The housing finance system in Kenya

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During the late 1970s and early 1980s the Kenyan economy changed from relatively high growth to stagnation. The economy was also characterised by a sharp increase in the level and volatility of inflation. As a result of this change in the economic environment, government control of economic activity increased significantly with effect from 1980. Government borrowing rose, increasing pressure on commercial banks, reducing the supply of funds available for private investment, and diverting a stagnating supply of financial assets to more speculative ventures. These ventures in turn have threatened the viability of a number of financial institutions.

Kenya’s financial conditions have important implications for the housing sector. The current financial system has led to less resources being directed to housing than would occur in a freely-operated system. A review of recent trends in fixed capital formation in dwellings as it relates to Gross Domestic Product and fixed capital formation generally, suggests a steady secular decline in housing’s share of GDP and gross fixed capital formation despite basic economic trends that suggest this share should be increasing. While previous empirical research suggests that effective housing demand should be in the order of 4.3 to 4.7% of GDP, this is 30 to 40% lower than what has been achieved in recent years.

While the social issues posed by the shortfall in housing production are important, an even more important question is the development of a financial system that can equitably and efficiently mobilise domestic resources. Development of a workable housing finance system can play a more important role in the construction of the finance system than it does in the fulfilment of housing needs. Improving the efficiency with which people finance housing can have the following effects:

- It is one of the most direct means to increasing the share of savings in financial assets.
- It can help to eliminate the regressive effects of the present financial system. Many long-term savers subsidise government borrowing through the below market interest payments they receive. Financing housing at market rates can provide these savers with a safe positive return.

Very recently, the Government recognised the need to alter its financial system and is now moving toward the establishment of a system that can mediate between borrowers and savers so that resources and risks are more efficiently allocated. The Government is beginning to rely less on commercial banks to support its borrowing, and further, is proposing tax reform measures and debt market and equity market reform which will help to equalise the allocation of business risk throughout the economy.

This effort, which is just beginning, will lead to real positive rates, greater fiduciary responsibility, and less government presence in credit markets. The recommendations of the study were geared to help the Government achieve these goals.

Governmental framework for housing

In Kenya, housing is financed and supplied through a variety of channels that include a number of government organisations. The Ministry of Works, Housing and Physical Planning is in charge of administering government policy with regard to housing. The National Housing Corporation and local government authorities are involved in actual housing development — primarily building subsidised units geared to low and moderate income families.

From the financial sector, funds for housing are supplied directly by non-
bank financial institutions (which accept deposits from the public that are repayable on demand), the building societies, and insurance companies. The Central Bank of Kenya (CBK) is the Government's regulatory body for banking and other deposit-taking financial institutions. This includes commercial banks and the so-called non-bank financial institutions.

The regulation of building societies falls primarily to the Registrar of Building Societies which is under the aegis of the Attorney General's office. Importantly, a new system of deposit insurance is in the initial implementation stages.

Specialised housing finance institutions

Although a variety of institutions finance housing in Kenya, the "specialised housing finance institutions," which include limited liability companies and building societies, receive special attention in this study.

These institutions raise resources primarily through deposits or through the issuance of housing bonds. What they lack is competitive access to long-term funds to support lending for long-term mortgages. With one exception, institutions get their money for three years or less. The short-term nature of these resources has severely affected lending activities. First, there is a tendency on the part of intermediaries to keep a large percentage of funds in short-term liquid investments. Second, they are more frequently lending or investing in activities other than long-term residential mortgages which they feel are more profitable but which either are much riskier or at subsidised rates to the Government.

The most common of these is development which some building societies see as a main vehicle for profit. As a result of these relative returns and the ability of lenders to essentially impose losses on the deposit insurer while keeping gains, relatively safe assets such as mort-

Financing. Some older institutions are in a relatively liquid state because potential borrowers cannot afford units that are currently on the market. For newer institutions, loan demand appears to exceed the funds available when taking into account what institutions think they must maintain by way of liquidity.

Affordability. Demand for housing is constrained by prices of houses now being developed and by the types of houses middle income people would like relative to their incomes. Part of the problem is that developers feel they will make larger profits by building expensive housing.

Non-mortgage activities. Housing finance institutions are increasingly turning to the development of housing projects as the way to profits. Some of these ventures present risks to the institutions and ultimately to the deposit insurance fund when it is established.

Management and operations. Given the growth of housing finance institutions in recent years, there is an inadequate supply of trained personnel and experienced management to staff them.

Public trust. There is indecision and confusion among potential borrowers and depositors as a result of rapid growth of this industry and because
of the collapse of several of the finance institutions.

Regulation and supervision. Underlying all of the problems noted above is the lack of a strong regulatory and supervisory framework to govern a rapidly expanding area of the financial sector. The Registrar of Building Societies is inadequately staffed to supervise the current number of institutions.

Benefits of a secondary finance market

A secondary financial market could have important benefits for the operation of specialised housing finance institutions. A secondary market is a market on which financial assets can either be sold from one investor to another or in which the nature of the financial asset is changed. For example, a mortgage purchase financed with a debenture effectively makes the mortgage like a corporate security which appeals to different investors.

If such markets are operative, the liquidity costs of holding various financial assets declines. As a result, lenders, particularly those that are deposit-based, need to hold less of their portfolio in liquid assets to meet unanticipated demands or changes in credit flows. The market also allows funds to move geographically to those areas of the country that most need them.

What are the advantages to creating a secondary mortgage market-type facility in Kenya? First, because of the high demand for housing and its clear positive return the market would increase the return to savers with the objective of increasing the share of savings in financial assets. In Kenya’s economy, appropriately structured mortgage contracts (that adjust for the high core rate of inflation) can be safe investments that are relatively uncorrelated with business risk, and afford a positive return on savings. To the extent that building societies and other finance institutions can rely upon such safe assets with which to pay higher returns to savers, the outreach of the formal financial sector will increase.

The principal achievement of a secondary market is increased asset liquidity and marketability. If long-term investors provide investment in mortgage lending institutions of comparable duration as the loans financed, many of the uncertainties that create the demand for liquidity would be eliminated. Alternatively, if refinancing facility were available at market rates, liquidity needs could also be more easily satisfied.

These instruments could be an important means by which the formal financial sector could attract household savings. Therefore, the market may be able to increase overall savings and can almost certainly help to increase the supply of savings in financial assets.

Study recommendations

The study team offered six recommendations for improving the housing finance system in Kenya. These include:

1. The Government should create a strengthened regulatory and supervisory framework for specialised housing finance institutions (including limited liability companies and building societies) to deal with the rapid increase in the number of companies and to regulate lending which is sometimes speculative.

2. A liquidity facility for specialised housing finance institutions should be developed if these institutions are to succeed in long-term lending. At present, resources are raised through deposit on short-term housing bonds, and since there is no secondary housing market, housing finance institutions always face a potential liquidity crisis.

3. A trade association for housing finance institutions should be created to exchange information, promote member training, and promote research and advertising.

4. Government and the private sector should take the initial steps to develop secondary financing facilities for housing. An initial step should be the placement of long-term deposits at market rates by government institutions in approved housing finance institutions. This could provide a measure of long-term stability and indicate government confidence in these institutions. It would also reduce the implicit taxation of the savings of investors in the National Social Security Fund. A second step, utilizing the trade association contacts suggested above, would be the sale or trading of mortgages to or among institutions looking for long-term investments and those wishing to generate more resources. That is, through informal contacts, a housing finance institution could arrange to sell a small block of mortgages to an insurance company with the understanding that if any mortgage defaulted the originating institution would buy it back. This kind of activity to help to develop trust and publicise the market.

5. Finally, there is a need for the Government to identify and clarify the relationship between public and private housing finance. While this study focused primarily on the financial institutions that provide housing finance, the National Housing Corporation and local authorities also carry out lending operations in connection with their programmes, usually at some level of subsidy. The appropriate role for government programmes and institutions needs to be examined.

Since the report was completed, some of the recommendations have been implemented, including the establishment of the Kenyan Association of Building Societies.