruction and Development / The World Bank
1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org

All rights reserved

This volume is a product of the staff of the International Bank for Reconstruction and Development/ The World Bank. The findings, interpretations, and conclusions expressed in this volume do not necessarily reflect the views of the Executive Directors of The World Bank or the governments they represent.

The World Bank does not guarantee the accuracy of the data included in this work. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.

Rights and Permissions

The material in this publication is copyrighted. Copying and/or transmitting portions or all of this work without permission may be a violation of applicable law. The International Bank for Reconstruction and Development/ The World Bank encourages dissemination of its work and will normally grant permission to reproduce portions of the work promptly.

For permission to photocopy or reprint any part of this work, please send a request with complete information to the Copyright Clearance Center Inc., 222 Rosewood Drive, Danvers, MA 01923, USA; telephone: 978-750-8400; fax: 978-750-4470; Internet: www.copyright.com.

All other queries on rights and licenses, including subsidiary rights, should be addressed to the Office of the Publisher, The World Bank, 1818 H Street NW, Washington, DC 20433, USA; fax: 202-522-2422; e-mail: pubrights@worldbank.org.

TABLE OF CONTENTS

ABBREVIATIONS AND ACRONYMS	III	
FOREWORD	IV	
ACKNOWLEDGEMENTS	V	
EXECUTIVE SUMMARY	1	
1. HOUSING DEMAND	7	
2. HOUSING SUPPLY	14	
3. LAND AND PROPERTY REGISTRATION	20	
4. HOUSING FINANCE SYSTEM	26	
5. SECONDARY MORTGAGE MARKET	41	
6. PRIORITIES AND RECOMMENDATIONS	54	
REFERENCES AND BIBLIOGRAPHY	60	
APPENDIX 1—MORTGAGE FINANCE IN KENYA: SURVEY ANALYSIS	62	
FIGURES		
Figure 1	Kenya’s Housing Finance Market—Key Trends	5
Figure 2	Kenya Rural and Urban Population 1950–2050 (millions)	8
Figure 3	Kenya Annual Housing Requirement 1950–2050	9
Figure 4	Rural Income Pyramid—2010 Annual household income	11
Figure 5	Urban Income Pyramid—2010 Annual household income	11
Figure 6	Total Income Distribution	11
Figure 7	Home Acquisition in Urban and Rural Areas	15
Figure 8	Home Construction by Province	15
Figure 9	Average Property Price—2001–2010	18
Figure 10	Average Apartment Price—2001–2010	18
Figure 11	Africa—Mortgage Debt to GDP—(<i>latest available data</i>)	26

Figure 12	Peer Group—Mortgage Debt to GDP—(<i>latest available data</i>)	27
Figure 13	Change in Bank lending to private sector—(<i>12 months to September 2010</i>)	27
Figure 14	Mortgage Interest Rate by Bank Size vs Average Commercial Lending Rate	29
Figure 15	91 Day and 182 T-Bill rates	30
Figure 16	Inflation Rate	30
Figure 17	Maximum mortgage loan based on a constant Ksh 42,615 monthly payment	37
Figure 18	Proportion of urban population able to afford a Ksh 3.2 million loan	38
Figure 19	Graduated Payment Mortgage Monthly Payments and Payment to Income	39
Figure 20	Treasury Bond Holdings by Investor type—September 2010	46
Figure 21	Estimated Long Term Investor Assets—Ksh billion2010	46
Figure 22	Mortgage Covered Bonds	47
Figure 23	Mechanics of Securitization	49
Figure 24	Mechanics of a Mortgage Liquidity Facility	51

BOXES

Box 1	Urbanization—Census data versus UN Population Data	8
Box 2	Housing Development Project outside Nairobi	17
Box 3	Affordable Housing in India	19
Box 4	Pension Backed Housing Loans in South Africa	36
Box 5	HFCK Housing Bond Issue	44
Box 6	The Egyptian Mortgage Refinance Company (EMRC)	52

TABLES

Table 1	Obstacles to Mortgage Market Development	2
Table 2	Kenya's Housing Finance Market—Key Facts	4
Table 3	Population and Land Area	7
Table 4	Kenyan Legislation for Land and Titling	22
Table 5	Registering Property	23
Table 6	Foreclosing on a Property	31
Table 7	Registering a Mortgage	33
Table 8	Access to Credit	33
Table 9	Mortgage Product Features	35
Table 10	Domestic Bank Deposits to GDP—2004 to 2009	43
Table 11	Private Credit to Domestic Bank Deposits—2004 to 2009	44

ABBREVIATIONS AND ACRONYMS

CBK	Central Bank of Kenya
CMA	Capital Markets Authority
CRB	Credit Reference Bureau
EMRC	Egyptian Mortgage Refinance Company
FIRST	Financial Sector Reform and Strengthening Initiative
FSV	Force Sale Value
GLA	The Government Lands Act (Chap. 280)
GPM	Graduated Payment Mortgage
HFCK	Housing Finance Company of Kenya
HOSP	Home Ownership Savings Plan
KIHBS	Kenya Integrated Household Budget Survey
LF	Liquidity Facility
MBS	Mortgage Backed Security
MBS	Mortgage Backed Security
NHB	National Housing Bank (India)
NHC	National Housing Corporation
NURCHA	National Urban and Reconstruction Agency (South Africa)
OTC	Over the counter (Trading)
RLA	The Registered Land Act (Chap. 300)
RTA	The Registration of Titles Act (Chap. 281)
RWA	Risk Weighted Assets
S&L	Savings and Loans (Kenya)
SPV	Special Purpose Vehicle
TLA	The Trust Land Act (Chap. 288)

Note: figures in Kenyan Shilling (Ksh) have been converted to US dollars at the rate of Ksh80.80 = \$1, the exchange rate in October 2010, and then rounded.

FOREWORD

The World Bank Group has been active over many years in helping emerging economies to build and develop their housing finance systems. This ranges from putting in place some of the basic building blocks, helping countries deepen the reach of their housing finance system or finding solutions to help fund a growing system.

Kenya has a burgeoning mortgage market, which together with other initiatives will be instrumental in providing some of the housing investment that will be needed in the coming years as the population continues to grow and Kenya's economic center shifts towards its urban settlements.

The selected peer group used throughout this study is Uganda, Tanzania, South Africa, India, Egypt and Colombia. These countries were specifically chosen as peers who are either geographically proximate or who have a similar level of economic development. In addition, each of the selected countries has some relevant experience in housing finance which has been used in this report to illustrate some of the areas of reform.

The World Bank
Financial and Private Sector Vice Presidency
May 2011

ACKNOWLEDGEMENTS

The author of the report is Simon Walley, Senior Housing Finance Specialist at the World Bank. The Annex which contains the results of the Mortgage Market Survey was compiled with the help of Sachin Gathani, and Ravi Ruparel of the World Bank's Kenya Country office. Oversight for the work has come from Yira Mascaro, Lead Financial Specialist at the World Bank who has helped raise housing finance up the public policy agenda.

The report has benefited tremendously from the support of the Central Bank of Kenya, especially in the survey work and in disseminating this report. Also the Ministry of Finance, Ministry of Land, Ministry of Housing all gave freely of their time in helping the author to better understand the housing finance system in Kenya.

The bankers themselves should be commended for the diligence with which they completed the survey questionnaires and for the valuable time they offered in interviews to the World Bank team. Numerous other market participants in the private sector provided their time and advice in informing this report; this includes developers, law firms, the Credit Reporting Bureau, FSD Kenya, pension funds and many others.

Lastly, this report has partly been built on earlier work done in this field to which the author pays thanks, and in particular to Sally Merrill of the Urban Institute who provided inputs, Kecia Rust, Head of the Centre for Affordable Housing in Africa, Marja Hoek Smit, Professor at the Wharton School, University of Pennsylvania and James Mutero at Matrix Consultants.

EXECUTIVE SUMMARY

A. CURRENT SITUATION

Mortgage Market—The Kenyan housing finance system has grown rapidly over recent years in both value of loans and number of loans. The market has now gone through the initial ‘germination’ stage and is preparing to enter its next development phase. Consideration now needs to be given to the requirements for ensuring continued growth. The mortgage market is the third most developed in Sub-Saharan Africa with mortgage assets equivalent to 2.5 percent of Kenya’s GDP. Only Namibia and South Africa rank higher, with Botswana just slightly smaller.

Housing Market—In common with much of Africa, Kenya has a large housing gap which is growing every year and is increasingly prevalent in urban areas. The current annual housing deficit is estimated at 156,000 units per annum based on the population growth and urban migration taking place. There is limited data on current levels of construction but according to the Ministry of Housing, it is 50,000 units a year. The deficit is largely filled by the growth in slum dwellings and continued self-construction of poor quality traditional housing. The housing gap can only be partially financed by mortgages, while other solutions are required for lower income groups such as Housing Micro-finance and rental housing.

Affordability/Access—Mortgage products are widespread and are offered by virtually all banks. A typical loan would be done at variable rates for around 14 percent for an amount of Ksh 4 million over a period of 15 years. Based on this, 2.4 percent of the total population could afford a mortgage for a basic house. This rises to 11 percent of the urban population. There is no viable market in rural areas given the low levels of income together with the high costs of developing a distribution network. The potential size of the mortgage market is currently around Ksh 800 billion or \$9.9 billion around 13 times the current level.

Legal & Regulatory Framework—The legal framework is overly complex but adequate. Lenders are content with the powers available to them to enforce collateral, although the borrower’s ability to make repeated frivolous court challenges to a foreclosure order undermines the system and needs to be addressed.

Land and Property Registration—The multiplicity of forms of tenure and methods of transfer creates some confusion, adds cost, creates legal uncertainty and is hampering the development of an efficient one-stop shop registry system.

Mortgage Funding—This is one of the key issues which has to be addressed on the way to developing the mortgage market. Lenders rated

this as the biggest obstacle to market development. The two largest lenders are starting to be liquidity constrained and struggle with the maturity mismatch brought on by long term lending. Kenya benefits from a large investor base arising from its fairly developed pension, insurance and mutual fund sector. Increasingly companies are resorting to the capital markets for equity and debt funding. Most recently the two largest lenders tapped the markets.

Market infrastructure—A credit bureau has recently begun limited operations and credit reporting became mandatory for all banks as of July 2010; there is an active secondary housing market complete with realtors and listing systems; there is an established and qualified valuation profession; and there is adequate insurance coverage for property. All of these provide sound building blocks for further growth in mortgage lending

B. CHALLENGES TO DEVELOPING THE MORTGAGE MARKET

The survey completed by lenders points to 2 or 3 key constraints on the further growth of the mortgage market. Most notably is access to long term access to funds, which was listed as the most important constraint to the mortgage market in Kenya. The absolute low level of incomes/informality and credit risk were listed as second and third respectively with high interest rates also being regarded as a major constraint.

These obstacles can be categorized into four key themes:

Affordability—The lack of affordability is a combination of factors which includes the low levels of income (especially in rural areas), and the high and volatile level of inflation and relatively high margins charged by banks. Issues on the supply side also create a price barrier for many, where the cost of even the most basic new house is out of reach for the vast majority.

Risk Management—Deficiencies in a lender's ability to capture or understand risks mean that lenders have to charge a high 'risk premium'. This is due to the fact that credit bureaus do not yet offer comprehensive credit histories, there is a high level of informality, and the value of collateral is tempered by deficiencies in the foreclosure process, resale market and the valuation process.

Funding—This is ranked as the biggest obstacle but the facts suggest a relatively liquid banking sector with a low loan to deposit ratio. The issue is the availability of long term funds and the mismatch between short term deposits and the longer term mortgage loans. However, the current ratios suggest that banks could engage in further maturity transformation before hitting limits. Some of the large lenders however are constrained and certainly if current levels of growth continue, the rest of the sector will be also.

Housing/Land Market—The lack of affordable construction combined with difficulties in accessing land make it difficult to expand access to homeownership. In particular the multiple land titling and registration mechanisms are grossly inefficient and overly complex.

C. WAY FORWARD

If Kenya is to start tackling its unmet housing demand it will need to mobilize large amounts of private capital. Growing the size and reach of the mortgage market is part of the solution for the upper and middle income urban segments of the population.

TABLE 1—OBSTACLES TO MORTGAGE MARKET DEVELOPMENT

<i>Mortgage Market Obstacles</i>	<i>Frequency of Response</i>
Access to Long Term Funds	21
Low level of incomes/informality	15
Credit Risk (lack of credit histories, documented income, etc.)	11
High interest Rates	10
Difficulties with property registration/titling	7
Cost and time of foreclosing on a property	6
Burden of regulation (provisioning, capital requirements, liquidity rules, etc.)	4
Lack of housing supply—new construction	4
Lack of capacity/skills in banking sector to develop products, carry out loan underwriting	3
Lack of understanding of mortgage product by consumer—lack of financial literacy	2
AIDS/HIV as an inhibitor of long term lending	1

Source: Central Bank of Kenya, Mortgage Survey, November 2010

It should also be clear from this report that mortgages alone cannot hope to satisfy the entire housing demand. Solutions are also required for lower income groups in the form of housing microfinance, rental frameworks and financing for self construction, especially on an incremental basis.

Likewise mortgages only affect the demand side of the housing equation. Supply side measures are also required to expand the available stock of affordable properties. This should be a collaborative effort between the private sector and government.

The following recommendations seek to address some of the constraints and barriers which prevent the mortgage market from going to scale.

1. Expand the Stock of Mortgageable Properties¹—Kenya’s market is more evolved than most in Sub-Saharan Africa but equally there is much room for improvement. The supply of land for housing and having a functioning secondary market for housing sales are essential elements of an efficient mortgage system. This requires:

- a more streamlined and cost efficient property registry system
- a unified and simplified mortgage law, limiting frivolous appeals

2. Provide Affordable Finance—The current cost of mortgage financing is prohibitive for the vast majority of the population. This report calculates that just 12 percent of the urban population could consider taking out a mortgage loan which represents just 2 or 3 percent of the national population. Mortgages are completely out of reach for the entire rural population. Some steps could be taken to improve affordability including:

- new products design to help affordability
- over the longer term look at options for suitable subsidy programs/guarantee mechanisms
- aside from the mortgage market it is important to consider options for informal population

3. Improve Risk Management/Efficiency—As the market grows in size, some economies of scale will arise, but efficiency gains and a lowering of the risk premium can also help to bring down the cost of loans.

- Expand coverage of the Credit Bureau to have fuller credit histories, as well as to non-bank financial intermediaries
- Standardization of documentation
- Underpin confidence in the sector by introducing prudential standards for loan underwriting

4. Developing a secondary mortgage market—A twin approach of firstly developing a mortgage liquidity facility which would benefit the sector as a whole, while also pursuing the development of a mortgage covered bond framework for the larger lenders. As this will target institutional investors, it would be important to review investment rules of Pensions Funds and Insurance Companies.

5. Implementation—To achieve the above, a consensual approach will be needed between public and private sector. There are two key recommendations to get this dialogue underway:

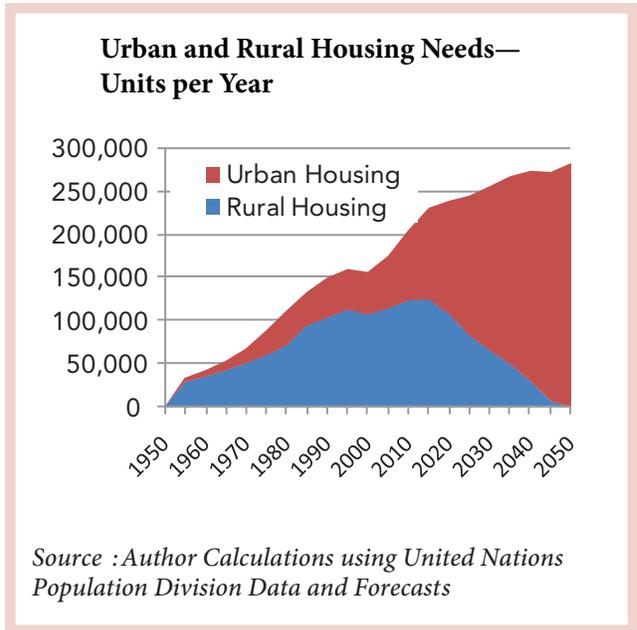
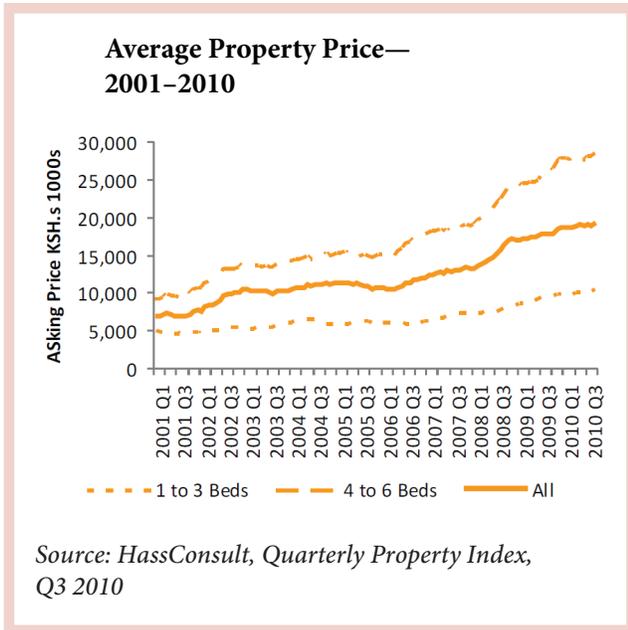
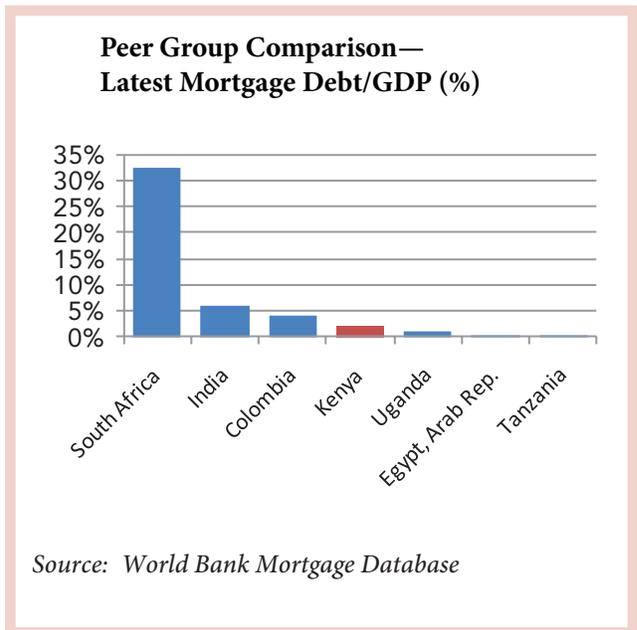
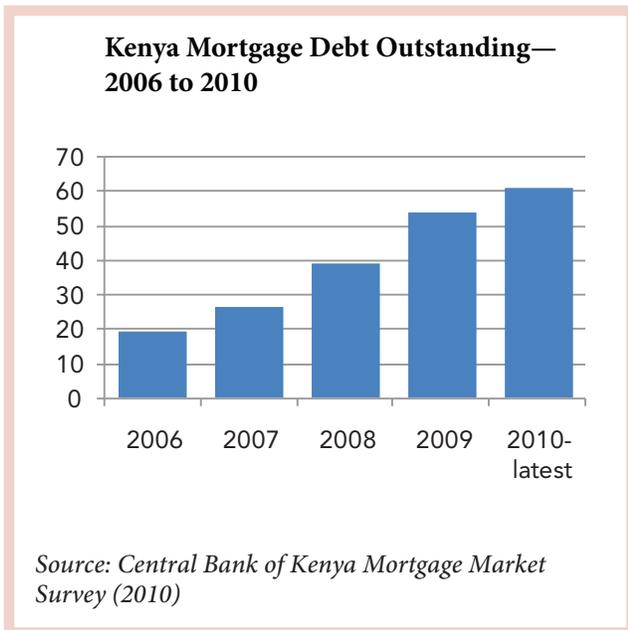
1. This is also a central recommendation in UN-Habitat’s State of African Cities, November 2010

- Establishment of a Mortgage Market Development Group which would bring together the main parties responsible for implementing change.
- The industry needs to organize itself and consider setting up a Mortgage Lenders Association—both as tool to represent its interests but also as a market development mechanism.

TABLE 2—KENYA’S HOUSING FINANCE MARKET—KEY FACTS

Size of Mortgage Market	Ksh 61.4 billion
Number of Mortgage Loans	13,803
Average Loan Size	Ksh 4 million
Typical Interest Rate	14%
Number of Mortgage Lenders	35
Mortgages as a Proportion of Credit	15%
Mortgage Debt as a Proportion of GDP	2.5%
Current Potential Size of Mortgage Market	Ksh 800 billion
Annual Housing Need	205,823 units
Current Annual Housing Production	50,000 units
Number of Houses Needed Over Next 10 Years	> 2.19 million
Urban Population in 2010	1 in 4
Urban Population in 2050	1 in 2
Urban Population living in Slums	1 in 3
Total Population Who Can Afford a Mortgage	2.4 %
Urban Population Who Could Afford a Mortgage	11.0%

Figure 1—Kenya’s Housing Finance Market—Key Trends



1. HOUSING DEMAND

The demand for housing in Kenya is immense and driven by a growing population and urbanization. Growing prosperity has also increased the demand for larger and better quality housing. The shortage of supply and of new construction exacerbates the unmet demand. This section provides some background and estimates quantifying the scale of the demand and where it is coming from. It is only by understanding the nature of the demand that policy solutions can be formulated to respond to it. One of the key points which this section will tackle is the lack of effective demand. This means that while there is an absolute shortage, and a growing one, for housing, consumers do not have the means to act on the demand as financing is often not available or unaffordable. A key conclusion is that formal

sector mortgage financing will only resolve this issue for a fraction of the urban population, but other solutions are needed for the rural population and the urban poor.

1.1 POPULATION

The estimated population of Kenya in 2010, was 40.9 million inhabitants making it the 8th most populous country on the African continent. The population has grown rapidly from just 6 million in 1950, and is forecast to reach 85 million by 2050. This represents a compound annual growth rate of 2.7 percent. Kenya is a large country in terms of land area and has a population density of just 69 inhabitants per square kilometer.

TABLE 3—POPULATION AND LAND AREA

	<i>Population Million</i>	<i>Urbanization Rate</i>	<i>Population in Cities of +1m</i>	<i>Land area (square km)</i>	<i>Population Density (people per square km)</i>
Kenya	40.9	22%	8.5	569,140	72
South Africa	48.7	62%	15.6	1,214,470	40
Uganda	31.7	13%	1.4	197,100	161
Tanzania	42.5	26%	2.9	885,800	48
India	1,140.0	30%	129.2	2,973,190	383
Egypt	81.5	44%	16.1	995,450	82
Colombia	45.0	76%	15.4	1,109,500	41

Source: World Development Indicators, World Bank

Box 1

Urbanization—Census data versus UN Population Data

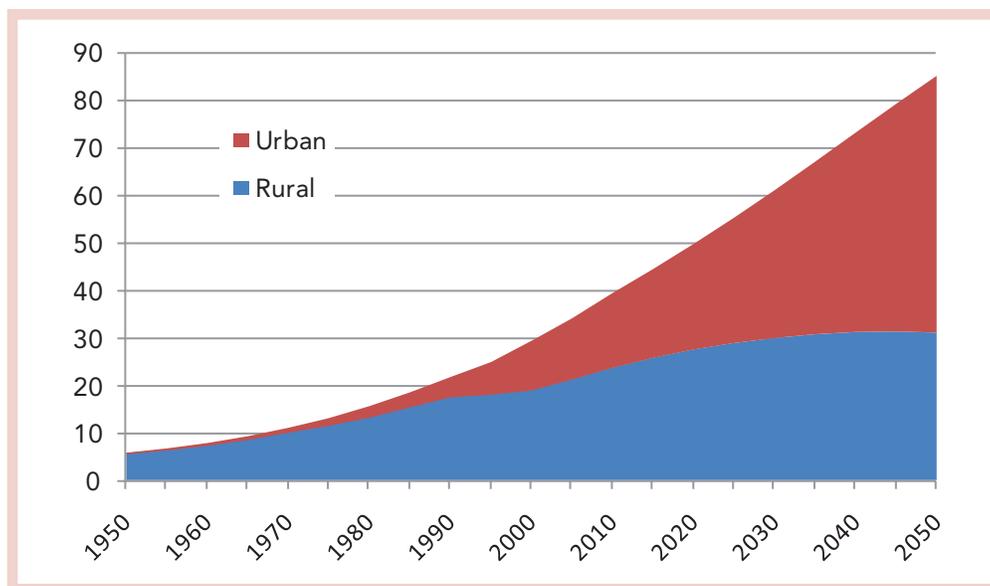
There are markedly different figures reported for Kenya's urbanisation rate. Varying from 22 percent which is reported by the UN Populations Division and used by the World Bank's World Development Indicators, up to circa. 32 percent which is a provisional figure based on 2009 Census data.

The main root of the discrepancy is the definition of what is considered urban. The Census data takes a broad definition and additionally includes 'peri-urban' areas as part of its definition. The two data series started diverging as far back as 1989.

This does create some confusion, as the census data is not easily comparable to other countries and may over-state the level of urbanisation. Equally the UN data seems to be calculated based on growth rates which need to be adjusted based on the census data. Either way a statistical reconciliation between the two measures would help in better understanding the urbanisation dynamics in Kenya. The model used for this report uses the UN data as an input. Different results come out when using Census data, but the resulting policy conclusions are unchanged.

As Figure 2 below shows, the population in 1950 was almost entirely located in rural areas. Urbanization has gradually happened with the growth of Nairobi and Mombasa as major population centers. By 2010, the urbanization rate is 22 percent which compares to a global urbanization level which is just slightly higher than 50 percent. By 2050, Kenya is forecast to have almost equal rural (51.9 percent) and urban populations (48.1 percent).

Figure 2 Kenya Rural and Urban Population 1950–2050 (millions)

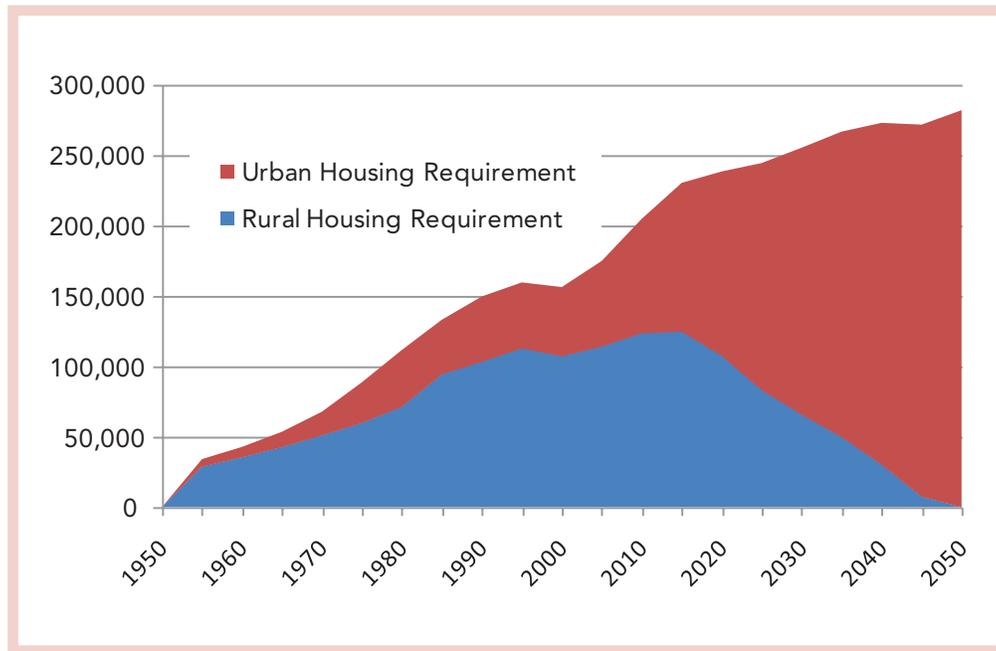


Source: *World Population Prospects (2009 Revision)*, United Nations Population Division

The rapid population growth also implies a rising need for housing. New housing is needed to cover both natural household formation arising from higher birth rates than death rates, but also internal migration. As population moves away from rural areas into urban areas extra urban housing is required to accommodate the internal migrants. The chart below estimates the level of household

formation in both rural and urban areas. The rate of household formation is based on the assumption that households in rural areas are made up of 5.5 people whilst those in urban areas have 4.0 people. These figures are applied for the whole period. In fact as urban households become wealthier it is likely they become smaller. The annual housing requirement may therefore be actually slightly higher than the estimate below.

Figure 3 Kenya Annual Housing Requirement 1950–2050



Source: Author Calculations , Kenya Census Data (2009), World Population Prospects (2009 Revision), United Nations Population Division

The annual housing requirement in 2010 is estimated at around 206,000 units. This is split between 124,000 units needed in rural areas (60 percent of total) and 82,000 in urban areas (40 percent). This rises to over 280,000 units by 2050 at which point, all of the population growth and housing requirements are in the urban areas of Kenya.

The Ministry of Housing estimates that current levels of construction are around 50,000 units annually. This implies an annual housing deficit of some 156,000 units currently. In addition it is estimated that there is a current existing shortage of 2 million units, where households are homeless, living in temporary shelters or in extremely low quality housing in slum areas. In order to reduce this deficit, as well as allowing for natural replacement of units falling into disrepair and to account for a reducing household size, 250,000 or 300,000 units need to be produced annually.

1.2 INCOME DISTRIBUTION

Income levels in Kenya are both low in absolute terms and also very unevenly distributed. This is a common occurrence in the majority of sub-Saharan Africa and is one of the single most difficult barriers to overcome in building a vibrant mortgage market.

In an ideal mortgage financing system, household income should have the following characteristics:

- **Sufficient absolute level of income**—Households should earn enough to cover the cost of a mortgage along with the regular household expenses. A prudent ratio is typically considered at 40 percent mortgage payment to income. This allows sufficient funds for other living expenses.
- **Income needs to be verifiable**—This is also a major challenge in much of sub-Saharan Africa where the majority of the population subsists on informal income. There are means of checking income by looking at household expenditure but this involves much more work by the lender and will be reflected in higher loan costs.
- **Income needs to be regular**—Given the longer duration of a mortgage loan, lenders need to have some certainty that a regular income will be earned over the lifetime of the loan. Although the formal private sector is growing rapidly, this still represents a small proportion of the population. The most secure jobs are probably civil servant functions but there the affordability levels are more restricted. The charts on the following page show the situation in Kenya relating to income and its ability to service mortgage loans.

The two income pyramids below show how income is distributed in rural and urban households. The estimates are calculated using survey data from the Kenya Integrated Household Budget Survey 2005–06 (KIHBS) and updated using latest GDP data.

The level of income inequality is dramatically shown in Figure 6 which brings together both urban and rural areas. The vast majority of the population has a total household income which is barely at subsistence level. Close to 40 percent of the population are surviving on a dollar a day. At the top end of the income distribution, income is much higher but for a very small minority. This presents a major obstacle in meeting the 'sufficient absolute level of income' criteria for the expansion of the mortgage market.

It is worth noting that in the modeling below, exchange rates are done at current prices and do not use Purchasing Power Parity (PPP). This does have a dramatic effect when looking at poverty measures. The latest data show that Kenya has made remarkable progress in lowering levels of poverty. The population below the poverty line of USD1.25 a day in PPP terms is around 20 percent. The reason for not using that measure in this context is that the income relates to taking out a mortgage and making monthly payments on a loan. A mortgage has to be paid in nominal currency and not PPP amounts.

An additional assumption which has been made is that urban incomes are on average four times the level of rural incomes. Previous surveys show that in 1997 this ratio was 3.5 and in 2005 it was slightly below 4. The disparity between rural and urban incomes is probably higher now but there is no accurate data available to feed into the model, therefore the last reading has been taken.

Figure 4 Rural Income Pyramid— 2010 Annual household income

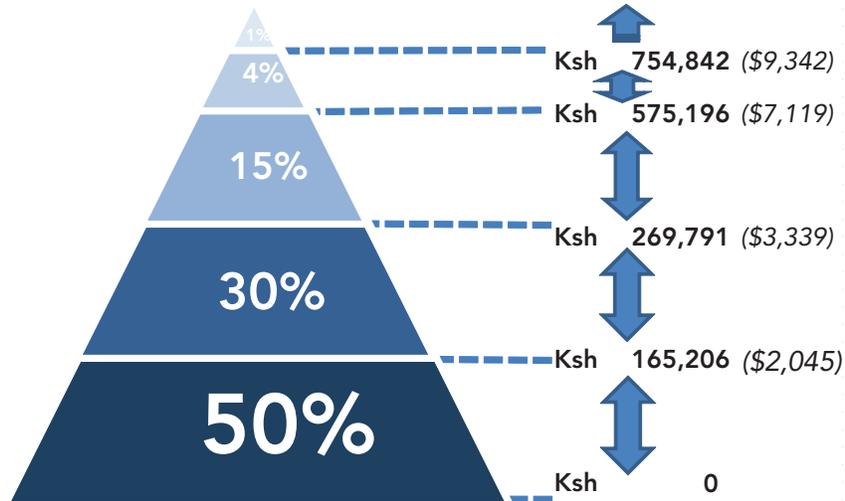


Figure 5 Urban Income Pyramid— 2010 Annual household income

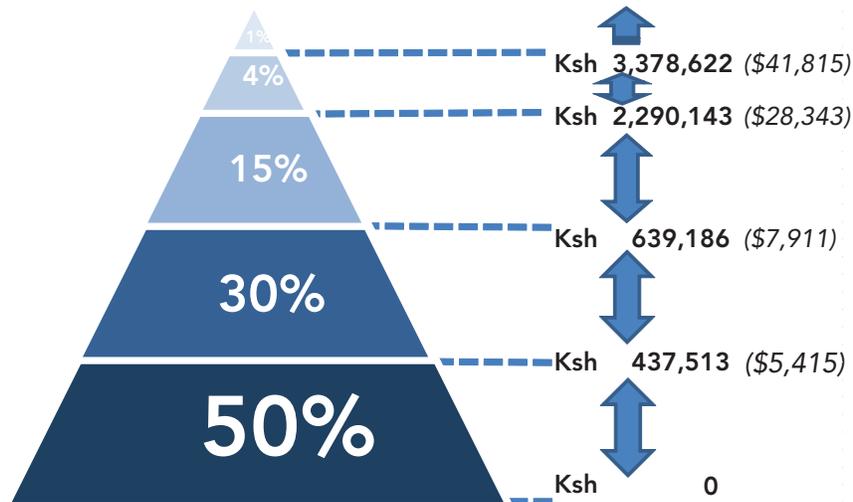
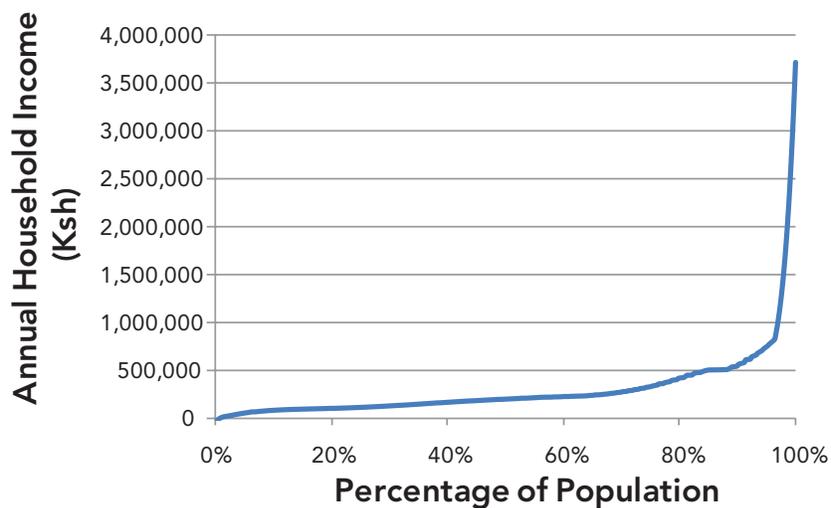


Figure 6 Total Income Distribution



Sources: Author Calculations using Kenya Integrated Household Budget Survey (2005), and World Development Indicators 2010.

1.3 MORTGAGE AFFORDABILITY

Using the income data, it is possible to calculate the potential population that could afford a mortgage loan and also therefore the potential mortgage market size based on current levels of income.

The bank survey data provide many of the key parameters needed for making the calculation which include:

- Average Rate of Interest—14 percent
- Average Loan to Value—80 percent
- Average Loan Maturity—15 years
- Payment to Income—40 percent
- Minimum value for a mortgageable property—Ksh 4.0 million

It is worth noting that based on the survey the typical payment to income level is above 50 percent. Although there are no globally established limits on this, it is usually considered prudent to constrain payment to income for mortgages at around 40 percent and to consider a 50 percent total debt service to income limit if including other debt payments.

Although Ksh 4.0 million (\$49,500) is a high starting price for an affordable property, there is very limited supply at the bottom end of the market. Those properties that are offered for less, may not meet necessary titling or construction standards to qualify for a mortgage loan. Some flats are increasingly becoming available at prices as low as Ksh 2.0 million but they are in short supply. As will be discussed later, construction costs could be brought down and properties of half the price and lower should be possible with improved techniques and economies of scale.

For the calculation, it is assumed that the mortgage is a regular amortizing, monthly repayment loan. Using the parameters above on a loan of Ksh 3.2 million would mean 180 monthly installments of Ksh 42,615, equivalent to \$527. Based on a 40 percent payment to income, it implies a minimum annual income of Ksh 1.28 million or \$15,823.

In addition, any prospective borrower would require the downpayment to purchase a property, as well as sufficient cash to cover taxes, stamp duty and fees which can be as much as 10 percent of the property value.

Returning to the income distribution pyramids, this level of income is earned by under 3 percent of the total population and exclusively in urban areas. There are of course some wealthier households in rural areas but these are the exceptions and do not register statistically. When considering the urban pyramid, it can be seen that just over 8 percent of the population in cities would have a sufficient level of income to afford a mortgage loan on the cheapest available property.

1.4 POTENTIAL MORTGAGE MARKET

The outcomes above can be used to estimate the potential size of the mortgage market as a whole. It is worth noting that at the very top of the income distribution it is likely that the wealthiest would not need loans. Nevertheless assuming that all 11 percent of the urban population who could afford a loan take one out, and further assuming that the average loan size is comparable to that in the bank-

ing survey, this would mean just over 249,260 loans of an average value of Ksh 3.2 million (\$39,600). This provides a potential mortgage market size of Ksh 800 billion or \$9.9 billion. This is of course considerably larger than the current level of lending- by a factor of 13— and would take time to develop the housing supply and the banking capacity to do these loans. This figure however represents the actual potential which could be converted into effective demand by developing the mortgage market.

Lending on this scale would raise the mortgage debt to GDP level from the current 2.5 percent up to 32.5 percent which is comparable with South Africa and some of the transition economies in Eastern Europe which have grown their mortgage markets over the past two decades.

2. HOUSING SUPPLY

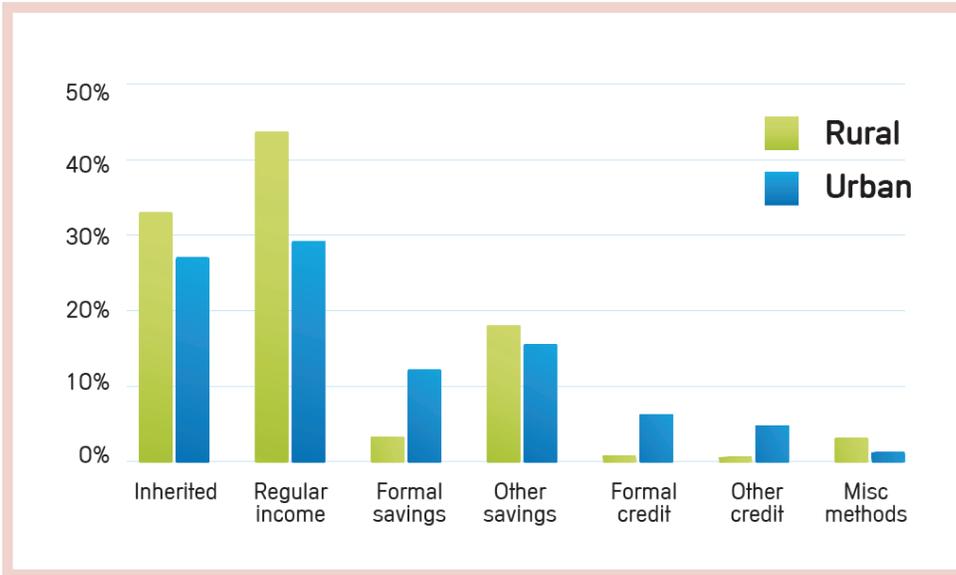
2.1 HOUSING IN KENYA

Homeownership levels in Kenya are high and comparable to economies in Europe or North America but with a marked split between ownership in rural and urban areas. Most people own the houses they live in (69 percent), but this is significantly different in urban (18 percent) and rural areas (82 percent). The non-home-owners are either renters or lodgers.

The FinAccess 2009 Survey has some very useful material on housing in Kenya. Below are some of the key findings.

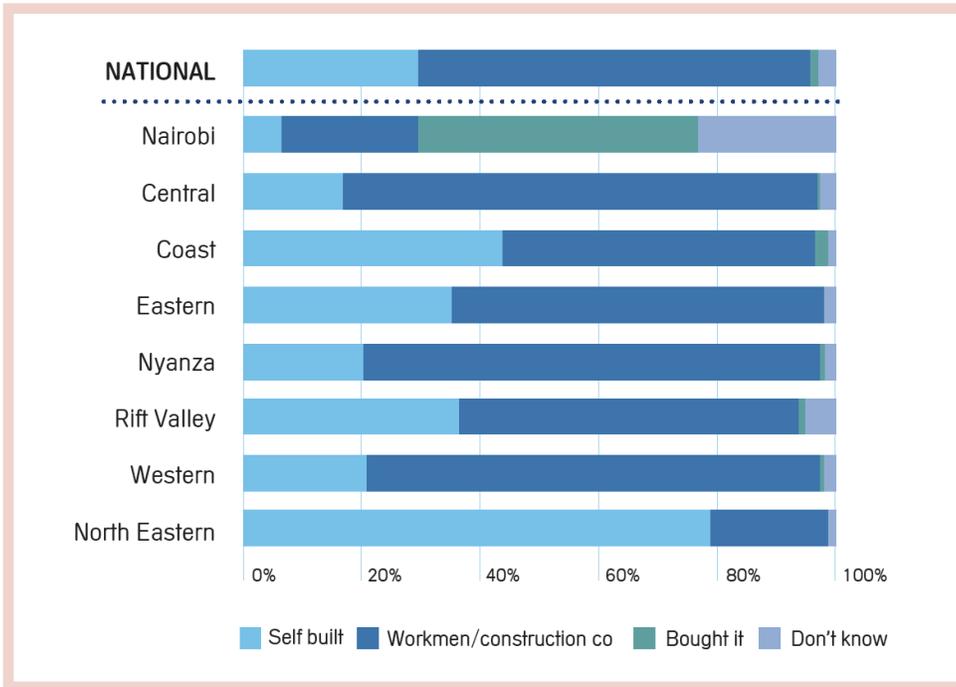
- A third of house-owners acquired their homes through inheritance; only 1.5 percent acquired their homes through formal or other credit.
- Almost half of Nairobi-based home owners bought their houses, but in all other provinces, the proportion of owners who bought is negligible, at 2 percent.
- Only 23.7 percent are willing to use their home as security to borrow money; the proportion is highest in Nairobi (33.6 percent) and lowest in Eastern (17.3 percent).
- In Nairobi 70.3 percent of houses are permanent dwellings; these are also common on the Coast, where 54.2 percent of houses are of this type.
- Traditional houses are common in North Eastern (55.1 percent) and on the Coast (23.2 percent).

Figure 7 Home Acquisition in Urban and Rural Areas



Source: FinAccess (2009)

Figure 8 Home Construction by Province



Source: FinAccess (2009)

2.2 HOUSING POLICY

Kenya's National Housing Policy dates back to 2004 and was aimed at addressing the deficit in housing supply and in arresting the deteriorating housing conditions countrywide and to bridge the shortfall in housing stock arising from demand that far surpasses supply, particularly in urban areas.

This situation has been exacerbated by population explosion, rapid urbanization, widespread poverty, and escalating costs of providing housing. The shortage in housing is manifested in overcrowding, slums and proliferation of informal settlements especially in peri-urban areas. In the rural areas the shortage manifests itself in the poor quality of the housing fabric and lack of basic services such as clean drinking water. The policy aims at:

- Enabling the poor to access housing and basic services and infrastructure necessary for a healthy living environment especially in urban areas;
- Encouraging integrated, participatory approaches to slum upgrading, including income generating activities that effectively combat poverty;
- Promoting and funding of research on the development of low cost building materials and construction techniques;
- Harmonizing existing laws governing urban development and electric power to facilitate more cost effective housing development;
- Facilitating increased investment by the formal and informal private sector, in the production of housing for low and middle-income urban dwellers; and
- Creating a Housing Development Fund to be financed through budgetary allocations and financial support from development partners and other sources.

The objectives above are laudable but the reality has been that slums have grown and the rapid pace of urbanization has undermined the successes that have been achieved.

2.3 SECONDARY HOUSING MARKET

As with most African cities the property market is segmented into several categories ranging from the slum market where the majority of units are rental units, to middle income properties which are not always in the formal sector to the upper end formal part of the market. By definition, little data exists on the lower and middle income parts of the market. The upper part of the market however is relatively developed.

Over the past decade, a secondary housing market has developed, in part modeled on the South African example. Having an organized secondary market is a rarity in Sub-Saharan Africa and helps in the development of a mortgage market. It allows banks to value property more accurately and also gives them comfort that should they need to realize their loan collateral a relatively liquid market exists where they will be able to sell their loan collateral.

2.4 REAL ESTATE PRICES

The analysis of property prices below is based on the Hass Property Price Index. The only existing house price index in Sub-Saharan Africa outside of South Africa. The index has some methodological shortcomings which are inevitable in such a young market, but it represents a very useful tool which will grow in importance as the market develops. In particular, some of the methodological issues are that basing the index on the asking price can inflate prices beyond what the final agreed price is. Secondly, the dataset will be very limited to those properties transacted through the Hass realtor. Thirdly it only represents the top end of the market and largely in Nairobi.

Box 2

Housing Development Project outside Nairobi

In a sign of growing investor confidence, as well as the potential returns to be made, real estate developments are increasing in size. The recent announcement of the 'Tatu City' project bears testament to this.

The Russian based Renaissance Group recently announced a massive development on 1,000 hectares of land formerly used as a coffee farm outside the town of Thika, about 40 kilometers north of Nairobi.

The project would be a 50/50 partnership with a locally created firm called Tatu City Ltd.

The project envisages a multi-billion dollar investment over several years, with the creation of up to 62,000 housing units.

The size of the development sets it apart from previous projects, as this is the creation of a whole new community complete with infra-structure and local economy.

A total of ten development phases are envisaged—some of these could be developed simultaneously, as demand requires. The starting point of the entire development concept is the environment, with over 35% of the land set aside for natural green belts.

A further 15% has been earmarked for infrastructure development. By committing to this, Tatu City hopes to become the first ever sustainable development in East and Central Africa.

This sort of project echoes the sort of investment planned for developments such as Eko City in Nigeria which recognize the need for greenfield developments but also the potential profitability of such projects.

(See www.tatucity.com for more information)

Property prices at the top end of the market can average as much as Ksh 20 million (USD 250,000) with some properties selling for much more. The Hass property index has been tracking property prices in the 'upper and middle' sectors of the Kenyan property market and has seen the average price in this sector rise from Ksh 15 million in 2006 to Ksh 20 million in 2010. This represents a compound annual growth rate of 7.5 percent. Given that inflation has been above this level for much of the period, it does not represent a very big real rate of return.

The average value of a property has gone from Ksh 6.83 million in 2001 to over Ksh 19 million in 2010. This is a tripling in value and an annual average compound growth rate of around 12.5 percent. Whilst this may seem like a high rate of return, the inflation adjusted rate or 'real rate of growth' is much more modest. Inflation over the same period has been running at an average rate of 10.8 percent², which means that the real rate of growth is closer to 1.7 percent.

Despite the lower real rate, few other investments in the Kenyan market could provide this sort of inflation positive return over such a long period. This sort of consistent growth is all the more surprising given some of the political instability which occurred during this period as well as the global economic slowdown. Neither of these issues seems to have had a significant impact on the real estate market. This can partly be explained by the lack of supply in housing which helps keep prices rising and the growing access to credit. Other factors which are widely credited for maintaining prices at

2. Calculated using the International Financial Statistics (IFS) Consumer Price Index data

Figure 9 Average Property Price 2001–2010

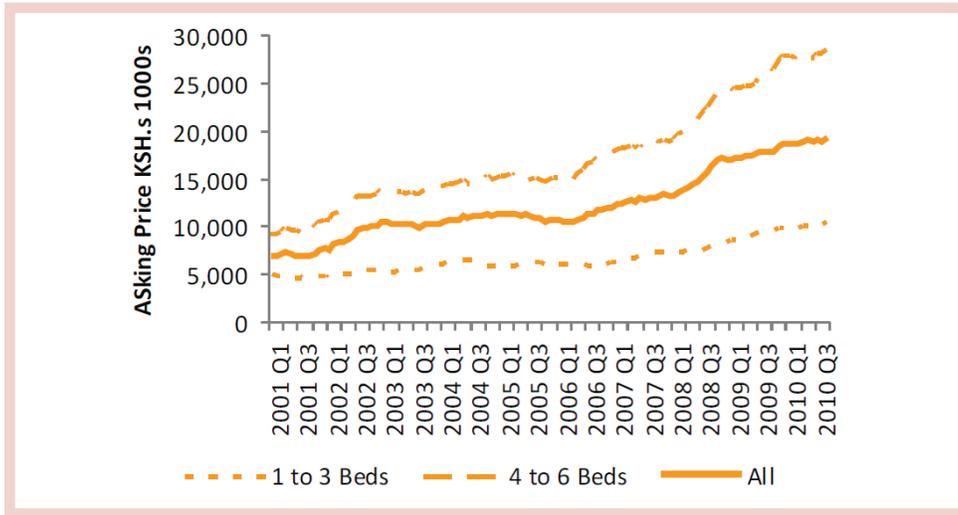
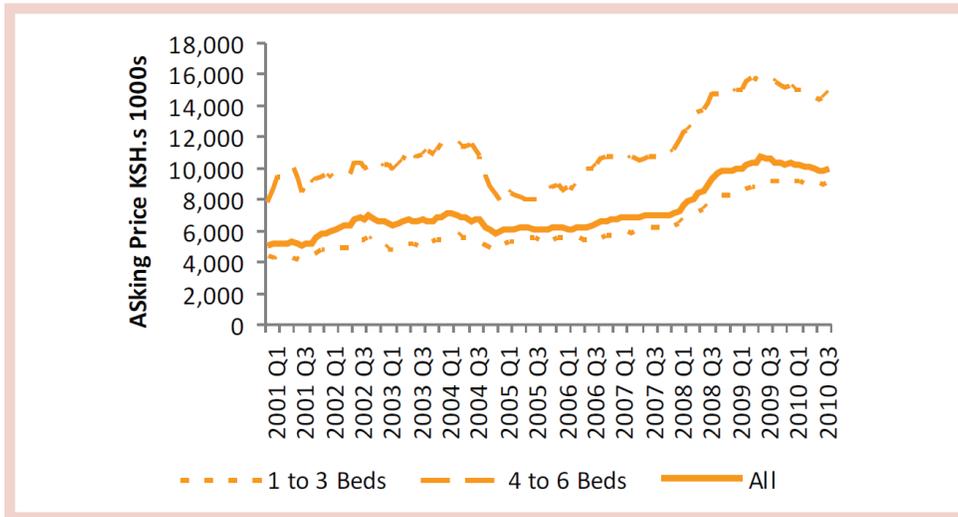


Figure 10 Average Apartment Price 2001–2010



Source: HassConsult, Quarterly Property Index, Q3 2010

the top end of the market is the influx of Somali funds obtained from ransoms being used to purchase property in Nairobi. This may have some limited impact, but realistically the total income from ransoms is estimated at USD 100 million, much of which will have been spent or invested elsewhere such as India or Dubai. The true impact is likely to be less significant than is supposed in the Kenyan media.

Figure 10 above shows the growth in prices for apartments which are priced at a lower level than houses but which have seen rapid growth in the last 2 or 3 years. Over the 10 year period, the average growth rate for apartments has been just 7.8 percent. Although between 2008 and 2010 prices did almost double for smaller apartments. The latest data suggest that the growth period may be coming to an end with prices falling by 5.4 percent over the past year.

Box 3

Affordable Housing in India

Rapid urbanization has led to an increase in the number of low income households in India's cities. Despite a vibrant housing market in India, decent housing in the formal sector is beyond the reach of the vast majority of these lower income households. Monitor Inclusive Markets conducted a study in 2006–7 for India's National Housing Bank (funded by FIRST Initiative and with active support by the World Bank), which found that even the cheapest houses in the market, were at best affordable for the top 15% of the urban population. Customers in the next 30% income segment generally rented rooms in slums and low income neighborhoods. They lived in poorly constructed houses with deplorable sanitary conditions (shared toilets, bad drainage and water-logging) and lacking basic neighborhood amenities (few common spaces or gardens, unsafe alleys, open gutters). Many families had tiny quarters, for which they paid high rent and yet remained at the mercy of their landlords. Moreover, these customers aspired to live in and could afford to buy houses between 250-400 square feet in suburban areas at current market prices, but there was virtually no supply of houses, and almost no access to mortgages from traditional financial institutions (even more the case for informal sector customers).

However, in the last three years, the low-income housing market has seen a series of encouraging developments. Driven partly by the macro-economic recession (which has led to some traditionally up-market developers down-switching their target customer segments, and starting to seriously consider the provision of low-income housing), and partly by the efforts of dedicated "market-makers" and "field-builders", (including NHB, World Bank, IFC, Michael and Susan Dell Foundation and Monitor Inclusive Markets) who are committed to market-based, alternative models of building commercially viable housing for the lower-income segments, and have demonstrated the value of and the opportunity in the urban low income housing market, there is now the beginnings of a robust supply curve in low-income urban housing.

(See www.mim.monitor.com for more information)

2.5 REAL ESTATE AGENTS

A good number of realtors or estate agents service the Kenyan property market. They include a number of websites such as www.propertyleo.com, www.propertypoint.co.ke or www.propertykenya.com, all of which act as aggregator sites bringing together properties on offer with smaller local realtors. The market tends to be limited to Nairobi and its surroundings, Mombassa and some tourist properties. Whilst this is a very positive development, it is also worth noting that at present it represents a very small share of the market. Around 250 properties are advertised at any one time, with only a few thousand properties having been advertised on these sites in their lifetime.

Real estate agents are subject to their own law which was passed in 1985. The Estate Agents Act (Chap 533). It provides for *"the registration of persons who, by way of business, negotiate for or otherwise act in relation to the selling, purchasing or letting of land and buildings erected thereon; for the regulation and control of the professional conduct of such persons and for connected purposes."*

2.6 PROPERTY VALUERS

Property valuation is also a well developed sector in the real estate market with several providers of services. Again it will be limited to the main urban conurbations and to the upper end formal sector of the property market. Property valuers operating for Kenyan banks are required to carry professional liability insurance which acts as a major tool for regulating the market also. In addition to become a member of the Institute of Surveyors of Kenya, valuers are required to have a relevant degree in surveying or land economics, to serve a five year apprenticeship and to pass an exam.

The main drawback on the reliability of property valuations will be the lack of comparative data as the property market is still relatively thin and not all transactions will be accurately captured, especially at the lower end of the market.

3. LAND AND PROPERTY REGISTRATION

The land registration system³ which Kenya inherited from the colonial period was poorly adapted to the actual practice on the ground and the traditional communal ownership of land. Legal and customary systems have subsisted side by side creating confusion and legal uncertainty. Kenya has a particularly complex land tenure mechanism vested into several different laws. Creating a balance between the traditional ownership system and finding a way of recognizing individual property rights on a legal basis remains a challenge in many African countries.

Strong property rights, the ability to use land and property as collateral is the basis for a strong collateral lending system. This is especially relevant in emerging markets where access to credit may be more difficult. Being able to provide collateral can be the basis for a loan. This at least is the thesis put forward by Hernando de Soto in his *Mystery of Capital* book. In practice, those on very low incomes with no other assets than their home are generally not willing to put this at risk given how fragile household incomes can be with no social safety net. However for middle income groups, having access to mortgage finance can represent a big opportunity in terms of accessing better housing conditions at more affordable

levels. Having a functioning registration and land allocation process is essential to underpin a collateral lending system.

3.1 FORMS OF LAND TENURE

Customary land tenure is controlled through a system of customary laws which are usually unwritten and rely on the hierarchy in a social unit or political community to administer the process.

Customary land ownership practices vary across Kenya depending on the predominant land use, different ethnic groups, climatic conditions and cultural practices. Customary laws allow land to be held communally, such as pasture land, or allocated to an individual by a leader within the group. The individual is free to benefit from any investment he/she makes in the land and would usually also be allowed to pass on the land right by way of inheritance.

Land which is subject to customary rights is legally defined as Trust Land in the old Constitution⁴ of Kenya. The land was vested to the local County Council who had powers under special circumstances to use the land for public projects so long as compensation was paid. However, generally the aim of the Trust

3. 1999 Population and Housing Census

4. Constitution of Kenya, Chapter IX (Section 114-120). A referendum was passed in August 2010, which approved a new Constitution, including changes related to land tenure, as described below.

Land Act and the Constitution in this respect were to protect the rights of customary land owners although they were ineffective and became a significant target for reform under the new National Land Policy and Constitution. Under the new constitution, this land was placed under a new category of Community land and vested in communities. Unregistered community land will be held in trust by county governments (yet to be formed) on behalf of communities for which it is held.

Former Trust Land is not present in Nairobi which was excluded from the provisions of the Trust Land Act although the definition of Nairobi as a geographical area is taken as the boundaries which existed in 1964, when Nairobi was a much smaller city.

Statutory Private Land Tenure is set out in Article 64 of the new constitution which allows for privately held land to be registered as either freehold or as leasehold. Article 65 of the new constitution allows foreign ownership of land but only under leasehold and for a maximum lease period of 99 years.

The statutory tenure system was controlled through the old constitution and a number of Acts of Parliament the main ones being the Government Land Act (cap 280), Registered Land Act (cap 300), Registration of Titles Act (cap 281) and the Trust Land Act (cap 288) all of which are being reviewed to harmonize them with the provisions of the new National Land Policy and the new Constitution.

TABLE 4—KENYAN LEGISLATION FOR LAND AND TITLING

	<i>Short Description</i>
The Trust Land Act, (Cap 288)	The aim of the TLA, together with the Constitution is to protect the rights of customary land owners. The land is entrusted to the local County Council who will manage the land for the benefit of the Customary Rights holder through the creation of Divisional Land Boards for each land division.
Registered Land Act (RLA) (Cap 300)	The RLA was enacted in 1963 with the aim of providing land owners with security and proof of title, as well as creating a methodology of transferring interests in land. It applies to freehold land and provides that the registration of a person as the proprietor of the land vests in that person the absolute ownership of that land together with all rights, privileges relating thereto. There are over 2 million titles under this act. It is based on UK system and has a mix of survey based and general boundary titles.
Registration of Titles Act (RTA) (Cap 281)	The RTA was enacted in 1918 to provide for the transfer of land by registration of titles. It is a Torrens based system which requires fixed boundary surveys. At present there are around 200,000 titles issued under this system.
Government Land Act (GLA) (Cap 280)	The aim of the GLA is to make further and better provision for regulating the leasing and other disposal of Government lands. It effectively lays out the framework for government land ownership and management.
Sectional Properties Act, 1987 (SPA)	The SPA was passed in 1987 and came into operation in April 1990. It only applies to properties which are on land registered under the RLA with a remaining lease of a minimum of 40 years or alternatively to freehold land. The aim of the SPA was to facilitate the development of multi-unit developments and in particular high rise apartments. The SPA creates a framework for the management of common areas through the creation of home owner corporations.
Land Titles Act, (Cap 282)	The original purpose of the Land Titles Act back in 1908, was to make provision for the removal of doubts that have arisen in regard to titles to land and to establish a Land Registration Court. In practice it sets out some of the mechanics and responsibilities of title registration and dispute resolution.

3.2 TITLE REGISTRATION

Title registration is both slow and expensive. It is also unreliable and prone to fraud with many fake documents circulating. The steps in registering land are comprehensively set out in both the Doing Business survey by the World Bank and the FSD Kenya review of the collateral system⁵. The table below provides a comparison for the peer group which shows that Kenya does not perform well on this measure, although it does do better than its immediate neighbors and outperforms the sub-Saharan Africa average.

TABLE 5—REGISTERING PROPERTY

	<i>Ranking</i>	<i>Number of steps</i>	<i>Number of days</i>	<i>Cost as % of property</i>
Kenya	129	8	64	4.2
South Africa	91	6	24	8.8
Uganda	150	13	77	3.2
Tanzania	151	9	73	4.4
India	94	5	44	7.4
Egypt	93	7	72	0.8
Colombia	55	7	20	2.0
sub-Saharan Africa	-	6.5	67.9	9.6
OECD	-	4.8	32.7	4.4

Source: Doing Business 2011, World Bank

One of the big disadvantages of having a multiplicity of laws is that it also requires a series of different registers to be set up, each registering interests in land as recorded under each different law. Although they are under the authority of the Ministry of Lands, it is not clear that the registries connect at the moment. This is both inefficient and again complicates a process which can be made very simple with the right processes and procedures.

The multiple systems also mean that both a title system and a deeds system are in existence. Deeds are in process of being phased out, but this has been the position since 1920 without them disappearing. Deeds are still used for land registered under the Registration of Documents Act, 1901, the Land Titles Act 1915 and the Government Lands Act 1915. In line with the provisions of the new National Land Policy, there is an on-going reform effort, revolving around the development and installation of a Land Information Management System (LIMS), which is reviewing business processes and work flows in the land registries with a view to re-engineering and computerizing them (together with the land records) so as to reduce the time and cost it takes to register land transactions.

Residential properties are often leaseholds, as the property is frequently leased from the state on 99-year leases. It is customary to have the lease renewed for a new 99-year term when obtaining a mortgage loan. This is not an unusual system, and should confer the exact same rights as full 'freehold' ownership. A leasehold title only starts being materially affected by its remaining term when there is usually under 50 years left on it. In the case of Kenya this will be an even shorter period given the high discount factor which would be used to measure the present value of the unexpired lease. In

6. Article in Daily Nation, September 8, 2010, "Do you Have Title to your Flat?"

the UK where the system is most common, it is usual practice to renew leases for a small administrative charge. Short leases should not represent an obstacle to mortgage lending.

It is clear that a number of political and administrative issues need to be resolved with regards to land, land allocation, land transfer and land registration. The process is currently slow, expensive and unreliable. As such it is a major obstacle to the smooth functioning and further development of lending collateralized by property.

In addition to the administration of the system, there are also deficiencies in the current laws. For instance when title deeds are issued under the Registered Land Act, section 143(1) outlaws the cancellation of first registration titles, even if issued by omission, fraud or mistake. In some regards this clause was meant to strengthen the titling system but it has also been used for fraudulent acquisition of land.

Another area directly related to the urban development of housing is the condominium law entitled Sectional Properties Act (SPA). The SPA has not been widely used thus far. Developers claim that registration through the SPA is cumbersome⁶. A preferred alternative is to set up a corporation which owns the freehold to the property or the main lease and sub-leases are then given to the purchasers of the units together with a share in the corporation which gives them rights to the common areas. Both systems exist in many countries. The difficulty with using a corporation is that it restricts the rights of the property owners to the terms of the sub-lease. This form of tenure may not be acceptable to banks for use as collateral as there may be restrictions on the sale of a property. Although it is reported that some banks do accept sub-leases as collateral despite some possible deficiencies.

Whilst access to title and more widespread registration is necessary to develop collateral based lending, it should not be at the expense of individual land rights. There is a danger that developing credit markets is used as an excuse to reform the titling and registration process, alienating the rights of customary land holders.

3.3 RECOMMENDATIONS

The recommendations pertaining to legal reform contained in Syagga (2006) are worth revisiting as they are still very much relevant. Some progress has been made through some of the principles outlined in the new Constitution but more needs to be done.

- Consolidate all statutes relating to land rights creation and delivery into one Act of Parliament with the aim of ensuring clarity and reducing the bureaucratic red tape and administrative bottlenecks that hamper easy transfer of land rights and other associated land transactions in the conveyance process.
- Review the law related to land adjudication to make the process transparent and efficient and provide for setting aside of land for public utility.
- Integrate statutory and traditional dispute resolution mechanisms to avoid conflicts arising from misunderstanding and occasionally misrepresentation of community interests in law.
- Document and map existing customary land tenure systems, codify principles, and develop specific norms on how to deal with community variations.

As well as the recommendations above, there is a need for further recommendations on *gender equality for land rights and inheritance rights for land*. The new Constitution is clear about the need for equality of rights between the genders. This should apply to both statutory and customary systems which should not be used as a means of excusing outdated practices.

Many of the above recommendations are also echoed in the FSD study on the *use of collateral*. The focus of that work is more focused on SME and commercial collateralized lending using either moveable or immovable property, rather than on lending to individuals but nevertheless many of the same problems exist in both areas. The key message from that work is that the value of collateral is undermined at present by the poor administrative system and the lack of reliability of the system which reduces the value of collateral as a credit risk mitigant. The end effect is to raise the cost of credit which for mortgage loans is already unaffordable to many.

The key additional recommendations drawn from this study is the need for a *unified registry*, ideally electronic, with easy and low cost access for both registration and searching.

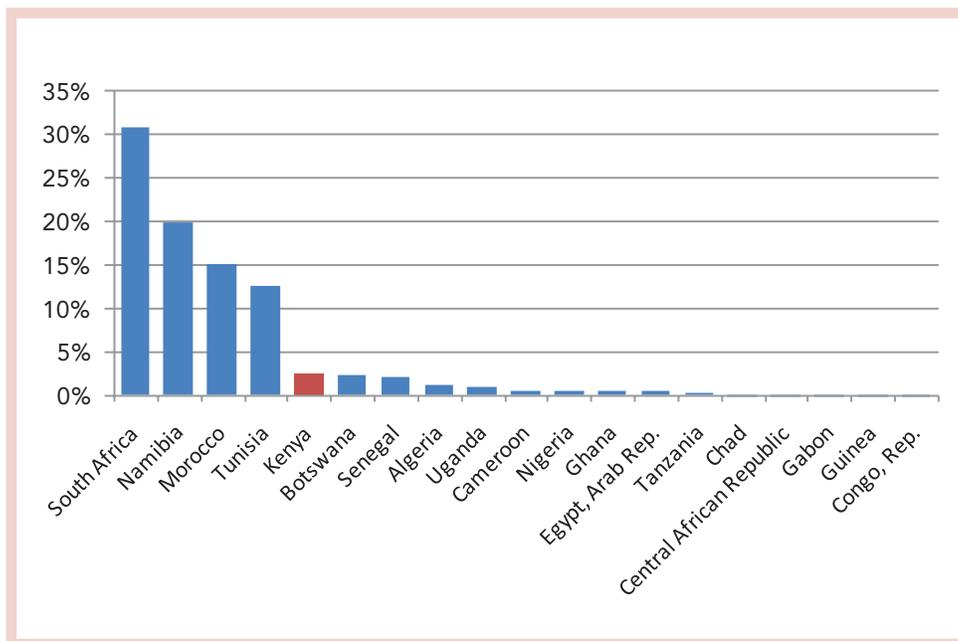
Lastly the lack of use of the Sectional Properties Act (SPA) is a concern to the future development of communal living space. Different approaches are possible, such as constituting homeowner associations who would own the freehold and agree on maintenance arrangements, however a functioning SPA would bring great benefits. The reasons for it not being used are unclear and it may simply be a case of public education and making the legal profession involved in property conveyancing more familiar with it.

4. HOUSING FINANCE SYSTEM

4.1 SIZE OF MORTGAGE MARKET

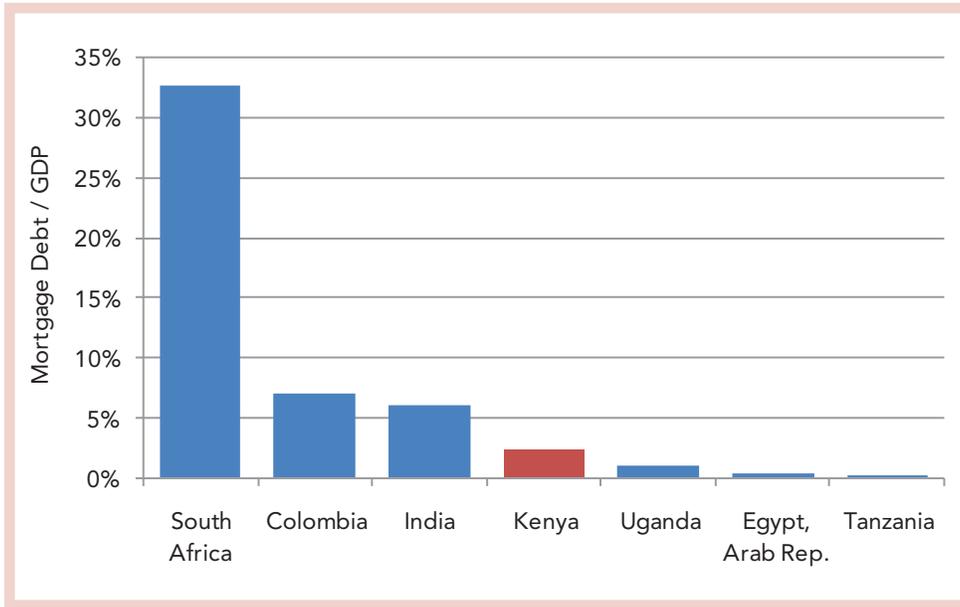
The mortgage market in Kenya is the largest in the region and is likely the third largest in sub-Saharan Africa after South Africa and Namibia. The chart below shows Kenya, relative to other African countries and also against the peer group selected for this report. Also by comparison, the average mortgage debt to GDP level in European countries is in the region of 50 percent, whilst in the US it reaches 72 percent.

Figure 11 Africa—Mortgage Debt to GDP—(latest available data)



Source: Central Banks, World Bank Mortgage Database

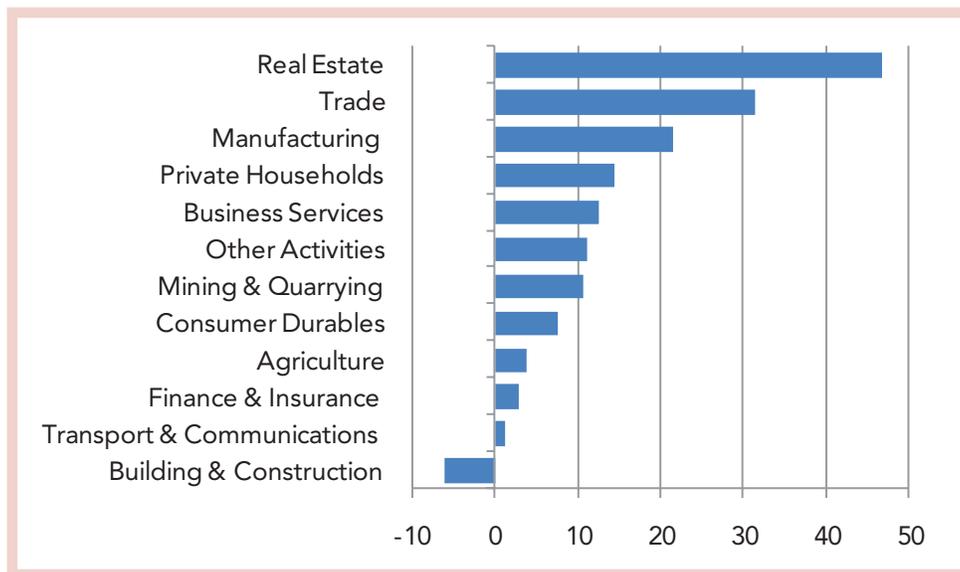
Figure 12 Peer Group—Mortgage Debt to GDP—(latest available data)



Source: Central Banks, World Bank Mortgage Database

Overall lending by banks for real estate purposes represents the major type of lending at present. This includes lending for commercial property and other real estate linked activities, but the chart below also classifies mortgages as lending to private households. The total exposure to real estate in the portfolio is smaller representing 11 percent of all lending. The boom in real estate lending however does point towards a readjustment in lending. The fall in lending for building and construction also suggests that the real estate lending is more to purchase land for speculative purposes than for engaging in new construction. Given the rapid rate of growth in real estate prices and the potential for them to fall back, this should be a concern for both banks and authorities monitoring systemic risks.

Figure 13 Change in Bank lending to private sector—(12 months to September 2010)



Source: Monthly Bulletin—September 2010, Central Bank of Kenya

4.2 MORTGAGE INSTITUTIONS

Mortgage lending is predominantly done by banks in Kenya. Of the 45 banks and one Mortgage Finance Company in the Kenyan banking system, 25 of them have mortgage portfolios of differing sizes. Some of the lenders have just one or two loans on their books which may be to staff members or special customers and other banks are much larger players who see mortgages as a major business center.

There are two types of lenders which can be authorized by the Central Bank of Kenya. These are ordinary banks, which have the right to engage in mortgage business and mortgage companies. The Housing Finance Company of Kenya (HFCK), which still has a small government investment (7 percent), is the sole remaining Mortgage Finance Company at present. There are no major differences in the regulations applying to the two types of institutions and they each compete on a level playing field. The largest lender in Kenya is now Kenya Commercial Bank (KCB) following its acquisition of Savings & Loans, which remains as a mortgage subsidiary of KCB.

Overall the two largest lenders control over half the market and only 9 banks (6 large, 2 medium and 1 small bank) have a mortgage portfolio exceeding Ksh 1 billion.

4.3 PORTFOLIO QUALITY

The strength of the growing market is highlighted by the reducing level of non-performing loans (NPLs). Nevertheless, almost one in ten loans is non-performing which is very high by developed market standards. Positively, the level of NPLs has been relatively low indicating prudent mortgage evaluations by the commercial banks but could be masked by the increasing portfolio of outstanding loans.

The rapidly rising property prices mean that it is more likely that an agreed sale will be reached if a borrower has repayment problems, rather than risk losing money by going through the forced sale process. This means that any payment difficulties are likely to be rapidly resolved. The majority of NPLs reflect legacy issues, largely concentrated in a small number of banks, which are gradually being written off. Compared to the number of outstanding loans, the number of NPLs has been decreasing and is close to half its 2006 level.

4.4 INTEREST RATES

The weighted average mortgage interest rate reported by the institutions is 14.07 percent in 2010, which compares favorably to the average lending rate of 14.64 percent in Kenya. The mortgage rates are consistent with commercial bank lending rates given the higher risk premiums associated with mortgages. In 2010, the highest mortgage interest rate reported was 18.50 percent and the lowest interest rate was 6.50 percent. It is worth noting that many of the lenders reported some significantly below market interest rates for staff mortgage schemes, which may have skewed the figures down a bit.

One of the advantages of a discretionary variable system is that adjustments are not automatic and can help provide some stability in volatile periods. So despite inflation having soared to 20 percent at beginning of 2009 (see Figure 16 below), the mortgage rate has remained reasonably constant at 14

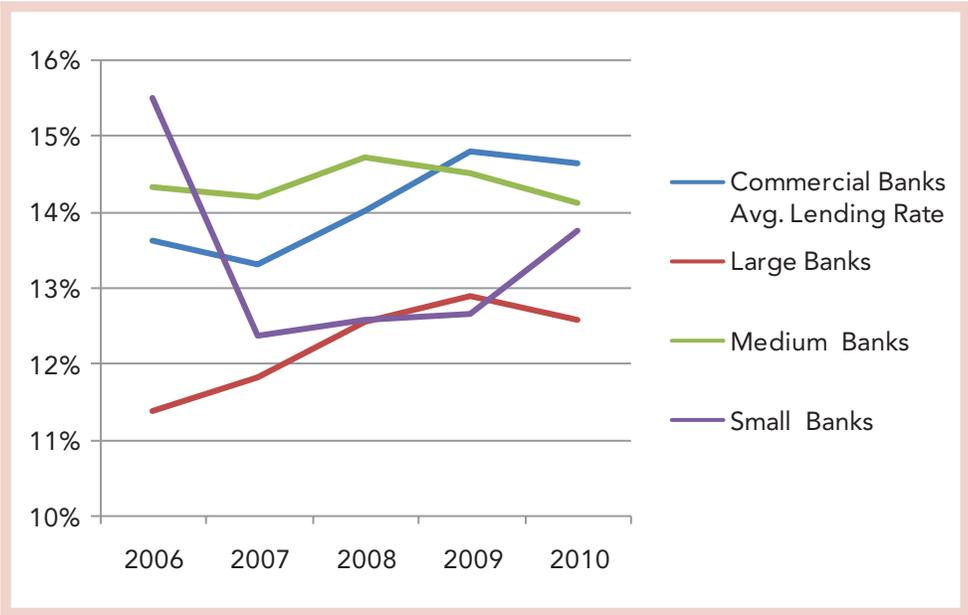
percent over the last 5 years. This could also have a negative effect, as inflation and interest rates fall, banks often show some downward resistance, preferring to boost their margins than cut rates.

Another indication of the lack of sensitivity in mortgage rate setting to the macro environment is the absence of response in mortgage rates to the sharp decline in the cost of money as seen in the T-Bill rates (see Figure 15 below). Mortgage rates should have fallen to their lowest levels ever as is the case in many developed markets. The absence of a strong link to capital market funding and the lack of consumer price elasticity mean that banks are able to offer rates which are much higher than their cost of funds.

The issue of risk premiums and bank margins has recently been tackled in depth in a World Bank paper⁷. The paper shows that Kenya’s banking system is efficient relative to its immediate neighbors. Banks charge a net interest margin of 6.6 percent in Kenya which is exactly the sub-Saharan average. The difficulty with such a high interest margin for term finance is that it has to be additional to the capital market rate as set by the yield curve. With long term funds currently costing in excess of 12 percent, it would mean mortgage rates closer to 20 percent.

Lenders are able to blend funds and partly use their deposit bases, capital and other funding sources to achieve a lower cost of funds, but over the long term the net interest margin will have to reduce if financial access is to improve.

Figure 14 Mortgage Interest Rate by Bank Size vs Average Commercial Lending Rate



Source: Central Bank of Kenya, Mortgage Survey, November 2010

7. See World Bank (2010), Banking Sector Stability, Efficiency, and Outreach in Kenya

Figure 15 91 Day and 182 T-Bill rates

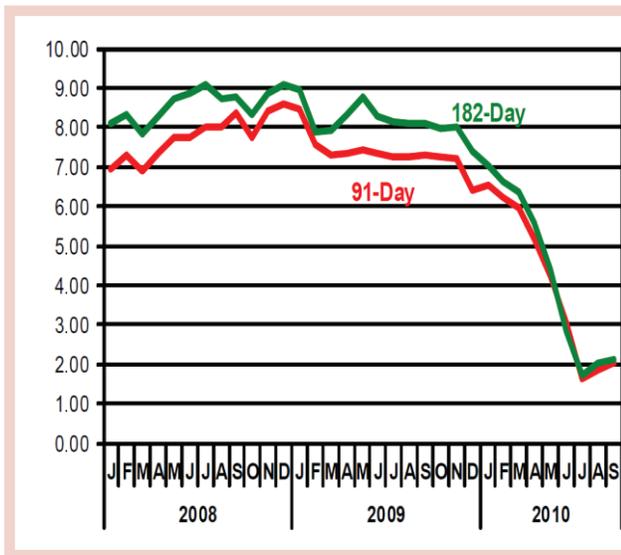
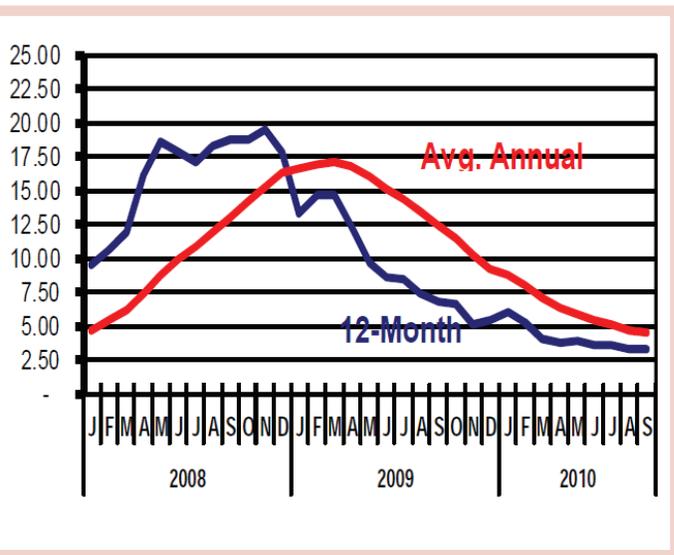


Figure 16 Inflation Rate



Source: Monthly Bulletin—September 2010, Central Bank of Kenya

4.5 LEGAL FRAMEWORK

The power of the mortgagee to sell a property which has been used as collateral for a loan is given by virtue of section 69 of the Transfer of Property Act, 1882, of India, or through section 74 (2) of the Registered Land Act depending on how the property was registered.

Further legislation sets out some of the procedures which have to be followed for a lender enforcing on the collateral. These are set out in the Mortgage (Special Provisions) Act (Chap. 304) which was enacted in 1968. This piece of legislation sets out the terms under which a mortgagee can exercise its power of sale or appoint receivers when enforcing their collateral.

Large parts of the legislation seem either inappropriate or outdated. In particular the Transfer of Property Act which although has had some updates was drafted in the 1880s. It is full of references to the Indian system including references to Rupee amounts, class system, and various Indian civil service institutions.

Although the system as it stands is workable, having a unified set of regulations for mortgage lending could certainly be beneficial in facilitating market development and simplifying the conveyancing process.

The foreclosure process is not seen to be a significant hindrance to mortgage market development according to the bank survey. It ranks just sixth in a list of constraints restricting the growth of the mortgage market. The banks indicated that the legal mechanisms and processes are clear for them to proceed with a foreclosure with the main impediment being the capacity of the legal system to process it.

There are a number of laws which can apply to mortgages which in large part depends under which law the property has been legally registered. The multiple legal frameworks can be confusing and also inefficient. The foreclosure process is underpinned by two pieces of legislation which set out the process by which a lender can enforce on its collateral. Firstly, the Mortgages (Special Provisions Act), Cap. 304 which allows a lender to foreclose on a property on a non-judicial basis. This tends to lead to faster resolution but by not going to court it does put a lot of power in the hands of banks. The current mismanagement of the foreclosure wave in the United States is a good example of the sort of abuse that can happen under this system. However for an emerging market such as Kenya where the court system has limited capacity and resources, non-judicial foreclosure is preferable.

TABLE 6—FORECLOSING ON A PROPERTY

	<i>Cost to foreclose</i>	<i>Time to foreclose</i>				<i>Predominant type of foreclosure</i>	<i>Is a public auction required?</i>
			<i>Time for notification</i>	<i>Time for judgement</i>	<i>Time for enforcement</i>		
Kenya	3.96	239	60	0	179	non judicial	yes
South Africa	2.55	199	31	33	135	judicial	no
Uganda	5.28	235	64	0	171	non judicial	yes
Tanzania	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
India	2.20	187	60	0	127	non judicial	no
Egypt	4.26	190	90	0	100	judicial	yes
Colombia	8.59	705	430	10	265	judicial	no

Source: *Financing Homes (2008)*—see data notes for more detail on methodology

4.6 PRUDENTIAL REGULATION FOR MORTGAGES

Under the Basel I and Basel II frameworks, mortgages were accorded a special status owing to their perceived low level of risk. This resulted in them obtaining a reduced weighting when calculating Risk Weighted Assets (RWA). The majority of high income countries implemented these systems where certain qualifying mortgage loans meeting minimum LTV limits and for residential, owner occupier purposes could be risk weighted at 50 percent under Basel I and then 35 percent under Basel II. If the more sophisticated approaches to capital requirements were used under Basel II this ratio could fall to as low as 17 percent. The minimum capital requirement to be applied under the Basel system is 8 percent. Which means that under the current framework banks must fund their qualifying mortgages with a minimum of 8 percent x 35 percent = 2.8 percent of the value of capital. So for every 100 lent 2.8 of the funding for those loans must come in the form of capital.

The position in emerging markets varies widely. Some countries have implemented Basel I and parts of Basel II. When it comes to mortgages though, the reasons which underlie the preferential risk weighting may not apply. The extra security provided by mortgage collateral may be weakened if it is difficult to foreclose, or if there is no liquid property market, so that the forced sale price may result in a substantial haircut. So whilst some countries have moved to a 50 percent risk weighting, others have maintained a 100 percent risk weighting with the prospect of it being lowered as the market improves.

In Kenya, mortgage loans are risk weighted at 50 percent already and according to the following criteria:

“Loans fully secured by a first legal charge over residential properties located within cities and municipalities in the Republic of Kenya that are either occupied by the borrower or rented will attract risk weight of 50%. The 50% weight will not be applied to loans granted to companies engaged in speculative residential building or property development. The underlying security held must be perfected in all respects and its forced sale value (FSV) should cover in full the outstanding debt with at least 20% margin. Any portion of the loan in excess of 80% of the FSV of the residential property should attract a risk weight of 100%. The account should neither be in arrears nor exhibit any weakness. Rescheduled facilities shall carry a risk weight of 100%.”

Source: Central Bank of Kenya, Prudential Guidelines for Institutions Licensed under the Banking Act

This is a very beneficial regulation for the promotion of mortgage lending in a market which is still in a development phase. The requirement for 80 percent of Forced Sale Value (FSV) is relatively conservative and balances out some of the other more relaxed requirements. Notably being able to risk weight a buy-to-let loan at 50 percent should potentially be reconsidered. Loans made to landlord will have a higher rate of default, as the security is just an asset rather than the borrower's home. Especially in the current real estate speculation phase, benefiting from a low risk weighting for such types of loans may not be appropriate.

In addition to those regulations, banks were bound by a limit which allowed for a maximum of 25 percent of their capital to be allocated for mortgage lending. This was recently increased to 40 percent. In addition, there were some restrictions on Mortgage Companies which have also recently been lifted in the most recent budget proposals. These included allowing Mortgage Companies to offer current accounts, leveling the playing field with commercial banks.

4.7 MORTGAGE REGISTRATION

As detailed in the land section, the process in Kenya suffers from the multiple registers for the different forms of land tenure. Not only is the process for registering a mortgage cumbersome it is also difficult to search the register for pre-existing liens on a property. There are many reported cases of fraud and invalid documents, which is common with paper based systems. One of the difficulties is that there are multiple systems, so it is not just a case of investing in one new system to computerize the process. As recommended in the land system, Kenya is working towards a unified registry system.

TABLE 7—REGISTERING A MORTGAGE

	<i>Time to register a mortgage and title transfer (days)</i>	<i>Cost to register a mortgage and title transfer (% of property value)</i>	<i>Registration fees and stamp duties (US\$)</i>	<i>Mandatory notary index (0–1)</i>	<i>Registry inefficiency index (0–1)</i>	<i>Is registry electronic?</i>	<i>Time to check for encumbrances (days)</i>
Kenya	79	4.35	45.7	0.75	0.63	no	7
South Africa	28	5.50	149.5	0.75	0.01	yes	1
Uganda	44	3.39	122.8	0.50	0.64	no	1
Tanzania	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
India	57	7.66	113.2	0.25	0.32	no	3
Egypt	193	0.67	347.3	1.00	0.37	no	3
Colombia	27	1.80	1,488.5	0.75	0.03	yes	1

Source: *Financing Homes* (2008)—see data notes for more detail on methodology

Notes: Assumes that all parties in the transaction are individuals (unlike *Doing Business* survey), located in an urban area, a standard mortgage is obtained on the property without any further complications.

Mandatory Notary Index measures the involvement of notaries in registration. The index ranges from 0 to 1 with higher values indicating higher levels of mandatory participation by notaries.

Registry Inefficiency Index measures speed, transparency, cost and accessibility. The index ranges from 0 to 1 with higher values indicating higher levels of inefficiency

4.8 CREDIT BUREAU

TABLE 8—ACCESS TO CREDIT

	<i>Ranking (out of 183)</i>	<i>Strength of Legal Rights (0–10)</i>	<i>Access to Credit Information</i>	<i>Public Registry Coverage (% of adults)</i>	<i>Private Registry Coverage (% of adults)</i>
Kenya	6	10	4	0.0	3.3
South Africa	2	9	6	0.0	54.9
Uganda	46	7	4	0.0	1.1
Tanzania	89	8	0	0.0	0.0
India	32	8	4	0.0	10.0
Egypt	72	3	6	2.9	10.3
Colombia	65	5	5	0.0	63.1
Sub-Saharan Africa	—	—	1.7	2.7	4.9
OECD	—	—	4.7	8.0	61.0

Source: *Doing Business 2011*, World Bank

Definitions:

Strength of Legal Rights index measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending.

Depth of credit information index measures the extent to which the rules of a credit information system facilitate lending based on the scope of information distributed, the ease of access to information and the quality of information.

Public registry coverage reports the number of individuals and firms covered by a public credit registry as a percentage of the adult population.

Private bureau coverage reports the number of individuals and firms, covered by a private credit bureau as a percentage of the adult population

Kenya has a private credit reference bureau called the Credit Reference Bureau (CRB). It is a private venture without any ownership by the banking system. It was formally licensed by the Central Bank of Kenya in February 2010 under the provisions of the Banking (Credit Reference Bureau), 2008 Regulations.

Overall, Kenya is still developing its capacity with regards to credit information and has the advantage of having a national ID scheme unlike Uganda or Tanzania. However the lack of positive information in the database means that the credit risk premium charged on loans is not likely to be affected. In addition, the coverage should be extended to include SACCOs, MFIs and other players. As the mortgage market grows it will become essential for lenders to have a full picture of a borrower's other financial commitments and their overall level of indebtedness.

4.9 MORTGAGE PRODUCTS

The table below shows that a broad range of loan products are available in the Kenyan market. The features do not change a great deal from one lender to another, and the pricing also stays relatively constant despite sharp movements in inflation.

TABLE 9—MORTGAGE PRODUCT FEATURES

<i>Product feature</i>	<i>Typical value</i>	<i>Comments</i>
Loan to Value	Up to 105%	This is in some specific cases for pension backed loan, where lenders have the collateral of a pension rather than the property.
	Up to 80% to 95 %	On owner-occupied residential property. Should be of Forced Sale Value, but not clear that it is done this way for all lenders.
	Up to 85%	For investment Residential—(buy-to-let properties)
Payment to Income	Up to 70%	Some of the larger lenders are willing to go this high in cases with low LTV, staff mortgages or some employer guarantee
	Up to 50%	Is a typical value, although there is no clear definition of what income should be included (ie income from rents, informal incomes, verifiable salary only,...)
	Up to 70%	For plot purchases
Loan Purpose	Purchase Construction Renovation Equity withdrawal	
Loan maturity	Up to 25 years	Typically Loan Maturity cannot exceed retirement age
	Down to 5 years	Smaller lenders routinely offer much shorter term mortgage loans of 5 to 7 years
Interest Rates	Up to 18.5%	This was the highest rate offered as reported in the lender survey
	Typical Rate of 14% As low as 6.5%	A number of banks offer staff mortgage loans at beneficial rates to their employees with rates as low as 6.5%
Loan Currency	Kenyan Shilling	No other currency offered at present
Interest Rate Type	Discretionary Variable	This was for 73% of all loans. This is the typical UK loan with interest informally linked to the Central Bank rate but variable at the lender's discretion.
	Short-term fixed then variable	This may include a 2 , 3 or 5 year fixed rate period followed by a variable rate. (18% of cases)
	Fixed Rate	A straight fixed rate was rare and probably applied only to short term loans of 7 years or less. (less than 10% of cases)
Charges	Legal Fees Valuation Arrangement fees (1%) Stamp Duty Mortgage protection policy premium	There are no standard fees, and the amounts charged varied widely from one lender to another. The overall cost can be as much as 10% of the property value though including the stamp duty of 4% and an origination fee of 1 to 2%. In addition a realtor fee can be as much as 3 percent also.

4.10 PENSION BACKED HOUSING LOANS

Pension backed housing loans were introduced to Kenya through the passing of the Retirement Benefits (Mortgage Loans) Regulations by the pensions regulator, the Retirement Benefit Authorities regulations, in June 2009.

Box 4

Pension Backed Housing Loans in South Africa

Pension-secured housing loans are increasingly forming a critical part of the financial sector's housing finance armoury with some 257 000 loans, valued at R 4.8 billion having been extended in the five-year period since inception of the Financial Sector Charter (FSC) in January 2004. They refer specifically to loans provided by financiers to individuals for housing purposes, where the collateral for the loan is some percentage of the borrower's accumulated retirement savings.

Proponents of the product see pension secured housing loans as an integral part of the private sector's housing finance solution, which offers an opportunity for low-income earners to release equity "trapped" in pension/provident funds to satisfy immediate housing needs and as a means to ultimately create wealth over the long-term. Others view these loans as the first step on the road to penury, putting people's retirement savings at risk and in the long-term compounding the State's burden of having to provide adequate social support for an aging population.

This Box is drawn from the FinMark Trust paper by Linda Sing, *Pension Secured Loans* (2009)

The scheme allows pension savers to use up to 60 percent of their accumulated pension savings as collateral guaranteeing a housing loan. These are not mortgage loans and one of the difficulties is in ensuring that the money advanced is used for the purposes of housing. This has been one of the ongoing difficulties in South Africa where the schemes results in substantial 'leakages' where loans are used for purposes other than housing.

A number of lenders have launched products notably Housing Finance and Stanbic. The latter in fact offers up to 105 percent loan to property value for loans backed by pensions.

Such products have largely been banned in developed economies. The risk of a borrower losing both home and retirement benefits was seen as too great and outweighed any benefits which could arise from increased access to housing finance. In emerging economies, these products are seen as providing an additional safeguard on top of the housing collateral. They are a popular product in South Africa (see Box). It is clear that the product can have a beneficial effect but it also has many risks attached to it.

It is recommended that a formal review be carried out in the near future to assess whether

pension backed loans is achieving benefits in terms of access, and at what cost. It should then consider whether any amendments to the regulations are needed and whether 60 percent of pension benefits is an acceptable level to be used to back such loans.

4.11 INTEREST RATE VARIABILITY

The standard mortgage product in Kenya is a discretionary variable rate fixed maturity amortizing loan. This is the standard product used in the United Kingdom and has been copied in many countries influenced by the UK system. However, it is not necessarily an ideal product especially under the stress conditions of high inflation.

Having a fully variable rate, puts a high level of interest rate risk on the borrower who might not be equipped to deal with large jumps in monthly payments. Introducing a longer term fixed rate product or a capped rate product would allow for a lower level of risk to be passed onto the consumer.

The difficulty with such products is that unless the lender is willing to take the risk, a matching source of funding has to be found. Raising long term fixed rates can be difficult in emerging markets. Although it may not come about immediately this would be one of the benefits of developing a secondary mortgage market.

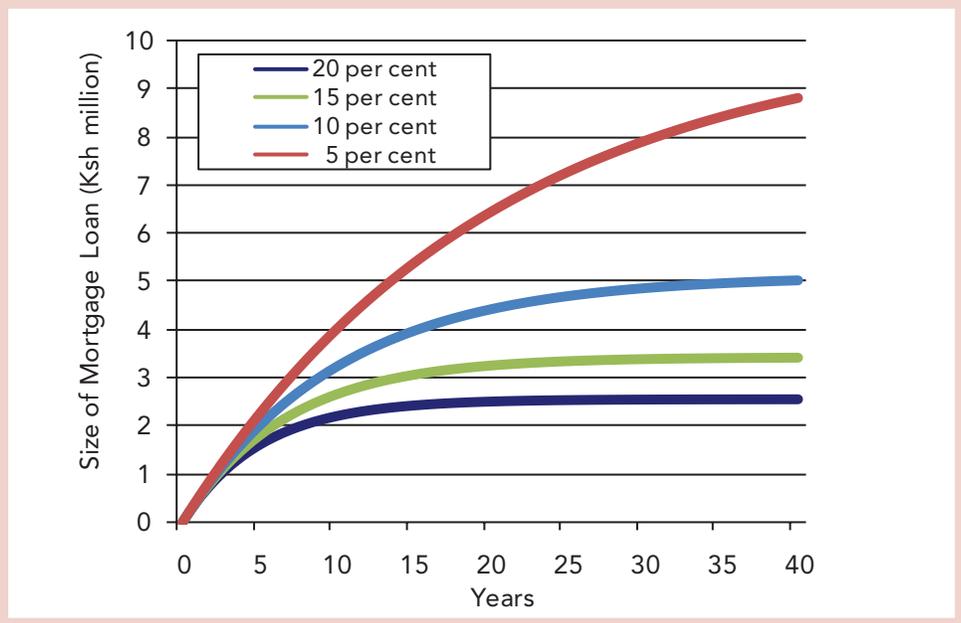
In the intervening time, lenders could consider introducing some product variations such as a flexible loan maturity which could adjust as interest rates change. This would allow for a constant monthly payment, but if interest rates rise, then the loan maturity can be extended. Another variation could be to introduce caps which would provide some protection to borrowers with a limit on how much the interest rate can change on an annual basis for instance.

4.12 DESIGNING AN AFFORDABLE MORTGAGE PRODUCT

The chart below shows that when interest rates are as high as they are in Kenya at the moment—above 10 percent—there is only minimal benefit in extending the loan maturity much past 10 to 12 years. The difference in affordability in year one is rapidly eroded by the time value of money over this period. It is only when interest rates are in single figures that extending maturity for a longer period makes sense. The difference on the 5 percent rate is marked and affordability keeps on improving even when maturity is extended to 40 years. Although, it may be some distance in the future, if rates were at 5 percent, a household with annual income of Ksh 1.25 million a year could technically afford a property worth in excess of Ksh 8 million.

As with the earlier discussion, the example below assumes a fixed mortgage repayment of Ksh 42,615 per month which corresponds to a Ksh 3.2 million loan under current conditions.

Figure 17—Maximum mortgage loan based on a constant Ksh 42,615 monthly payment



Source: Author Calculation

4.13 AFFORDABILITY SCENARIOS IN URBAN KENYA

Using the data arrived in part one from the income distribution, it is also possible to look at the potential reach of the mortgage market if rates were to fall from their current levels. The analysis is limited to the urban population, as even when doing scenario analysis with the rural population only a very small fraction are able to afford any sort of mortgage payment. At current levels around 11 percent of the urban population could afford a mortgage loan. This increases to over 1 household in 4, if rates as a low as 5 percent and the loan maturity is raised to 30 years.

Figure 18—Proportion of urban population able to afford a Ksh 3.2 million loan

	5 years	10 years	15 years	20 years	25 years	30 years
5.00%	8%	14%	18%	21%	24%	27%
7.50%	7%	13%	16%	17%	19%	20%
10.00%	7%	12%	14%	15%	16%	16%
12.50%	6%	10%	12%	13%	14%	14%
15.00%	6%	9%	11%	12%	12%	12%
17.50%	5%	9%	10%	10%	10%	10%
20.00%	4%	8%	9%	9%	9%	9%

Source: Author Calculation

Another problem in economies with persistently high levels of interest rates and inflation is that the burden of paying back the loan is highest in the initial period of the loan. If interest rates are assumed to be constant, then the mortgage repayment will be constant over the lifetime of the loan. However, in an inflationary environment, prices and wages will be rising. As wages and household income rise in nominal terms the real value of the debt us being eroded, as is the monthly payment. So what started out as 40 percent of income, rapidly becomes much more manageable and gradually decreases. This means the burden of paying back the loan is loaded to the front end of the repayment period.

4.14 EXPANDING AFFORDABILITY: USING A GRADUATED PAYMENT MORTGAGE

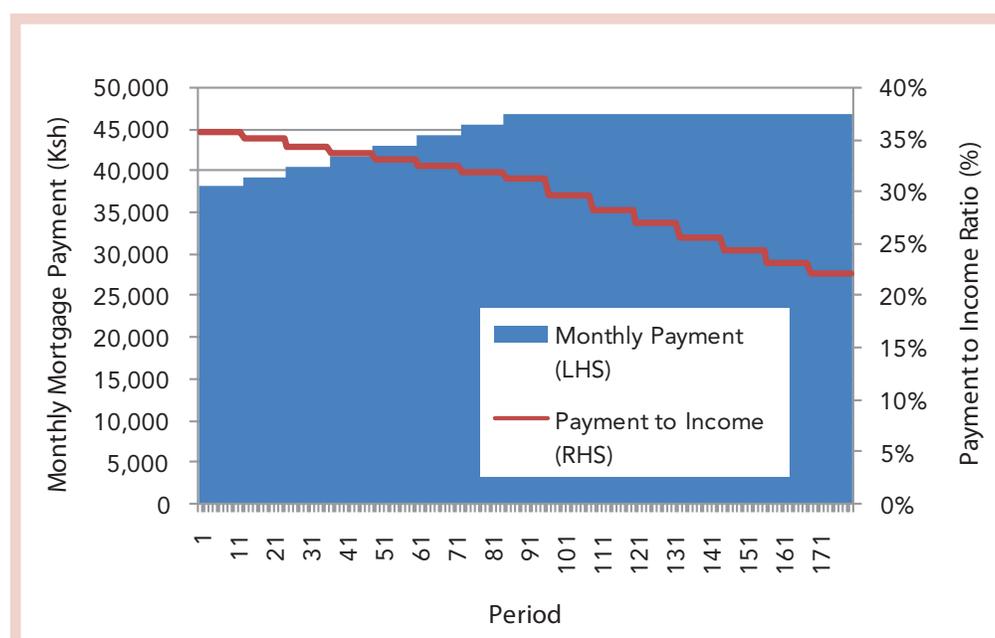
A potential way of dealing with this and improving affordability is to introduce a product such as a Graduated Payment Mortgage (GPM). This is a mortgage product where in the initial period of the loan, the monthly payments rise on an annual basis. This means that the repayment burden is spread more evenly over the lifetime of the loans and can help improve affordability in the initial years by allowing for a larger loan.

As an example assume that nominal wages are rising by 5 percent per year⁸ A mortgage product could be designed whereby over the first 7 years of its life, there would be an automatic rise in the repayment amount of 3 percent. So rather than paying a fixed monthly repayment of Ksh 42,615 for a Ksh 3.2 million loan as in the example above, the initial payment would be Ksh 37,333 and would rise gradually up to 47,781 in year 8 of the loan at which point it would be fixed. It means that a greater proportion of the population could access such a loan as it is more affordable in the early years, and because the increase is less than that in the wages, it will remain so. The chart below shows the repayment profile of a GPM loan. It also shows that despite the rising payments the overall burden on the borrower is decreasing on a year by year basis, as the salary increases more than compensate for the mortgage payment increases.

8. The Kenya Economic Survey reports that wages rose by just over 4 percent in 2009 and by 8.3 percent in 2008.

Figure 19—Graduated Payment Mortgage Monthly Payments and Payment to Income

Loan Amount of Ksh 3.2m at interest rate of 14 percent over 15 years.



Source: Author Calculation

Another way of looking at this example is that a borrower whose maximum affordable loan was Ksh 3.2 million under the present system could afford a loan of just under Ksh 3.6 million using a GPM. An affordability gain of over 12 percent.

4.15 GRADUATED PAYMENT MORTGAGE RISKS

The risks associated with GPM should be highlighted:

- Higher bank exposure—Because the repayments are lower in the initial phase, the loan amortizes more slowly meaning that the exposure for the bank is larger for a longer period.
- Slower or negative loan amortization—If the rate at which the GPM adjusts is set too high, the loan may actually show negative amortization in the initial years. This means the payments would not be sufficient to cover the interest and the loan balance would actually increase.
- Increased credit risk—There is a risk for the consumer in that rising payments do require a rising income. This could place some stress on the financial situation of the borrower where the expected income rises do not occur.
- Combination with variable interest rate—Combining GPM with variable rate loans could result in a two-fold increase. The borrower should be fully aware of this risk. An income stress-test should be done at the underwriting stage to ensure that the loan will remain affordable.

In the example explained above, the rate of GPM increase is set at just 3 percent, which is low enough to ensure some amortization happens, but high enough to have some impact on affordability. Additional safeguards could be built into the product such as a cap on interest rate resets which

would combine the variable rate and the GPM. This, however, would come at a cost which the lender would pass onto the borrower in all likelihood.

The risks outlined above need to be balanced against the increased affordability that such a product could provide. The longer term solution is of course to reduce interest rates and bring inflation under control for macro-economic stability, but in the intervening period this product provides some relief. It may be possible to consider a pilot exercise to test such a product.

4.16 SAVING FOR HOUSING SCHEMES⁹

The next chapter of this report looks at the options available of raising long term funds from the capital markets. However, another way of extending the funding base of lenders is by lengthening the term of deposits. A traditional way of doing this in established mortgage markets has been by creating savings groups with the purpose of building houses or developing savings products designed specifically for housing.

The Kenyan market has some schemes already, most notably that offered by Housing Finance. The scheme called 1stHop¹⁰ is targeted at first time home buyers. The product allows savings for as long as 10 years. It is an open scheme without restrictions as long as the saver has not owned a property before. It is generally aimed at younger home buyers with regular income and a regular savings capacity. Up to Ksh4,000 a month can be put in the scheme and is tax exempt. Savings can accumulate up to Ksh 3 million with the interest earned being tax free. There is a minimum monthly contribution of Ksh 1,000. Similar products are also available from other lenders.

The Income Tax Law¹¹ makes specific provisions for a *Home Ownership Savings Plan (HOSP)*. There are few limitations on how the scheme can function, but the main points are that interest earned on the savings is tax exempt and the amount saved is tax deductible. This represents a significant benefit, although it is only permissible up to Ksh 4,000 a month or equivalent to about USD 600 annually. Any withdrawals from the scheme need to be used for housing purchase or construction within 12 months of the withdrawal.

Given that the minimum deposit necessary to purchase a property is in the region of Ksh 1million, it would take 250 monthly payments to save this much or just over 20 years. Extending the tax benefit could allow for a more rapid accrual of the necessary deposit and, whilst it is being accumulated, it provides lenders with an increased pool of long term deposits. If this is then complemented with further funds from demand deposits and capital market funding, Treasury departments of lenders have a good funding mix for managing their assets and liabilities.

9. For more details see Duebel (2009), "Contractual Savings for Households" in *Housing Policy in Emerging Markets*, World Bank 2009 available at www.worldbank.org/housingfinance

10. See www.firsthop.co.ke

11. Income Tax Act Cap.470

5. SECONDARY MORTGAGE MARKET

5.1 INTRODUCTION

Traditionally mortgage markets have relied on deposits in their initial stages with banks engaging in some maturity transformation whilst relying on the relative stability of their deposit base. Financial innovation has introduced a number of other possible options for lenders to fund themselves. The majority of these introduce the concept of a secondary mortgage market where funding is obtained from investors in the capital markets.¹²

The capital markets in many economies provide an attractive and potentially large source of long-term funding for housing. Pension and insurance reform has created large and rapidly growing pools of funds. The advent of institutional investors has given rise to skills necessary to manage the complex risks associated with housing finance. The creation of mortgage-related securities (bonds, pass-throughs, and structured finance instruments) has provided the multiple instruments by which housing lenders can access these important sources of funds and better manage and allocate part of their risks.

The use of mortgage-related securities to fund housing has a long and rich history in industrial countries. Mortgage bonds were first intro-

duced in Europe in the late 18th century and are a major component of housing finance today. Mortgage pass through securities were introduced in the United States in the early 1970s and along with more complex structured finance instruments now fund more than 50 percent of outstanding debt in that country. Today, mortgage-related securities have been issued in almost all European and many Asian and Latin American countries.

There have been numerous attempts to develop mortgage securities to secure longer-term funding for housing in emerging economies. The view has been that such instruments can help lenders more efficiently mobilize domestic savings for housing, much as they do in industrial countries. In addition, mortgage securities are pursued to develop and diversify fixed-income markets as a complement to government bonds for institutional investors.

Despite the strong appeal of financing housing through the capital markets, there are significant barriers to the development of mortgage securities in emerging markets. Their success is dependent on many factors, starting with a proper legal and regulatory framework and liberalized financial sector, and including a developed primary mortgage market. Perhaps not surprisingly,

12. For an in-depth description of Secondary mortgage markets in emerging economies see Chapter 12 — Mortgage Securities in Emerging Markets in World Bank (2009)

the experience in developing mortgage securities in emerging markets has been mixed. This paper reviews that experience and explores the various policy issues related to this theme, including the supportive role of the state.

5.2 WHY ARE MORTGAGE SECURITIES IMPORTANT?

Mortgage securities can perform a number of valuable functions in emerging economies. Their introduction and use can improve housing affordability, increase the flow of funds to the housing sector and better allocate the risks inherent in housing finance.

In economies with pools of contractual savings funds, mortgage securities can tap new funds for housing. Institutional investors (pension, insurance funds) with long-term liabilities are potentially important sources of funds for housing as they can manage the liquidity risk of housing loans more effectively than short-funded depository institutions. Investors that specialize in certain securities can broaden the types of loans and borrowers served by the primary market. Securities issued against mortgage pools may vary widely in their duration and credit quality, so different investors can select the securities that meet their particular preferences. An increase in the supply of funds can, all other things equal, reduce the relative cost of mortgage finance and improve accessibility to finance by the population.

The resulting increased liquidity of mortgages helps to reduce the risk for originators and their required risk premium. The ability to dispose of an asset within a reasonable time and value, a crucial factor for mobilizing long-term resources, is a service that capital markets, as opposed to banking systems, can provide. A frequently expressed reluctance of primary-market financial institutions to provide housing loans is a lack of long-term funds. This is not only a matter of availability of resources: deposit-taking institutions can be cash rich, but be rightly concerned by the management of their liquidity situation over a long period. Access to the long-term funds mobilized by institutional investors can reduce the liquidity risk of making long-term housing loans and lengthen the maturity of loans, thus improving affordability, particularly in low-interest-rate environments.

A third rationale for introducing mortgage securities is to increase competition in primary markets. The development of capital-market funding sources frees lenders from having to develop expensive retail funding sources (e.g., branch networks) to mobilize funds. Securitization, for example, can allow small, thinly capitalized lenders who specialize in mortgage origination and servicing to enter the market. These lenders can increase competition in the market and can lower margins and introduce product and technology innovation into the market.

Increasing competition and specialization can in turn increase efficiency in the housing finance system. Greater specialization can lead to cost-savings and reduce spreads.

Capital market funding can also help smooth housing cycles. Lenders relying on deposits may be subject to periodic outflows because of economic downturns or widening differentials between deposit and alternative investment rates (e.g., if deposit rates are regulated). Access to alternative sources of funds through the capital markets may allow lenders to keep providing housing finance throughout the cycle.¹³

13. The subprime credit crunch demonstrated that securitization, particularly complex types, can have destabilizing effects as well. A combination of rising default rates on U.S. subprime loans and falling house prices led to a panic among investors in sub-prime and other non-government backed mortgage securities as well as more complex mortgage-related securities. Their refusal to hold or buy such securities not only shut off funding to the mortgage market but also destabilized the banking industry as trust in banks that held or lent against such securities disappeared.

Finally, there are general economic benefits to developing capital markets, including financial deepening, fostering economic growth and improved stability of the financial system. The ability to spread risk and match maturities can stimulate investment and lower the cost of capital to lenders. Creating long-term assets can foster the development of contractual savings institutions by providing an attractive low-risk alternative to government debt.

5.3 IDENTIFYING THE FUNDING NEED IN KENYA

Before seeking a funding solution, it is important to be clear what the funding problem is. From the bank survey, it is clear that access to long term funds ranks as the number one issue among banks holding back the development of mortgage lending. The table below would indicate that banks in Kenya have higher than average levels of deposits relative to sub-Saharan Africa, but this is less than half the level of other countries in the peer group and almost a third of the level for OECD countries. The Central Bank of Kenya indicates that deposits represent 78 percent of total funding for banks. Although it may be growing rapidly, 26.7 percent per year on average over past few years, this may not be sufficient to keep up with potential credit growth.

TABLE 10—DOMESTIC BANK DEPOSITS TO GDP—2004 TO 2009

	2004	2005	2006	2007	2008	2009
Kenya	34.1%	33.5%	34.6%	37.2%	38.2%	39.9%
South Africa	53.1%	57.7%	62.1%	65.5%	66.2%	62.9%
Uganda	13.5%	13.4%	13.6%	14.6%	16.0%	15.8%
Tanzania	19.8%	21.0%	23.0%	24.1%	24.5%	25.2%
India	54.4%	55.2%	58.8%	63.5%	68.2%	68.9%
Egypt	84.4%	84.3%	83.9%	84.7%	77.0%	71.2%
Colombia	15.3%	16.7%	17.5%	17.4%	17.0%	18.3%
SSA Average	26.2%	26.5%	29.1%	30.4%	30.3%	32.1%
HIC OECD	75.2%	80.5%	85.2%	92.0%	96.3%	91.15

Source: IMF International Financial Statistics

It is not just the absolute amount of deposits available for funding but also the term structure of those deposits. There is not much data available on this, but the indications are that there are very few products which allow for long term savings such as savings bonds or certificates of deposits.

Another statistic which gives a more complete picture of how well deposits are put to work is the proportion of loans to deposits. This again is higher than the average for Sub-Saharan Africa but has remained relatively constant over past few years. This may indicate that the financial system has reached its regulatory ceiling which limits loan balances to 75 percent of deposit balances. If Kenya is to expand, it may need to emulate countries such as Colombia and South Africa, both of which have developed secondary mortgage markets. This would allow it to safely go beyond the current credit/deposit levels and engage in longer term lending.

TABLE 11—PRIVATE CREDIT TO DOMESTIC BANK DEPOSITS—2004 TO 2009

	2004	2005	2006	2007	2008	2009
Kenya	78.9%	76.4%	74.7%	72.6%	78.2%	75.8%
South Africa	124.5%	121.2%	124.9%	126.2%	120.1%	123.6%
Uganda	56.8%	56.9%	66.3%	62.9%	74.5%	72.7%
Tanzania	48.8%	46.0%	52.8%	59.7%	64.8%	58.8%
India	67.3%	73.4%	76.4%	74.5%	75.3%	71.4%
Egypt	64.0%	60.7%	58.7%	54.7%	56.6%	50.9%
Colombia	161.7%	146.8%	170.5%	188.0%	—	165.7%
SSA Average	66.4%	68.4%	67.1%	67.5%	70.8%	71.5%
HIC OECD	119.3%	118.9%	122.5%	123.6%	123.0%	124.9%

Source: IMF International Financial Statistics

5.4 LIMITATIONS OF DEPOSITS AS A SOURCE OF LONG TERM FUNDS

Contractually, deposits are mostly short term liabilities, however they may behave just like longer term funding sources. This is because, although depositors have the right to withdraw their savings at any time, in practice a large proportion of deposits will be 'sticky' and not show price elasticity to changing interest rates. A core deposit ratio of 15 percent can be safely assumed and a higher ratio could be used based on analysis of depository 'stickiness'. These core deposits can be thought of in the same way as long term funds when calculating liquidity ratios and looking at the maturity mismatches on a bank's balance sheet.

Total deposits at end of 2009 amounted to just over Ksh 1 trillion. Using a 15 percent ratio, would mean that Kenya has around Ksh 150 billion of long term deposits. Added to this is shareholder equity, which is genuinely long term funding worth Ksh 196 billion. This does provide some capacity for long term loans, but it will also vary from one institution to another.

Given that the mortgage market is currently just over Ksh 60 billion, it indicates that some room for growth remains, although the situation may vary from one institution to another. Also other term products may exist including medium term lending to corporate or SMEs or term lending for infrastructure.

Looking at individual institutions provides some important insights, especially given the high level of concentration in the two largest lenders:

Box 5

HFCK Housing Bond Issue

One new corporate bond was issued by Housing Finance during the period under review. The issue raised Ksh 7 billion, against an initial first tranche target of Ksh 5 billion. The bond was therefore oversubscribed by 41%. The mortgage finance company was to use the funds to finance its housing projects. Having received more than the target amount, HFCK opted to exercise a "Greenshoe" option, resulting in it absorbing all the amounts put in by investors. No foreign companies subscribed to the issue, with 98% of the total amount getting invested in the bond by local companies and 2% by individuals. The Medium Term Note matures in seven years with both a fixed and floating rate. The Floating Rate bond amounted to 20% of subscription while the remaining 80% went to Fixed Rate subscribers.

Source: CMA

- HFCK—The institution which is most constrained is HFCK which has more housing loans than deposits. This means it is dipping into its equity to fund itself together with the use of bank lines of credit. This is an expensive form of funding, and would not be sustainable over the longer term. This explains HFCK's recent foray into the bond market to raise Ksh 10 billion. It is also actively promoting term savings products which will help extend the maturity of its retail deposit liabilities.
- KCB—The other institution which may be under pressure is KCB. It has a mortgage loan portfolio in excess of 10 percent of its deposit base. Whilst it still has room to grow, it has sought to address its funding situation by doing a rights issue for Ksh 15 billion. This is in part to fund its regional growth in East Africa but also to allow it to expand its mortgage lending business in a prudent way. In addition, it is also entering into arrangements with IFC for a credit facility to help expand its mortgage business.
- Others—Other lenders which have yet to develop large mortgage books still have some headroom to grow, although this may be in part limited by the extent of medium term lending to corporate and SMEs, and how close they are on the regulatory loans to deposit ratio.

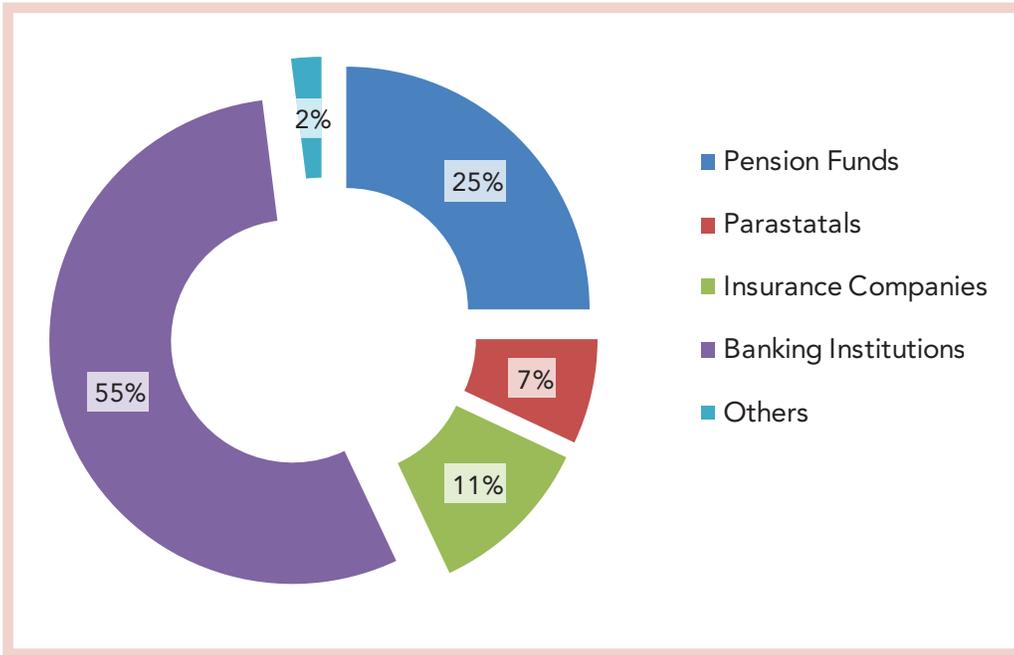
5.5 INSTITUTIONAL INVESTORS

Kenya has a large investor base made up of individual investors, pension funds, insurance companies and banks themselves. The Capital Markets Authority publishes regular data on investment holdings by type of asset and by investor which provides a useful profile of the potential investors in a secondary mortgage market. The key Institutions which are potential investors into a secondary mortgage market are pension funds, insurance companies, banks and the NSSF.

Together these institutions have substantial funds which in many cases are seeking long term investments to match the long term liabilities which are generated by the pension or insurance businesses. The charts below gives some indication of the size and composition of the sector and the potential for extending housing finance. Figure 20 below shows that the largest investors in Treasury bonds are banks themselves, owning over half of all bonds outstanding. The same breakdown for corporate bonds suggests more interest from the investment sector in the higher returns which can be offered there.

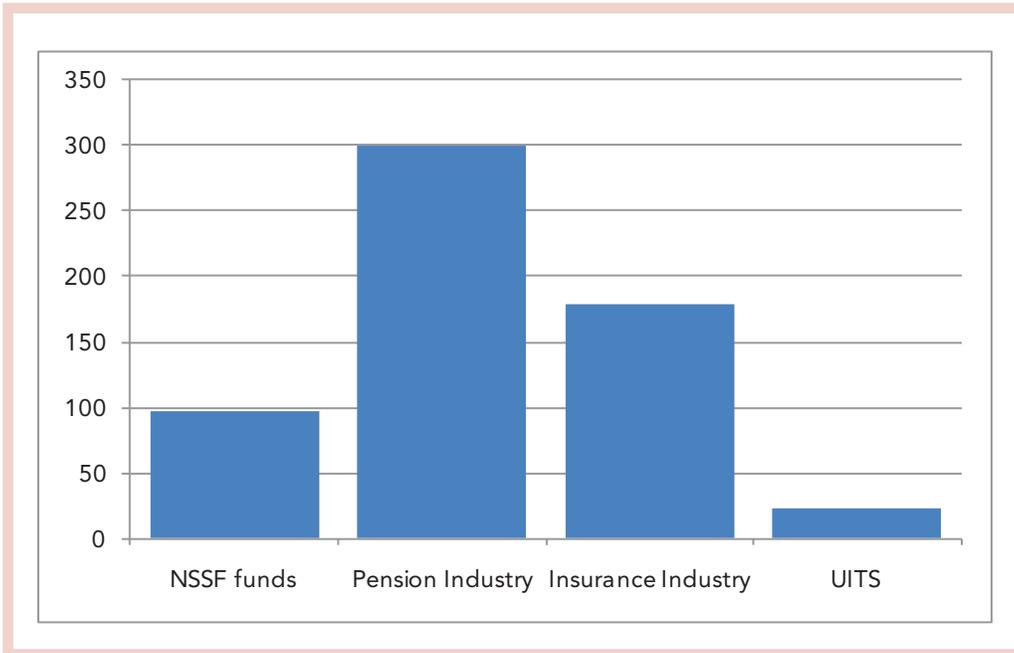
The second chart below, Figure 21, provides a rough split of available long term funds for investment. Updated figures are not easily available but total pension assets are close to Ksh 400 billion when NSSF funds are also included, insurance assets are around Ksh 180 billion and the Unit Trust market as at end 2010 was worth Ksh 28 billion. Overall funds of institutional investors, excluding the banking sector amount to over Ksh 600 billion. Almost 10 times the current size of the mortgage market.

Figure 20 Treasury Bond Holdings by Investor type—September 2010



Source: Capital Markets Authority Statistical Bulletin September 2010

Figure 21 Estimated Long Term Investor Assets—Ksh billion—2010



Source: ESMID project and Capital Markets Authority

5.6 MARKET INFRASTRUCTURE

As well as the presence of an investor community, another supporting factor for the development of a secondary mortgage market is the advanced level of market infrastructure in Kenya. The market

benefits from a strong and competent regulator, and a secondary bond market exists with trading growing rapidly. Trading in government securities in the secondary market increased by 93 percent in 2009 and is thought to have shown similar growth in 2010.

The bond market is currently dominated by government securities, but there is an active corporate bond market which accounts for around 9 percent¹⁴ of issuance. The total market has grown to over Ksh 800 billion, with turnover in 2010 amounting to Ksh 479 billion and new issues of Ksh 190 billion. Corporate bonds outstanding as at end 2010 were worth Ksh 57 billion.

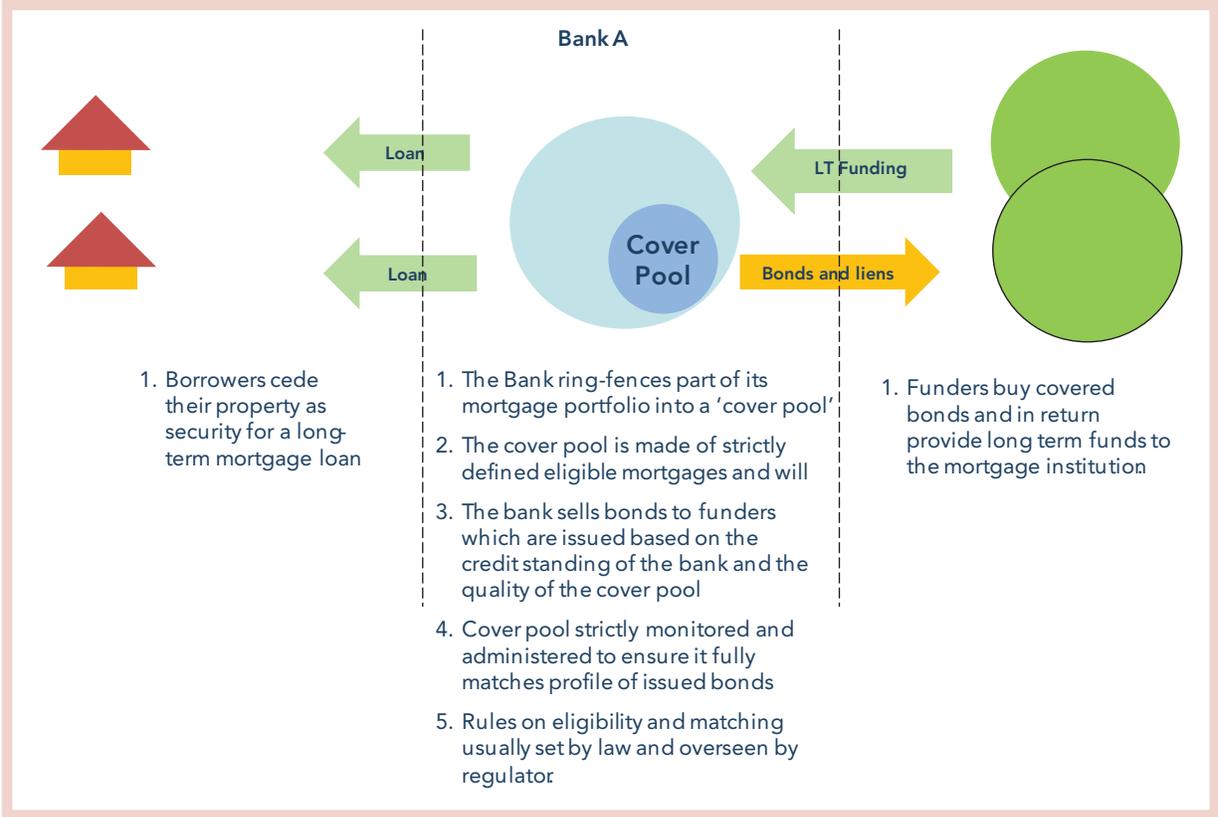
The Central Bank of Kenya is actively working on the development of a Primary Dealer network which would significantly improve liquidity in the government bond market and could potentially be a platform used for mortgage securities as in other jurisdictions. In addition, the central bank is also looking to develop an over the counter trading (OTC) system which would further enhance market liquidity.

Lastly, the CBK is regularly issuing long term bonds and is creating a 25 year benchmark (with issues up to 30 years) which will serve to establish a longer maturity yield curve and help with pricing of long term debt.

Below several alternatives are considered for the type of security which could be offered.

5.7 OPTION A—COVERED BONDS

Figure 22— Mortgage Covered Bonds



Sources: Genesis Analytics and World Bank

14. From presentation by Ms Stella Kilonzo, CEO of Capital Markets Authority, April 2011

Covered Bonds are the framework preferred in many European countries, most notably Germany, France and Denmark, but now most European countries have legislation in place allowing for the issuance of Covered Bonds. So far Sub-Saharan Africa has not had any issues and legislation has not been put in place in any country.

The advantages of a Covered Bond system are principally that it is a simpler system than securitization, which is also more transparent in terms of risk allocation. It creates a resilient system with many risk mitigants. This has been demonstrated in the recent crisis where covered bonds emerged in much better shape than MBS.

One of the other often cited benefits of a covered bond system is the standardisation which it introduces. By having a uniform set of requirements for mortgages to be included in a cover pool, a set of market standards is created which covers the documentation, valuation, risk management, underwriting process.

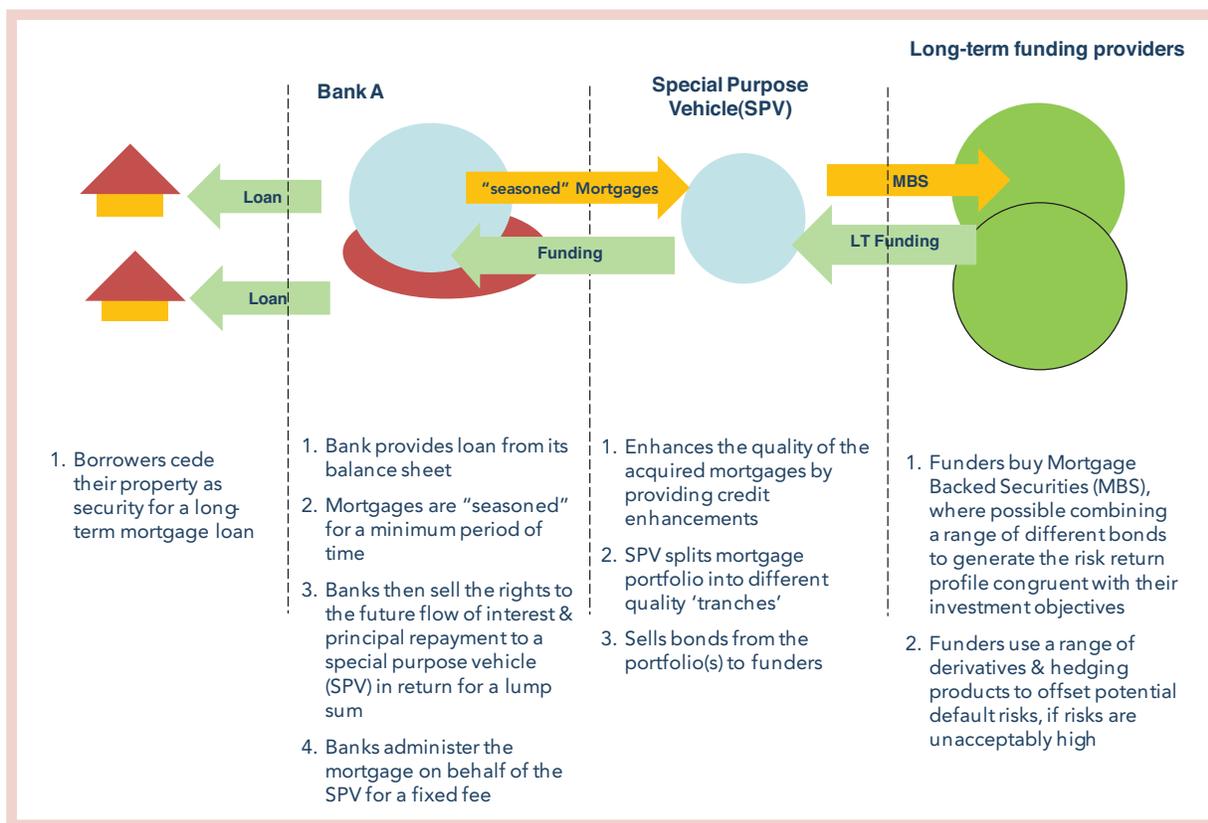
One of the key features of a covered bond system is a strong basis in law. The right of the investor over the cover asset has to be absolute to give the bonds their strength. Rating agencies and regulators have therefore generally pushed for a covered bond law to be enacted rather than just legislation.

The big drawback in developing such an instrument in Kenya would be the lack of liquidity initially. It has been a feature in European markets that smaller countries have struggled to really establish a covered bond system due to a lack of scale. However there is increasing interest in covered bonds outside of Europe in both developed and emerging markets. As the Kenya's corporate and government bond market develops further, a covered bond market could be considered.

5.8 OPTION B—SECURITIZATION

Securitisation is an off-balance sheet approach where assets are removed and sold from the balance sheet of the lender to raise funding. Securitization can involve significant costs and complexity to set up and administer. Because there is risk transfer it also raises a number of issues related to the ability of banks to manage their risks and investors to take on credit risk, interest rate risk, pre-payment risk. Figure 23 describes the securitisation process in more detail.

Figure 23—Mechanics of Securitization



Sources: Genesis Analytics and World Bank

The key difference between securitisation and funding from an institutional investor is that banks effectively sell the rights of the mortgage to a securitisation entity who then sells bonds onto investors who are now directly exposed to the risk of default.

Securitisation has some potential in Kenya given the size of the mortgage market and the number of institutional investors. However some key obstacles to the successful use of securitisation at present include but are not limited to:

- **High issuance costs**—The economics of securitization may not yet make sense. Lenders would have to be prepared to offer a significant premium on the securities above the risk free T-bill rate to attract investors. This cost would most likely be in the form of credit enhancements such as over-collateralization, quality of securitized assets, a liquidity facility for the SPV or other mechanisms limiting some of the risk.
- **Lack of detailed portfolio data**—Lack of mortgage data limits the amount of analysis which can be done by investors on possible mortgage portfolios to be securitized. Without good data, investors would assume the worst case scenario and demand a higher level of risk mitigation which makes securitization more expensive for issuers.
- **Potentially negative impact on competition**—Would limit market to just two players who have the scale and portfolio to develop a securitization issuance program; Could entrench duopoly model
- **Risk Management issues**—Many of the lessons from the MBS problems in US are still being digested, but one is the dangers of separating the origination servicing and risk taking functions.

Different actors operate under a different set of incentives and with different motives which can be to the detriment of the mortgage borrower if not carefully managed.

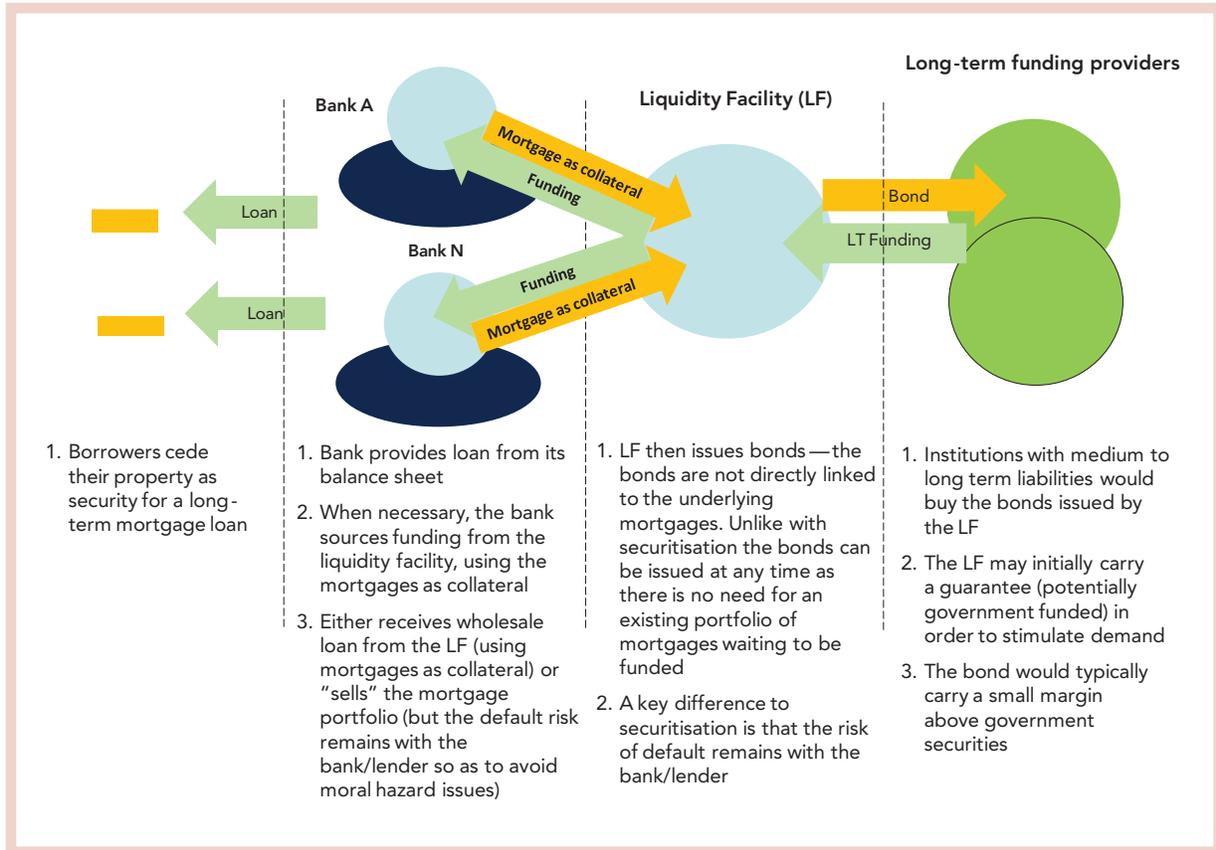
- **Prudential risks**—Securitizing the best assets from a bank’s portfolio leaves a bank with more funding and capital but a higher proportion of non-performing loans. This has prudential implications for the regulator who may have concerns about banks weakening their balance sheets in this way.
- **Lack of ‘feed stock’**—For securitization to work, market liquidity needs to be generated through regular issuances in large amounts. At present the size of the mortgage market is not sufficiently large to get the necessary economies of scale and the volumes of issuance that would lead to a liquid MBS market. This would be reflected in the pricing of the MBS which would be even more expensive than otherwise.

It should be noted that although securitisation, particularly the most sophisticated methods, as a model and a technique is currently under fire given its role in the sub-prime debt crisis in the USA, it is unlikely that it will disappear entirely as a business model. At the same time the criticism that the model suffers from a principal—agent problem in that the originating institution pays less attention to the quality of an asset that it intends to on-sell does have some merit, and will no doubt result in some important modifications to the traditional model. In particular, regulation will need to be enhanced to better account for the risks inherent in this model.

5.9 OPTION C—MORTGAGE LIQUIDITY FACILITY

An alternative to the aforementioned funding structures is a mortgage liquidity facility, which is generally more appropriate for emerging markets than securitisation and can play a vital role in the establishment of a more developed secondary mortgage market (including securitisation). Key differences between a liquidity facility and securitisation include that liquidity facilities are generally less complex, involve lower levels of risk transfer (the risk of default remains with the bank/lender), and that the bonds are not directly linked to the underlying mortgages. These differences combine to make liquidity facilities more appropriate for emerging markets. Figure 10 describes how a liquidity facility fits into the mortgage market.

Figure 24: Mechanics of a Mortgage Liquidity Facility



Sources: Genesis Analytics and World Bank

Benefits

Liquidity facilities have notable benefits and have proved successful in boosting some stagnant/constrained mortgage markets.¹⁵

Notable benefits include the following:

- Liquidity facilities can provide lenders with lower cost funding than they would be able to access individually. This is especially beneficial to second tier banks, which suffer the most from liquidity constraints. In turn, this enables lenders to improve interest rates offered thus improving end user affordability
- In the absence of a liquidity facility only financial institutions with good credit ratings or extensive branch networks (with sufficient deposits) could meaningfully participate in the mortgage industry. However, because liquidity facilities enable smaller banks and non-bank financial institutions to participate in the industry, a more competitive environment can exist
- Liquidity facilities increase the leverage of existing funding, allowing short term deposits to (more easily) be converted into long term assets, with the safety net of the liquidity facility to deal with liquidity risk issues

15. Essentially lenders in these markets became much more willing to extend the terms of their mortgage lending once the liquidity management tool was offered. The process has usually included one or two lenders being convinced to extend maturities, and the broader market following soon thereafter, usually extending terms to 15 years or longer.

- Even if Kenya does not yet move to securitization, a liquidity facility can act as a first step in linking mortgage markets to capital markets but without the same levels of complexity and risk transfer as a fully fledged secondary mortgage market (while still allowing the mortgage market to grow in the absence of the infrastructure necessary for a more developed secondary market)
- A liquidity facility provides long term investment opportunities in which long term liabilities can be invested. This is particularly useful for pension funds, life insurance companies and social security funds. These institutions often invest directly in mortgage or real estate markets with limited success (as these areas do not lie within their core areas of expertise)
- Policy objectives such as the promotion of affordable housing can be supported by the liquidity facility. For example by offering different terms for the refinancing of loans to the targeted group (i.e. low income communities). However care must be taken to avoid distorting the market.

Box 6

The Egyptian Mortgage Refinance Company (EMRC)

EMRC is a joint stock, wholesale (second tier), specialized liquidity facility operating on commercial principles with a profit making goal. It is majority privately owned by the users of its financial services, mainly Mortgage Finance Companies (MFCs) and active banks. Many public and private lenders have joined the capitalization of the EMRC, which indicates their interest in expanding their mortgage lending. The Central Bank of Egypt is a strategic investor with around 20 percent ownership share; the Mortgage Market Fund (a government housing subsidy agency) with a small, 2 percent ownership share, and 19 banks and 6 MFCs have the remaining shares.

EMRC neither takes deposits nor lends directly to households. Its presence helps to promote prudential lending standards while enhancing competition in the mortgage market by creating a funding source also accessible to non-depository institutions. Its business is the refinancing of long-term residential mortgage loans originated by primary lenders for which it will raise term funding by issuing bonds in the capital markets.*

This narrow mandate will strengthen the credit quality of the bonds and thereby help to keep the EMRC's cost of funds relatively close to rates on government bonds. By borrowing from the EMRC, or at least by having the EMRC available when needed to serve as first resort source of finance, mortgage lenders will be better enabled to offer longer-term financing for residential housing development on market terms and conditions that are favorable for many potential homebuyers. Lenders also view EMRC as a source of liquidity they can tap at short notice.

EMRC began its refinancing operation in August 2008. The participating lenders were able to increase their lending for housing and improve their credit affordability through lengthening the maturity of mortgage loans. The EMRC will mostly rely for funding on issuing bonds and other securities in the capital market. The primary lenders will also be able to use the EMRC to improve the efficiency of their portfolio and risk-management activities, which should help lower financial spreads in the market to the benefit of borrowers.

* There are a number of international examples of liquidity facilities, including the Federal Home Loan Banks in the US, Cagamas Berhad in Malaysia, Caisse de Refinancement de l'Habitat in France, the Jordan Mortgage Refinance Company, and the Swiss Pfandbriefe Institute. These institutions have similar missions but somewhat different structure, powers and privileges.

5.10 RECOMMENDATIONS

In summary, Kenya is very well positioned to support the future growth of its mortgage market by tapping into its capital market. The investors are present and interested in gaining exposure to the sector. The market infrastructure is among the best in Sub-Saharan Africa with a dynamic and growing fixed income market. There is a good and supportive regulatory environment from the CBK, CMA and RBA. The question is then what should be the next step?

The mortgage market is really split into two groups at present, on one side is KCB and HFCK and then on the other are all the other mortgage lenders. KCB and HFCK have just demonstrated through their Rights Issue and Corporate Bond issue that they have the capacity and scale to tap the market on their own. Especially in the case of HFCK this is now essential if it is to grow. For other lenders, issuing a bond for housing purposes is less realistic as they may not be large enough to justify the costs of an issuance or have a portfolio large enough to warrant it. Given this split, a twin approach may be justified, with KCB and HFCK potentially looking to develop a mortgage funding instrument with some credit risk transfer, whilst the sector as a whole looks into establishing a simpler mechanism which can be accessed by all.

There are many drawbacks to doing securitization, especially in an emerging market such as Kenya. The risk premium which would be charged together with the issuance costs would outweigh many of the benefits of tapping the capital markets. A longer term and more sustainable solution for the two large lenders would be to look at a simple covered bond framework, which would build on their existing issuance program.

A mortgage liquidity facility would be a solution for the sector as a whole, and one which could also benefit HFCK and KCB, regardless of them pursuing their own fund raising strategies. This is a mechanism which has been set up in a number of emerging markets, and has been shown to function in environments with a lower level of financial sector development.

In addition to the above specialised funding tools, greater focus should also be given to lengthening the term of deposits by introducing term savings products. Also as part of balanced funding solutions using the available resources from the inter-bank market and also the growing corporate bond market all provide additional funding avenues. Typically a balanced approach allows for greater stability in the system without over-reliance on a specific source of long term funds. So whatever secondary mortgage market solution is developed, it should be done alongside other more traditional sources of mortgage funding.

6. PRIORITIES AND RECOMMENDATIONS

6.1 PRIORITIES

The Mortgage Market in Kenya has many of the attributes necessary for its further development. These include a good number of lenders active in the market, some risk management tools such as good property valuation and a credit bureau, and it also has an active property market complete with one of the very few house price indices in sub-Saharan Africa.

The challenge which the market now faces is in how to achieve scale and move on from the 15,000 or so loans that exist to a position where true scale can be achieved and the average cost per loan can be brought down.

The three critical areas which are necessary for this scaling up to happen are (i) a greater supply of affordable properties (ii) long term cheap funding and (iii) lower mortgage interest rates.

For (i) to happen will necessitate a supply side response from developers and from government to tackle all of the areas which are currently keeping prices for new housing beyond the reach of the vast majority of the population. A full analysis of this issue is beyond the scope of this report, but it would seem that addressing zoning rules, land prices, cost of raw materials, financing for developers, cost of infrastructure

and taking each one in turn, could lead to substantially cheaper housing.

For (ii), long term funding, Kenya is in an enviable position with substantial long term liabilities held by institutional investors seeking long term assets to invest in. The current pool of investor funds is in excess of Ksh 600 billion, not including the banks themselves who could make use of their liquid deposit bases by potentially investing a proportion into mortgage securities or mortgage bonds. The key question is what mechanism would best suit Kenya? Whilst several systems can co-exist, the simplest way to initiate a secondary mortgage market is through a mortgage liquidity facility. A mortgage liquidity facility would also have the benefit of being accessible to a wider range of financial institutions as opposed to mortgage covered bonds or mortgage backed securities which would be limited to the largest two institutions in the market.

For (iii), lowering of mortgage interest rates, this study has clearly shown the importance of lower rates in terms of expanding affordability. There are several steps which can be taken which over time should lead to lower rates. The main component of rates will be the risk free rate which is determined in large part by the rate of inflation in an economy. The importance of a low inflation, stable economy cannot be over-empha-

sised when trying to develop a long term lending market. Other important steps to consider are better risk management to lower the risk premium charged on loans to cover the cost of defaults. This can be achieved at the individual lender level and also by making increased use of the credit bureau. A second way would be through product innovation. Expanding the range of products, in particular away from the discretionary variable rates, potentially considering a product such as graduated payment mortgage could lead to affordability gains. Lastly, lenders could decrease their cost of funds by making use of resources available in capital markets which would also allow them to better leverage their deposit bases.

The recommendations below attempt to set out a program of reform which can achieve the goals set out above.

6.2 SUMMARY OF RECOMMENDATIONS

Short Term (over next 18 months)

- **Set up a Mortgage Development Group made up of stakeholders**—There are multiple interested participants in the mortgage market and the related sectors such as construction, housing, capital markets, as well as government departments and civil society. A policy group should be convened under the auspices of the CBK or a government department to help drive and direct the change process, and to provide inputs into work as it progresses.
- **Industry to form a Mortgage Lenders Association**—From the industry side, an important development mechanism is the creation of a strong trade association to represent the interests of lenders. This would act as a lobby group reviewing regulatory proposals and as a standards group for mortgage best practice, and could push into areas such as research or data collection for the wider benefit of the sector.
- **CBK to collect and publish regular mortgage market data**—The Annex to this report represents a first attempt at collating lender level mortgage data. This is an important instrument for both market development but also market monitoring. CBK should take lead in collecting this information and making it available to the market on a regular and timely basis.
- **Ensure CRB collects all positive/negative data**—Coverage is inadequate at present and although it is a new area, more could be done to push lenders into providing all loan data. The next step would be to collect data from other providers of credit. This is an important building block towards lowering the cost of credit and building a secondary market.
- **Begin work on developing a mortgage liquidity facility**—The concept is simpler than Covered Bonds or Securitization and will allow access to longer term finance to mid-tier lenders who may not otherwise be able to raise sufficient term funding. Based on experience, it can take up to 18 months to do all necessary preparation work to create such an institution,
- **Draft mortgage regulations—prudential standards**—The CBK should consider exploring more prescriptive rules which would set some minimum product standards for mortgage loans in terms of both loan to value and payment to income. This should be done with a view to ensuring 'responsible' lending for the protection of both consumer and lender.
- **Amend current foreclosure law to limit frivolous appeals**—The current foreclosure process works relatively well in most cases, but the potential is there for long drawn out cases through the use of repeated appeals. This should be eliminated through an updated law which would be clear for the basis on which an appeal is allowable.

- **Introduce consumer protection framework and mortgage financial literacy campaign**—As the market grows it is important that it is underpinned by confidence on the part of consumers. It would be worth considering introducing some mechanisms for ensuring minimum levels of disclosure, complaints handling procedures and adjudication processes. Alongside this it is clear from FinAccess survey that there is some resistance to and a lack of understanding of collateralized lending with property. Explaining mortgages, how they work and their benefit would help to ensure that lending is done in safe way and that the benefits of financing are understood.

Medium Term (18 months to 3 years)

- **Review of risks and regulation for pension backed housing loans**—Pension Backed Housing Loans carry a high level of risk for both lender and borrower. In the absence of other forms of reliable collateral, they have proved popular in South Africa especially. However, but a thorough review of the products and the regulatory framework for them should be done to avoid a future crisis should lenders start losing their retirement income.
- **Set up mortgage liquidity facility**—In the medium term, the liquidity facility can be set up and refinancing operations can begin. This could be done with the support of the World Bank or through other means.
- **Work to standardize mortgage market documentation**—Standardized documentation carries a number of benefits for development of the sector. It helps consumers feel more comfortable with documentation. It facilitates a homogenous market, which can then more easily turn to the capital markets and offer standard mortgage assets in return for funding. Lastly it makes it easier to enforce regulatory standards.
- **Develop more advanced capital market tool**—mortgage covered bond—Kenya has a relatively sophisticated institutional investor market who may be interested in taking some credit risk on mortgages but in a limited, transparent way. Covered Bonds offer a more secure instrument than Mortgage Backed Securities and could be considered for the Kenyan market in the medium to long term.
- **Review property registration system**—work towards a one-stop shop with unified database—Numerous reports all point towards the need of a unified land and property registration titling and registration system. A simpler, more secure, reliable process which is both cheap and efficient could significantly boost the development of the mortgage market. This will require large scale investment, and would ideally lead to the full computerization of the registry system.
- **Banks to work to diversify product range including Graduated Payment Mortgages (GPM)**—Affordability is a key constraint on the future growth of the market. One way of tackling affordability is by designing products where cost of the loan is spread out more evenly over the lifetime of the loan. A GPM would allow for a small manageable increase annually in the mortgage payment, which means the initial loan can be higher than would otherwise be the case.

Long Term (3 to 5 years)

- **Develop options for a Government program to help market reach further down income distribution**—Fiscal resources are constrained and there are numerous priorities and demands on the budget, but as the mortgage market develops it will reach a point where it needs a helping hand to reach lower income groups. This could be done through a guarantee mechanism, private or public, through subsidies, or through other means. Having a review of the options would help guide the market onto the next phase of development.

- **Develop unified mortgage law**—Although it is not a big impediment as the current system does function, having a more streamlined and standard process would improve market efficiency. This could be done in line with changes to the titling and registration system.

6.3 ACTION PLAN

<i>Category</i>	<i>Action</i>	<i>Timing</i>	<i>Responsibility</i>
Implementation	• Set up a Mortgage Development Group made up of stakeholders	Short Term	Treasury but all included
	• Industry to form a Mortgage Lenders Association	Short Term	Mortgage Lenders
Risk Management	• CBK to collect and publish regular mortgage market data	Short Term	CBK
	• Review of risks and regulation for pension backed housing loans	Medium Term	RBA/Treasury
Market Infrastructure	• Work to standardize mortgage market documentation	Medium Term	Lenders/CBK
	• Review property and mortgage registration system—work towards a one-stop shop with unified database	Medium Term	Min of Lands
	• Ensure CRB collects all positive/negative data	Short Term	
Mortgage Regulation	• Draft mortgage regulations—prudential standards	Short Term	CBK
	• Amend current foreclosure law to limit frivolous appeals	Short Term	Min of Housing/ Min of Lands
	• Introduce consumer protection framework and mortgage financial literacy campaign	Short Term	CBK/Treasury Min of Housing/
	• Develop unified mortgage law	Long Term	Min of Lands
Access Issues	• Banks to work to diversify product range including Graduated Payment Mortgages (GPM)	Medium Term	Lenders
	• Develop options for a Government program to help market reach further down income distribution	Long Term	Treasury/ Min of Housing
Mortgage Market Funding	• Begin work on developing a mortgage liquidity facility	Short Term	CBK/Treasury/lenders Lenders.CBK
	• Set up mortgage liquidity facility	Medium Term	
	• Develop more advanced capital market tool—mortgage covered bond	Medium Term	Treasury/CBK

6.4 IMPLEMENTATION

Coordination—A key challenge with such a program is the implementation process. A coordinated approach is required across different Ministries and with a public/private partnership. A crucial feature in putting this program into practice will be the constitution of a Mortgage Market Development Committee which will bring together different stakeholders and act as coordinating body.

Leadership—It is also important that clear leadership be taken in implementing this strategy. so whilst many bodies will be involved, a single champion needs to take responsibility and ownership of the overall program and deliver on it. Ideally, the Ministry of Finance or the Central Bank would take the lead, in close cooperation with Ministry of Lands and Ministry of Housing.

Resources—Many of the recommendations are policy based and therefore do not require direct funds for investment. One of the main planks of the program would be a mortgage liquidity facility which could be set up as a private venture. Typically in other countries, the World Bank has facilitated the initial years of a mortgage liquidity facility with a loan to the government for on-lending by the facility. This could be an option for Kenya or alternatively a fully private system raising its own funding from the outset could also be considered but would carry greater risks.

Results—Although there is a heavy policy content in the proposed program, several steps could be taken to speed up implementation through the use of judiciously selected pilot programs. This could include trials of new products both on the saving side and lending side. Equally as more work is done in defining the priorities for lower income groups and for housing delivery policy, pilot exercises could be done which would include some mortgage lending for affordable housing.

6.5 MONITORING & EVALUATION

Responsibility—One of the advantages of setting up a Mortgage Market Development Committee is that this could be the body charged with monitoring progress against a set of defined indicators. The indicators would be drawn from a number of sources but consolidated into a single report focused on developing the mortgage sector.

Indicators—Any set of indicators would have to measure both the level of overall growth in the mortgage market but also the quality of growth and improvements in access. The following indicators are an initial suggestion covering these aims:

- Number of mortgage loans
- Size of Mortgage Market (Ksh)
- Mortgage Market size as a proportion of GDP
- Average Loan Size
- Average interest rate on new loans
- Spread between average mortgage rate and 12 month T-bill rate (or other 'risk-free' measure)
- Number of residential housing building permits issued
- House price inflation
- Non-performing loans as a proportion of total mortgage loans.

6.6 FURTHER WORK

Mortgage loans represent just one facet of the housing finance market. As this study demonstrated, even the mortgage market reaches its maximum current potential as the best that can be hoped for at present is for mortgages to serve 8 percent of the urban population of 3 percent of all Kenyans. Other solutions need to be considered in parallel for lower income groups.

Two further studies are proposed which will mesh in with this work and provide analysis and solutions across the income spectrum. The studies will be:

1. **Expanding the supply of affordable housing in Kenya**¹⁶—This is a crucial missing piece of the puzzle towards improving access to housing. Current levels of production are too low and too expensive. Lessons could be learned from other countries which have successfully lowered the cost of housing by looking at size, materials used, construction techniques, zoning, land acquisition and provision of infrastructure. Increasing the scale of developments will be a crucial factor in ensuring that low cost housing makes economic sense and can attract private capital.

Alongside affordable housing for ownership, this study will also consider the role that rental housing could play in improving housing conditions and bridging some of the affordability gap for those households not in a position to buy a home. The current rental framework and incentives for landlords to invest in properties for lower income groups will be considered.

The role of the state in terms of housing provision will be considered also. There is clearly a limited fiscal envelope within which to work, but the incentive system for lower income housing will be looked at covering housing subsidies, tax system, provision of infrastructure and provision of land for housing development.

Lastly, a more detailed analysis of the housing development industry will examine the economics of the sector and some of the blockages or missing incentives which prevent developers meaningfully addressing the needs of lower income households.

2. **Expanding Access to Housing Finance**—The limited reach of the mortgage market is clear and even though it will gradually go further down market over time, there is still a need to look at other forms of improving access to financing for housing among lower income groups. This study will provide an analysis of typical lower income groups and examine their needs and capacity to borrow. Potential products could include 'mini'-mortgages, housing microfinance, as well as rental housing. An important facet to this work would also be to look at how lenders can manage the risks from lower income groups, and whether some form of insurance may be required either through private or public provision.

A further aspect of this work will be to understand the capacity to save of lower income groups and whether a saving-for-housing program could be tailored for lower income groups.

Finally the study would have to consider the current level of provision of financial services and housing finance to lower income groups and what capacity improvements are required. This could range from a need for training in risk management to loan underwriting or marketing. The possible ways of funding low income housing products would also be an important consideration in this work.

16. A World Bank project—the Kenya Informal Settlements Improvement Project - approved in early 2011, will specifically look at issues around security of tenure, infrastructure in informal settlements and also housing issues.

REFERENCES AND BIBLIOGRAPHY

Central Bank of Kenya, FSD Kenya, FinAccess National Survey, June 2009

Central Bank of Kenya, World Bank, Mortgage Finance in Kenya: Survey Analysis, October 2010

Chiquier, L., & Lea, M., (editors) Housing Finance Policy in Emerging Markets, World Bank , June 2009

Chiquier, L., Hassler, O., & Lea, M., Mortgage Securities in Emerging Markets, World Bank Policy Research Working Paper 3370, August 2004

Deb, A., Karamchandani, A. & Singh, R., Building Houses, Financing Homes, Monitor Group, July 2010

Financial Sector Deepening Kenya, Costs of Collateral in Kenya—Opportunities for Reform, September 2009.

Genesis Analytics, Expanding Housing Finance in Uganda, Study on the use of retail funds for mortgage lending, funded by FIRST, June 2009

Hassler, O., & Walley, S., Mortgage Liquidity Facilities, Housing Finance International, Vol. XXII No. 2 December 2007.

International Securities Consultancy (ISC), Recommendations on Securitisation legislation and policy changes, International Finance Corporation (IFC), Efficient Securities Market Institutional Development (ESMID), February 2009.

Mutero, Dr.J, Access to Housing Finance in Africa: Exploring the Issues: Kenya, Finmark Trust, December 2007.

Safavian, M., Financing Homes—Comparing Regulation in 42 Countries, World Bank , 2008

Syagga, P., Chap. 8, Land Ownership and Use in Kenya: Policy Prescriptions from an Inequality Perspective, in Readings on Inequality in Kenya : Sectoral Dynamics and Perspectives, published by Society for International Development, 2006.

Urban Institute, Development of Mortgage Default Insurance in Kenya Assessment Report, prepared for OPIC, August 2006

UN-HABITAT, The State of African Cities 2010: Governance, Inequalities and Urban Land Markets, November 2010

Sing, L., Pension-Secured Loans: Facilitating Access to Housing in South Africa?, Finmark Trust, June 2009

World Bank, Banking Sector Stability, Efficiency, and Outreach in Kenya, Policy Research Working Paper 5442, October 2010.

World Bank, Doing Business 2011, www.doingbusiness.org

APPENDIX 1

MORTGAGE FINANCE IN KENYA: SURVEY ANALYSIS

I. INTRODUCTION

A. Background

This survey analysis is part of an overall Housing Finance Study that profiles Kenya's mortgage finance market. The survey was conducted by the Central Bank in June 2010 and the analysis presents the findings on the overall mortgage finance market, mortgage loan characteristics, and the main constraints to the primary mortgage market in Kenya. A subsequent report is being prepared based on extensive interviews with commercial banks, government agencies, property developers and fund managers that will examine in detail the primary mortgage finance market, housing supply and demand constraints, and the potential for a secondary mortgage finance market.

B. Survey Methodology

The analysis is based on survey of all the 45 banks in Kenya¹⁷. All banks responded to the request in writing (7 banks indicated that they did not provide mortgage financing). The three-part questionnaire requested the banks to answer questions related to the size of mortgage portfolio, loan characteristics and mortgage market obstacles. The survey focuses exclusively on the primary residential mortgage

market which is mainly concentrated around the Nairobi region. Two key caveats regarding the survey results are: (i) the data on total loans may be overstated due to the reporting of developer financing loans by some institutions and (ii) the data on interest rates may be understated due to the inclusion of employee mortgage loans which are typically provided at subsidized rates.

C. Report Structure

The report has three sections covering (i) Overall Market Characteristics—profile of the Kenyan mortgage market, with a focus on the growth, segmentation and portfolio quality (ii) Mortgage Loan Characteristics—profile of the typical Kenyan mortgage loan and (iii) Mortgage Market Constraints—summary of the main constraints in the primary mortgage market identified by the commercial banks.

D. Definitions

For the purposes of this survey, we have used the following definitions:

Primary Mortgage—a bank loan made to an individual for the purpose of purchasing, renovating or constructing a residential dwelling. The loan is secured by a mortgage lien over the property

17. The survey included only banking institutions and other financial institutions such as SACCOs were not part of this survey. The survey is available online at http://www.centralbank.go.ke/downloads/Surveys/Housing_Finance_Survey_Annex_sg_111010.pdf

Large/Medium/Small Banks—the CBK classifies banks based on assets size: *large* with assets above Ksh 15 billion; *medium* with assets valued at between Ksh 5—15 billion; and *small* with assets valued at less than Ksh 5 billion. Nineteen (19) financial institutions were classified as large, fourteen (14) institutions were medium and twelve (12) institutions were small. Please refer to the table below for bank size classifications.

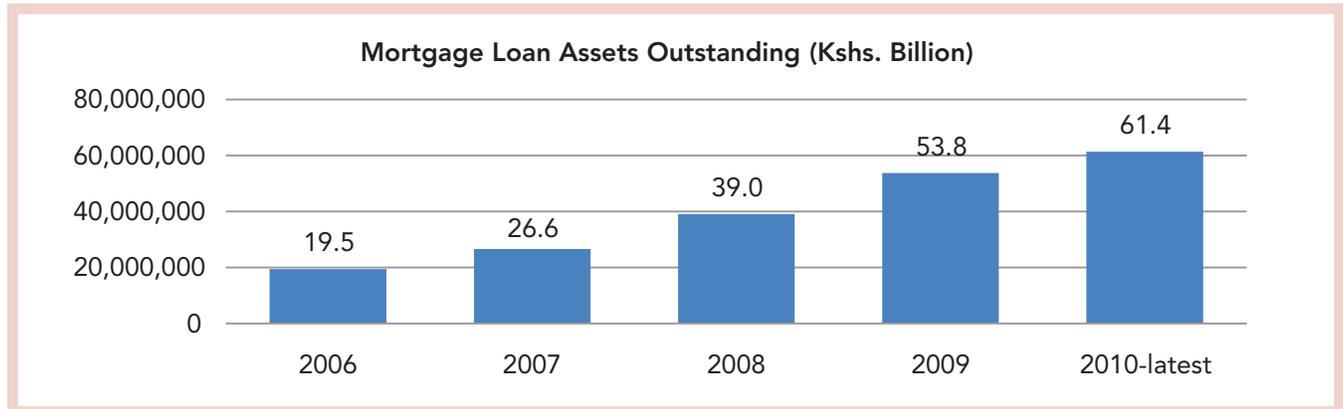
BANKING SECTOR MARKET SHARE REPORT AS AT DECEMBER 2009 - Ksh.M											Appendix IV
	TOTAL NET	MARKET SHARE	NET ADVANCES	MARKET SHARE	CUSTOMER DEPOSITS	MARKET SHARE	CAPITAL & RESERVES	MARKET SHARE	PRE-TAX PROFITS	MARKET SHARE	
INSTITUTION	ASSETS	%		%		%	RESERVES	%		%	
Large (Assets above Ksh 15 billion)											
1 Kenya Commercial Bank Ltd	172,384	12.74%	96,558	13.38%	137,968	13.71%	22,398	11.41%	6,426	13.13%	
2 Barclays Bank of Kenya Ltd	165,151	12.20%	93,543	12.96%	125,869	12.51%	24,210	12.34%	9,002	18.40%	
3 Standard Chartered Bank Ltd	123,909	9.15%	56,695	7.86%	86,774	8.63%	13,807	7.04%	6,726	13.75%	
4 Cooperative Bank of Kenya Ltd	110,531	8.17%	62,274	8.63%	91,553	9.10%	16,103	8.21%	3,727	7.62%	
5 CFCStanbic Bank Ltd	97,337	7.19%	44,978	6.23%	55,786	5.55%	8,143	4.15%	1,333	2.72%	
6 Equity Bank Ltd	96,512	7.13%	59,868	8.30%	65,825	6.54%	23,337	11.89%	5,570	11.38%	
7 Commercial Bank of Africa Ltd	57,593	4.26%	30,087	4.17%	44,273	4.40%	6,323	3.22%	1,768	3.61%	
8 National Bank of Kenya Ltd	51,404	3.80%	13,156	1.82%	41,995	4.17%	7,908	4.03%	2,159	4.41%	
9 Citibank N.A.	51,372	3.80%	21,402	2.97%	33,247	3.30%	11,077	5.64%	3,055	6.24%	
10 Diamond Trust Bank Ltd	47,147	3.48%	30,634	4.25%	36,274	3.61%	6,263	3.19%	1,634	3.34%	
11 NIC Bank Ltd	44,655	3.30%	31,133	4.31%	36,977	3.68%	6,434	3.28%	1,529	3.12%	
12 I&M Bank Ltd	44,009	3.25%	24,592	3.41%	34,799	3.46%	7,419	3.78%	1,752	3.58%	
13 Prime Bank Ltd	23,700	1.75%	10,615	1.47%	19,184	1.91%	3,065	1.56%	564	1.15%	
14 Bank of Baroda Ltd	21,940	1.62%	9,084	1.26%	18,634	1.85%	2,565	1.31%	726	1.48%	
15 Savings and Loan Ltd	19,281	1.42%	14,980	2.08%	6,243	0.62%	1,686	0.86%	1,016	2.08%	
16 Housing Finance Company of Kenya Ltd	18,281	1.35%	14,495	2.01%	12,235	1.22%	4,084	2.08%	354	0.72%	
17 Bank of Africa Ltd	16,920	1.25%	9,120	1.26%	12,405	1.23%	2,511	1.28%	260	0.53%	
18 Bank of India	15,395	1.14%	5,440	0.75%	13,005	1.29%	2,069	1.05%	609	1.24%	
19 Imperial Bank Ltd	15,358	1.13%	9,676	1.34%	12,270	1.22%	2,247	1.14%	802	1.64%	
	1,192,880	88.13%	638,331	88.5%	885,315	88.00%	171,649	87.46%	49,012	100.18%	
Medium (Assets above Ksh 5 billion and below Ksh 15 billion)											
20 Ecobank Ltd	13,949	1.03%	6,444	0.89%	10,819	1.08%	2,148	1.09%	-1,151	-2.35%	
21 FamilyBank Ltd	13,306	0.98%	7,676	1.06%	10,490	1.04%	1,853	0.94%	343	0.70%	
22 Chase Bank Ltd	12,970	0.96%	6,745	0.93%	10,117	1.01%	1,223	0.62%	318	0.65%	
23 Fina Bank Ltd	12,279	0.91%	5,937	0.82%	9,986	0.99%	1,198	0.61%	23	0.05%	
24 African Banking Corporation Ltd	8,841	0.65%	3,992	0.55%	7,208	0.72%	1,145	0.58%	257	0.53%	
25 Development Bank of Kenya Ltd	8,136	0.60%	4,769	0.66%	2,411	0.24%	1,363	0.69%	188	0.38%	
26 Gulf African Bank Ltd	7,749	0.57%	4,950	0.69%	6,425	0.64%	1,150	0.59%	-162	-0.33%	
27 Habib AG Zurich	7,339	0.54%	2,175	0.30%	5,839	0.58%	958	0.49%	286	0.58%	
28 K-Rep Bank Ltd	7,136	0.53%	4,817	0.67%	4,436	0.44%	1,107	0.56%	-289	-0.59%	
29 Giro Bank Ltd	6,914	0.51%	3,682	0.51%	5,943	0.59%	857	0.44%	185	0.38%	
30 Consolidated Bank of Kenya Ltd	6,899	0.51%	3,868	0.54%	4,882	0.49%	927	0.47%	117	0.24%	
31 Guardian Bank Ltd	6,778	0.50%	4,122	0.57%	5,760	0.57%	873	0.44%	61	0.12%	
32 Fidelity Commercial Bank Ltd	5,499	0.41%	3,293	0.46%	4,888	0.49%	490	0.25%	52	0.11%	
33 Victoria Commercial Bank Ltd	5,130	0.38%	3,174	0.44%	4,073	0.40%	935	0.48%	216	0.44%	
	122,925	9.08%	65,646	9.10%	93,277	9.27%	16,227	8.27%	444	0.91%	
Small (Assets below Ksh 5 billion)											
34 Habib Bank Ltd	4,659	0.34%	1,254	0.17%	3,525	0.35%	747	0.38%	197	0.40%	
35 Southern Credit Banking Corporation Ltd	4,491	0.33%	1,953	0.27%	4,308	0.43%	-5	0.00%	-730	-1.49%	
36 Equatorial Commercial Bank Ltd	4,466	0.33%	2,750	0.38%	3,522	0.35%	730	0.37%	77	0.16%	
37 First Community Bank Ltd	4,452	0.33%	2,290	0.32%	3,642	0.36%	663	0.34%	-152	-0.31%	
38 Credit Bank Ltd	3,665	0.27%	1,881	0.26%	2,793	0.28%	728	0.37%	83	0.17%	
39 Trans-National Bank	3,364	0.25%	1,689	0.23%	1,857	0.18%	1,325	0.68%	88	0.18%	
40 Middle East Bank Ltd	3,141	0.23%	1,619	0.22%	1,893	0.19%	904	0.46%	44	0.09%	
41 Paramount Universal Bank Ltd	3,100	0.23%	1,356	0.19%	2,547	0.25%	527	0.27%	42	0.09%	
42 Oriental Commercial Bank Ltd	3,052	0.23%	1,519	0.21%	2,012	0.20%	982	0.50%	33	0.07%	
43 Dubai Bank Ltd	1,596	0.12%	1,144	0.16%	986	0.10%	463	0.24%	9	0.02%	
44 UBA Kenya Bank Ltd	1,216	0.09%	0	0.00%	189	0.02%	996	0.51%	-213	-0.43%	
45 City Finance Bank Ltd	491	0.04%	184	0.03%	155	0.02%	315	0.16%	-7	-0.01%	
	37,694	2.78%	17,638	2.44%	27,429	2.73%	8,374	4.27%	-530	-1.08%	
Grand - Total	1,353,499	100.0%	721,615	100.0%	1,006,021	100.0%	196,250	100.0%	48,926	100.0%	

Source: Central Bank of Kenya: Banking Supervision Annual Report 2009

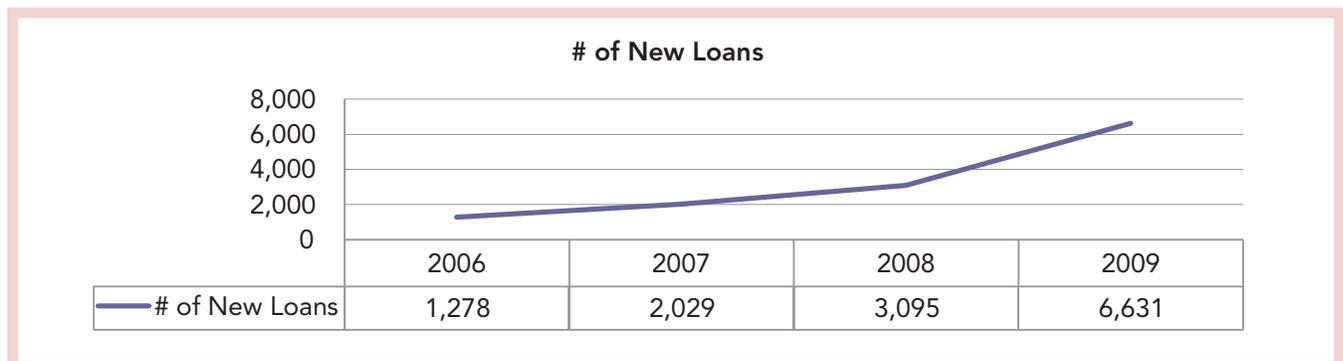
II. OVERALL MARKET CHARACTERISTICS

A. Growth

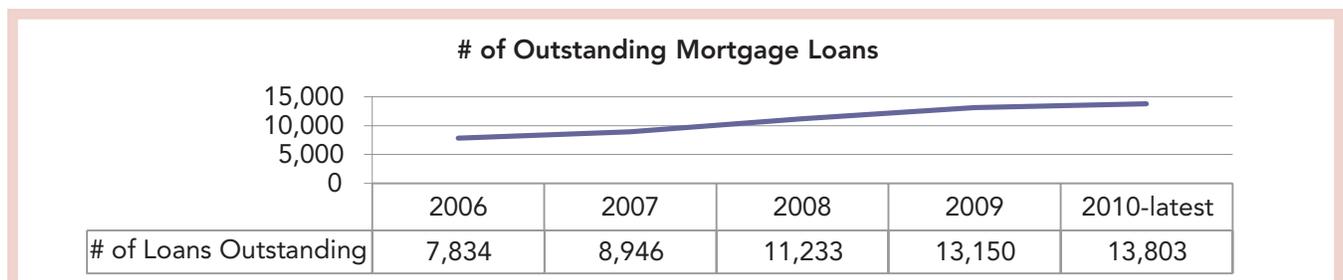
i. Kenya's mortgage market has more than tripled in the past five years. Kenya's mortgage market has grown from Ksh 19 billion in 2006 to just over Ksh 61 billion by mid-2010 (nominal growth). This translates to an annual average growth of 36 percent, indicating an exponential increase in mortgage loans.



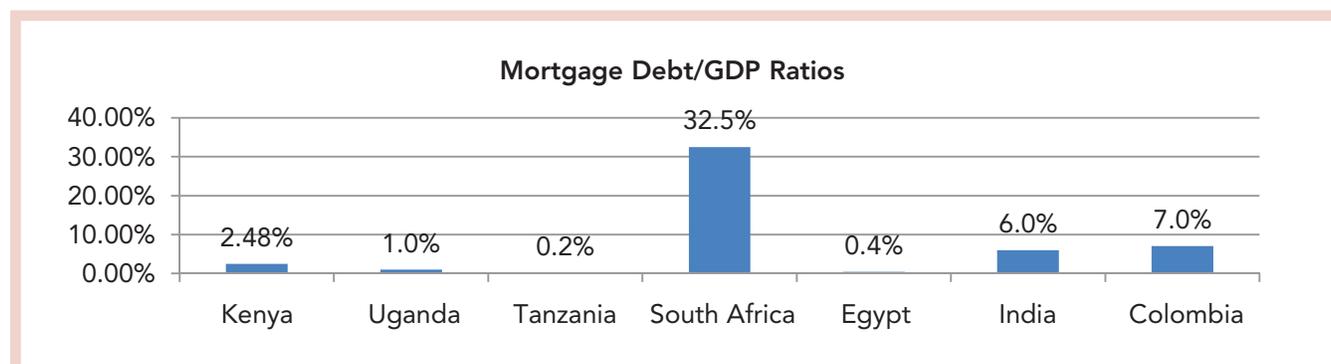
ii. The number of new loans has also been rapidly increasing. Since 2006, there has been a steady growth in new loans further validating the growing mortgage market. In 2006, new loans were approximately 1,278 whereas by 2009 the new loan portfolio has grown to over 6,000. By mid 2010, the number of new loans was 2,966 which is line with the steady growth seen in the previous years.



iii. But the mortgage market is still relatively small by international standards with only 13,803 loans. While the growth rate in mortgage loans has been rapid at just over 50 percent since 2006 and has been growing steadily at 14 percent annually, the loan portfolio remains small.

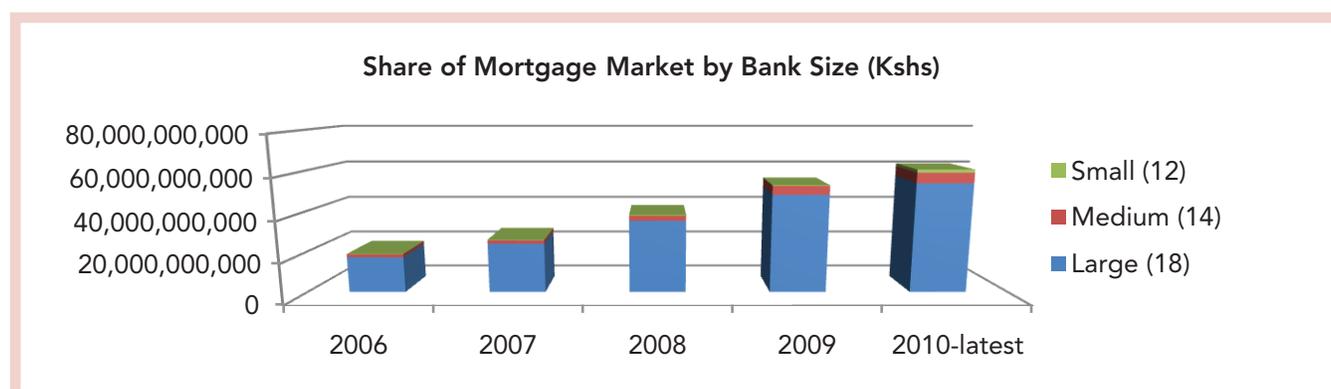


iv. In terms of mortgage debt to GDP ratios, Kenya is low by international standards but is on par with its neighboring peers. Kenya's mortgage debt compared to its GDP is better than its East African neighbors, Tanzania and Uganda at just under 2.5 percent but is not as developed as its developing country peers such as India (6 percent) and Colombia (7 percent). However, the mortgage debt to GDP ratio is around 50 percent in Europe and over 70 percent in US indicating there is significant room to grow.



B. Segmentation

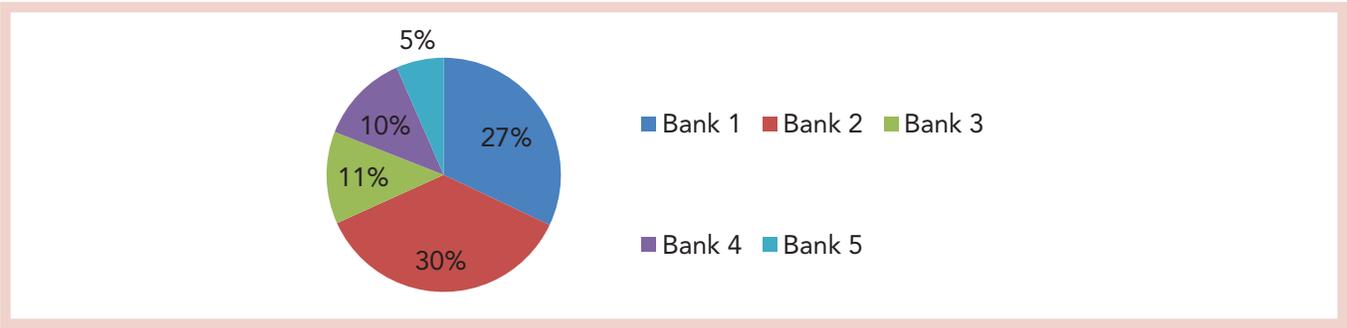
i. Kenya's mortgage market is dominated by the large banks, comprising over 90 percent of the outstanding loan assets portfolio. While Kenya's mortgage market is growing, the industry is dominated by the large banks indicating barriers to entry or high risk for medium and smaller banks. However, the growth rates indicate that the small sized banks have the fastest growth rate of 38% on average, followed by medium banks which are growing at 25% on average with large banks closely following at 24% on average



Mortgage Loan

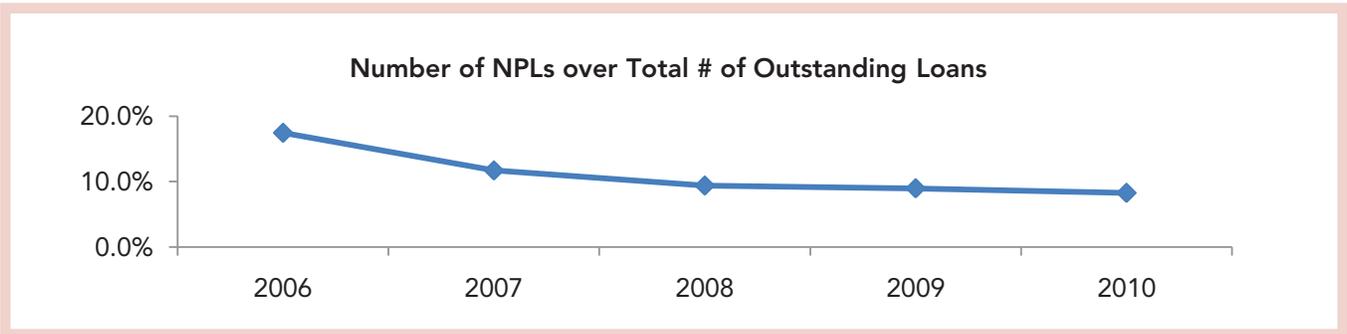
Assets (Ksh Billion)	2006	2007	2008	2009	2010-latest
Large (18)	17.7	24.6	36.1	49.1	54.7
Medium (14)	1.6	1.7	2.5	4.3	5.2
Small (12)	0.2	0.2	0.4	0.4	1.5
TOTAL (44)	19.5	26.5	39.0	53.8	61.4

ii. The market is further concentrated by having the top five lenders represent over 80 percent of the total mortgage portfolio. The top two banks hold over 50 percent of the mortgage market share and only 9 banks (6 large, 2 medium and 1 small bank) have a mortgage portfolio exceeding Ksh 1 billion.



C. PORTFOLIO QUALITY

i. The strength of the growing market is highlighted by the low non-performing loans portfolio which has not been increasing over time. Positively, the NPL portfolio has been relatively low indicating prudent mortgage evaluations by the commercial banks but could be masked by the increasing portfolio of outstanding loans. Compared to the number of outstanding loans, the number of NPLs has been decreasing and is close to half its 2006 portfolio.



Year	2006	2007	2008	2009	2010-latest
Number of NPLs	1,388	1,124	1,107	1,215	1,099

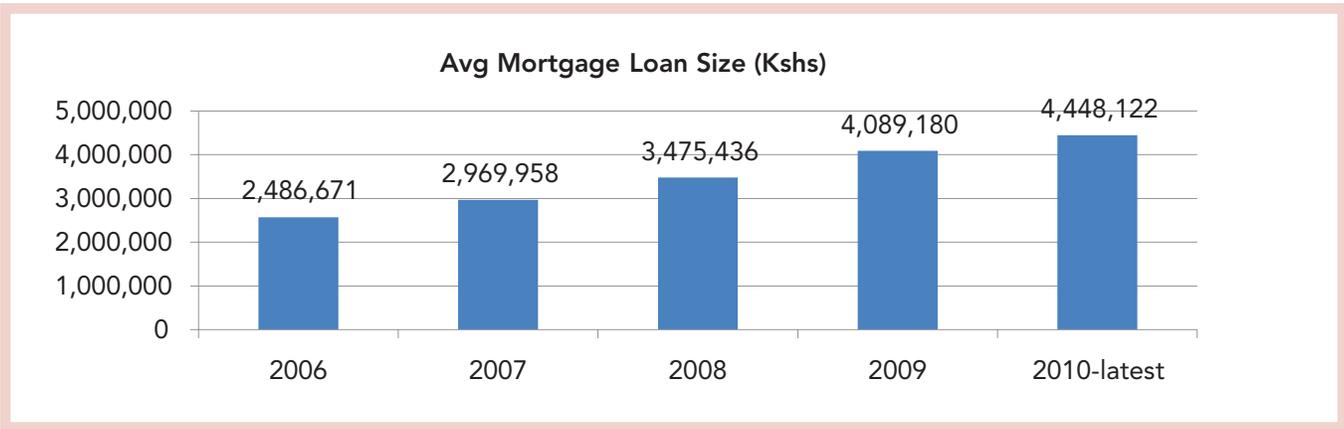
III. Mortgage Loan Characteristics

A. Average Loan Size

i. The average mortgage loan is approximately Ksh 4 million¹⁸ which reflects on the expensive housing market¹⁹ or a predominance of high-income mortgage borrowers in Kenya. Since 2006, the average mortgage loan size has been growing steadily but is still concentrated around the higher-end clientele of Kenya’s mortgage market, based primarily in the Nairobi region. This illustrates that the Kenyan mortgage market has yet to move downstream to the medium-to-low income mortgage market.

18. Average loan size numbers may include developer financing and employee mortgage loans which can skew the average residential mortgage loan size

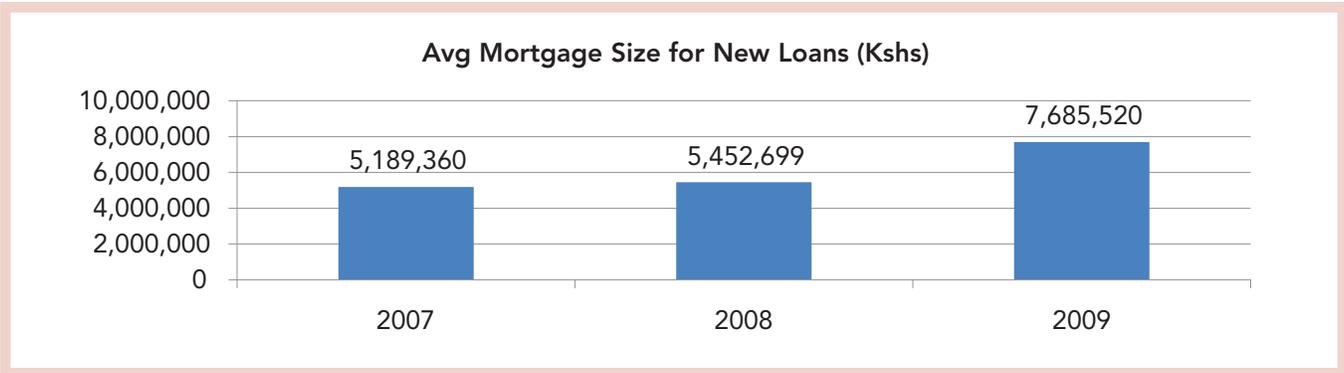
19. Ksh 4 million mortgage loan assumes residential house prices in the range of Ksh. 5-7M (identified as high-income houses by ad hoc interviews with developers), based on an average 70-80% loan to value financing



ii. Furthermore, the average loan size of approximately Ksh 4 million is consistent among large and small banks. While there are some outliers that can be attributed to developer financing and/or employee mortgage loan financing, the average loans sizes among large and small banks do not vary, indicating that all commercial banks are targeting the same higher end housing finance market. The medium banks have a relatively higher average loan size that can be attributed to outliers.

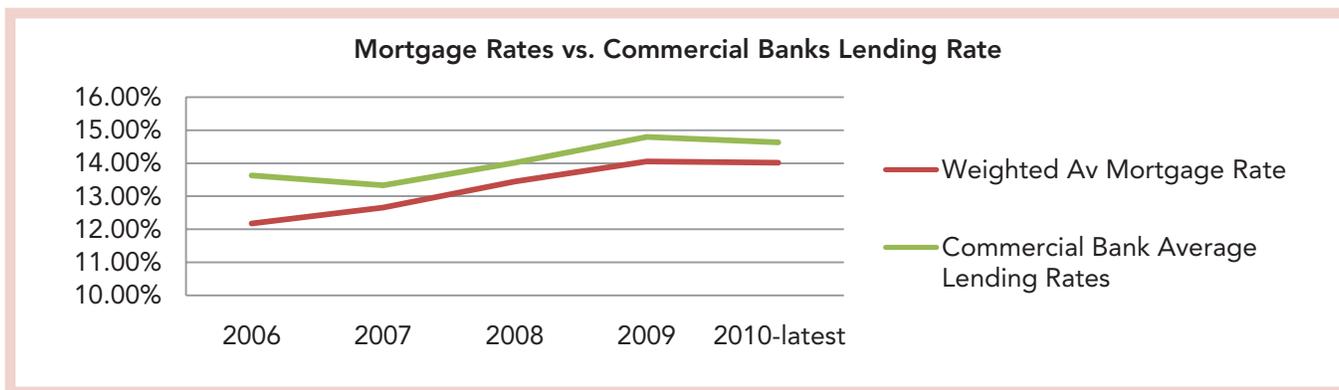
Avg. Loan Size	2006	2007	2008	2009	2010-latest
Large Banks	2,761,257	3,481,069	4,687,598	4,785,001	4,662,243
Medium Banks	3,656,155	4,135,900	4,508,117	5,830,687	5,391,285
Small Banks	1,897,583	2,382,204	2,688,523	2,467,694	4,049,658

iii. The average mortgage loan size has also been steadily increasing. On average, the new mortgage loan size is approximately Kshs. 6 million over the past few years indicating that the housing finance market is yet to move downstream. This may be explained by the undeveloped medium-to-low income housing market or the latent demand in the high-income housing market that is yet to be met.



B. Interest Rates

i. The weighted average mortgage interest rate reported by the institutions is 14.07 percent in 2010 which compares favorably to the average lending rate of 14.64 percent in Kenya. The mortgage rates are consistent with commercial bank lending rates given the higher risk premiums associated with mortgages. In 2010, the highest interest rate reported was 18.5 percent and the lowest interest rate was 6.5 percent.



	2006	2007	2008	2009	2010
Weighted Avg. Mortgage Rate	12.45%	12.83%	13.54%	14.11%	14.07%
Commercial Banks Avg. Lending Rate	13.63%	13.33%	14.02%	14.80%	14.64%

	2006	2007	2008	2009	2010
Large Banks	11.40%	11.84%	12.56%	12.90%	12.59%
Medium Banks	14.32%	14.19%	14.73%	14.53%	14.12%
Small Banks	15.50%	12.37%	12.59%	12.65%	13.75%

ii. Most banks reported that variable rates were the most favorable interest rate type. There is a consistent preference for variable rates across all segments of banks (73 percent of all banks surveyed), followed by fixed and variable rates (18 percent of all banks) and a marginal preference for fixed rates only (9 percent of all banks).

Bank Segment	Fixed Rates Only	Variable Rates Only	Fixed & Variable Rates
% of Large Banks reporting	8%	75%	17%
% of Medium Banks reporting	20%	80%	N/A
% of Small Banks reporting	N/A	60%	40%
Average	9%	73%	18%

C. Other Loan Characteristics

i. Loan to Maturity: The large banks provide longer Loan to Maturity periods ranging from a minimum of 5 years and a maximum of 25 years with medium and small banks typically offering Loan to Maturity periods of between 5–15 years.²⁰

*ii. Loan to Value*²¹: On average, the loan to value is approximately 82 percent of the property value, with larger institutions offering much higher loan to value ratios (85 percent) than medium (77 percent) and smaller banks (79 percent).

20. Early repayment is reported to be the norm at most banks

21. Please note that some banks may have reported developer/construction financing loan to value ratios

<i>Bank Segment</i>	<i>Average Loan to Value</i>	<i>Minimum Loan to Value</i>	<i>Maximum Loan to Value</i>
Large Banks	85%	60%	100%
Medium Banks	77%	60%	90%
Small Banks	79%	65%	90%
Average	82%		

iii. Payment to Income: The average of the maximum allowable debt service ratio is approximately 51 percent, with no discernible difference between bank segments.

<i>Bank Segment</i>	<i>Average Payment to Income Ratio</i>	<i>Minimum Payment to Income Ratio</i>	<i>Maximum Payment to Income Ratio</i>
Large Banks	54%	35%	70%
Medium Banks	50%	15%	67%
Small Banks	45%	33%	50%
Average	51%		

iv. Acceptable Collateral: Most banks required both personal guarantees and mortgage lien, with only 25 percent of banks reporting that personal guarantees were not required. Several banks also noted that the first legal charge and personal guarantees were sufficient for collateral purposes.

v. Repayment Schedule: 86 percent of banks surveyed reported that fixed payments were the preferred mode of repayment schedules for the duration of the loan, with only a few banks providing for fixed and/or decreasing payment schedules.

vi. Purpose of Mortgage Loans: A majority of banks indicated that they offer mortgage financing for house purchase, construction and refinancing purposes. More than 80 percent of banks provide financing for home purchase in addition to a wider range of financing possibilities.

vii. Payable Fees²²: The most common fees payable reported are:

- Legal Fees
- Valuation
- Arrangement fees (1 percent)
- Stamp Duty
- Mortgage protection policy premium

22. Payable fees are estimated at approximately 10 percent of the mortgage cost

IV. Mortgage Market Constraints

i. Long term access to funds was listed as the most important constraint to the mortgage market in Kenya. Based on a ranking of mortgage market constraints, banks identified access to long-term funds as the most important impediment to the growth of their mortgage portfolio. Overlapping constraints of low level of incomes/informality and credit risk were listed as second and third respectively with high interest rates also being regarded as a major constraint.

<i>Mortgage Market Obstacles</i>	<i>Frequency of Response</i>
Access to Long Term Funds	21
Low level of incomes/informality	15
Credit Risk (lack of credit histories, documented income, etc.)	11
High interest Rates	10
Difficulties with property registration/titling	7
Cost and time of foreclosing on a property	6
Burden of regulation (provisioning, capital requirements, liquidity rules, etc.)	4
Lack of housing supply—new construction	4
Lack of capacity/skills in banking sector to develop products, carry out loan underwriting	3
Lack of understanding of mortgage product by consumer—lack of financial literacy	2
AIDS/HIV as an inhibitor of long term lending	1

ii. Other Comments regarding constraints

"Inadequate housing supply especially in major towns such as Nairobi, Mombasa and Kisumu continues to be a challenge"

"Complicated legislation for land titling and registration"

"Apathy by lenders to finance property outside urban areas"

Cost of housing remains one of the most binding constraints to the growth of the mortgage market"

"Lack of property price indices and a lack of information on the property market hinder mortgage evaluations"

High incidental costs of borrowing, e.g. stamp duty fees, advocate fees, valuation charges, insurance premiums, etc"

Bank Name	Bank Segment	2006		2007		2008		2009		2010	
		Mortgage Loan Assets	# of Loans	Mortgage Loan Assets	# of Loans	Mortgage Loan Assets	# of Loans	Mortgage Loan Assets	# of Loans	Mortgage Loan Assets	# of Loans
KCB	Large	4,077,361,000	2,077	6,264,323,000	2,518	9,703,074,000	3,170	15,639,607,000	4,176	17,974,354,000	4051
HFCB	Large	8,330,000,000	3,478	8,960,000,000	3,441	11,300,000,000	3,805	15,100,000,000	3,869	16,900,000,000	3988
CFC Stanbic	Large	652,415,000	149	2,725,152,000	421	5,349,932,000	743	6,137,238,000	869	6,497,427,000	939
Standard Chartered	Large	2,909,875,000	941	3,646,074,000	1,019	4,424,805,000	1,118	4,897,843,000	1,122	4,960,423,000	1107
Barclays Bank	Large	968,525,109	254	1,701,917,328	449	2,363,937,424	618	2,913,833,384	726	3,055,270,533	742
Commercial Bank of Africa	Large	361,584,000	49	446,911,000	77	911,488,000	150	1,113,257,000	220	1,158,811,000	238
I&M Bank	Large	246,496,540	78	323,373,160	70	502,938,415	121	686,304,912	132	732,413,468	135
Equity Bank	Large	N/A	N/A	29,560,000	4	299,272,183	70	537,699,122	129	673,267,179	151
National Bank of Kenya	Large	N/A	N/A	N/A	N/A	272,877,637	14	452,703,776	36	568,277,703	57
Diamond Trust Bank	Large	N/A	N/A	130,415,000	33	225,684,000	49	350,084,000	69	562,312,000	90
NIC Bank	Large	N/A	N/A	122,897,000	28	379,780,000	52	477,341,000	96	517,096,000	112
Bank of India	Large	27,591,000	65	42,890,000	79	109,026,000	93	355,130,000	116	310,215,000	125
Cooperative Bank of Kenya	Large	N/A	N/A	N/A	N/A	N/A	N/A	55,515,840	5	246,317,981	27
Prime Bank	Large	29,462,291	183	44,366,412	265	42,931,681	532	98,400,674	612	227,551,195	651
Imperial Bank	Large	23,044,514	7	51,242,541	15	133,516,944	37	121,388,447	36	128,598,809	37
Bank of Africa	Large	62,065,750	27	53,364,165	24	54,960,180	24	74,883,451	25	106,538,418	31
Bank of Baroda	Large	52,068,000	67	42,007,000	54	45,263,000	49	45,263,000	88	51,341,000	84
Citibank N.A.	Large	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Development Bank	Medium	N/A	N/A	N/A	N/A	683,812,000	60	1,709,598,985	185	1,711,007,860	322
Consolidated Bank of Kenya	Medium	N/A	N/A	N/A	N/A	N/A	N/A	207,620,973	18	794,515,803	120
Family Bank	Medium	21,954,411	7	89,357,219	22	164,006,996	49	694,779,916	124	663,260,138	154
Victoria Commercial Bank	Medium	20,260,875	5	25,888,410	8	17,340,280	7	86,332,458	11	61,080,865	7
Chase Bank	Medium	283,187,000	47	380,876,000	75	421,952,000	109	483,110,000	126	528,743,000	151
Fidelity Commercial Bank	Medium	N/A	N/A	10,978,031	3	25,772,217	6	69,800,147	12	113,867,259	19
African Banking Corp	Medium	22,331,000	10	31,357,000	11	36,228,000	12	33,243,000	13	58,238,000	15
Giro Bank	Medium	19,712,000	8	51,414,000	13	52,306,000	18	48,539,892	14	43,171,609	11
EcoBank	Medium	1,215,869,000	302	1,143,673,000	218	1,135,173,000	206	969,013,000	183	1,203,569,000	146
Guardian Bank	Medium	N/A	N/A	10,000,000	2	7,500,000	2	6,219,000	2	3,400,000	1
Fina Bank	Medium	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Gulf African Bank	Medium	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Habib AG Zurich	Medium	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
K-Rep Bank	Medium	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
First Community Bank	Small	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1,162,295,656	157
Paramount Bank	Small	108,427,589	51	122,616,638	59	179,146,023	63	160,014,052	72	193,781,768	78
Trans-National Bank	Small	17,208,832	5	79,857,962	13	134,487,062	24	190,002,203	34	69,066,731	21
Credit Bank	Small	N/A	N/A	2,707,328	2	10,782,401	5	12,748,830	7	45,897,330	9
Middle East Bank	Small	4,166,000	3	5,133,000	4	12,864,000	8	17,734,000	7	34,528,000	9
Habib Bank	Small	25,091,000	18	29,401,000	16	34,704,000	16	25,147,000	13	23,295,000	13
Oriental Commercial Bank	Small	1,885,773	3	1,495,876	3	2,009,755	3	2,316,323	3	12,282,205	4
Equatorial Bank	Small	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
UBA Kenya	Small	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Dubai Bank	Small	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
City Finance Bank	Small	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Southern Credit Banking Corp	Small	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
TOTAL		19,480,581,683	7,834	26,569,248,069	8,946	39,039,570,198	11,233	53,772,712,385	13,150	61,397,423,508	13,803

*Please note that developer financing loans may have been included in the survey data