Raising Capital for Housing Finance in Africa

By Niels Jørgenson

INTRODUCTION

With an urban population growth of over 10 million per year and more than half of that population living in substandard housing, it is not necessary to make the case for more and better housing in Africa. That case has been made often enough. In fact, the immensity of the problem tends to paralyze rather than challenge those in positions to do something about it. In contrast to the current tragedy of food shortages, the need for shelter is long term. It therefore requires finance to turn unquestionable "need" into effective "demand".

This paper investigates the supply of housing finance by analysing the nature of demand for it. Only by understanding the true nature of its market can housing finance business expand its capital base on a sustainable basis and make an impact on the enormous housing problem. Indeed, indications are that it is the failure of financial institutions to cater to those most in need of housing that has exacerbated the problem. That "poor people are not worth the risk" is not only a misconception of the potential they represent, it is simply not true. Instead of repeating the many legitimate calls on government and others to do something for housing finance, we will focus on what the industry can do for itself to raise more capital.

Raising capital for housing finance in Africa is basically a question of tapping the biggest section of the market, namely the low income families in urban areas. How it is done, and by whom, are covered under the following headings:

1. Characteristics of the housing market in Africa.
2. Performance of housing finance institutions.
3. Viability of housing investments.
4. Creating an enabling environment.
5. Innovations in housing finance mobilisation.

1. CHARACTERISTICS OF THE HOUSING MARKET IN AFRICA

As in most developing parts of the world housing markets in Africa are characterized by a few mansions for the rich, multitudes of shacks for the poor and very little in between. Since there is practically no housing market in the rural areas, we shall deal exclusively with urban areas. The rate of urbanization is estimated to be between two and three times the rate of growth of the population as a whole, or 6% - 9%. Some major cities in Africa report growth rates of over 10%. The consequences are apparent everywhere.

This huge urbanisation rate is often regretted or, worse, ignored, because it presents planners with the daunting task of accommodating millions of new arrivals in housing which must meet standards far higher than those they left behind in the rural areas. That this problem is not being adequately addressed is illustrated by the mushrooming of squatter settlements around every city. This is our starting point.

Let's first look at the bright side of this apparently overwhelming problem. Economic history shows that there is much to be gained from large conurbations via a dramatic increase in money circulation and thereby in the generation of income. The division of labour, which results from high densities of population, increases the availability - and lowers the price - of many skills, including those needed for the construction of houses. Moreover, when demand for housing increases it gives rise to numerous locally-based enterprises in both formal and informal sectors which boosts employment. But most importantly from our point of view, it creates a housing market in which dwellings act not only as shelter but as income generating assets capable of attracting investment capital.

This scenario has been repeated throughout history, and there is no reason it should not

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be relevant to Africa. That it has been slow in coming about is one aspect that will be looked at in some detail here with a view to recommending some practical steps to be taken by leaders in the housing finance industry. The adherence to an old adage of "letting the private sector cater to the rich, and the public sector to the poor" is one of the main reasons for the present situation.

It is not the purpose of this paper to describe the physical dimensions of the housing market and all its shortcomings vis-a-vis the far too high official building standards required. Instead, it makes much more sense to gain an understanding of what constitutes effective demand for housing. If the market does not reflect all the different values people attach to housing, then something is amiss and prices will be distorted. These values include not only "shelter" *per se* but other related attributes such as location, appearance, infrastructural services and, not least, availability and terms of finance.

One aspect of demand for housing is often overlooked: It is income *inelastic,* i.e. as family income rises, expenditure on housing does not increase proportionally. This is particularly true for the lowest income strata where demand for food and clothing are reduced below normally acceptable levels in order to secure a roof over one's head. This inelasticity appears to prevail also at higher income levels, though to a lesser degree as most other demands are met. To ignore this fact in determining so called "affordability" by using a flat rate, say 25%, is therefore to do injustice to the poor who already spend more than that on housing. As an average rate, it may be fairly accurate, but that does not help the applicant for a housing loan, who is prepared to spend 35% or 40%. We shall return to the subject of "affordability" in a later section.

Another relevant characteristic of the African housing market is that the demand for rental accommodation is quite high. About 35% of urban dwellings are single-room, rented units. The total proportion of rented, as opposed to owner occupied units, is over 50%, albeit with some variation from country to country and from smaller towns to larger ones. However much we would like to promote owner occupation for good reasons, the rental market must not be looked upon as undesirable. There is a definite demand for rental space even in highly developed countries where, in theory, every family can afford its own house.

Basic services and a sustainable environment are part of the housing market. The implication for housing finance is that if the technical and social infrastructure is not available, because long term finance is not forthcoming, investments in structures are hardly viable. Private financial institutions tend to regard this area as a public responsibility. So do many local governments, but they just don't have the resources to cope. How they might generate such resources will be highlighted in Section 4. Meanwhile, private developers solve the problem by including the cost of both on-site and off-site infrastructure in their projects, and in the price of houses, thus reducing their potential market. To add insult to injury, the new owners will in addition pay twice for metered services.

Some 25 years ago the World Bank launched its "site-and-service" schemes in Senegal in order to help alleviate the problem outlined above. It has since then modified this concept considerably, because it was discovered that urbanites do not behave like their rural counterparts. In towns, people have neither the time (they are busy working or looking for work) nor the skills (building standards are too high) to build the houses themselves. So the typical town dweller would prefer to have the house provided along with the services and would be willing to pay for it, provided it can be financed long-term.

Several other aspects of the housing market have a bearing on the kind and magnitude of housing finance required. Suffice it to say that the better the supplier of finance understands and meets the demand for its services, the more the market will pay. With a higher price on housing finance, more capital will be forthcoming.

2. PERFORMANCE OF HOUSING FINANCE INSTITUTIONS

In Africa, public sector institutions finance as many houses as do institutions in the private sector. There are exceptions to this rule e.g. South Africa and Kenya, but their principle business is the same. However, with different profit objectives and drawing on public sources of capital, they often have different lending criteria. Much could be said about publicly owned institutions, but for obvious reasons, private sector institutions concern us more here. Still, public sector institutions and especially those owned jointly by private and public shareholders may benefit from reading on.

The main actors in the private sector are the Building Societies, Commercial Banks, Insurance Companies and various forms of Cooperatives. The distinction between formal and informal is largely superfluous in this context, so is volume of lending by each type of institution. What is of paramount importance, however, are the mechanisms by which these institutions mobilize and allocate their funds. It is here the bottlenecks in the system may be found. A case will be made for making the demand side of the market more important than narrowly focusing on mobilisation of capital, as the title of this paper may suggest.

A number of myths continue to plague the housing finance industry. Some of them are explained by the fact that Housing Finance Institutions (HFIs) operate in a seller's market, others are simply old, inherited procedures which die hard. In effect, such myths distort the market and subvert the notion of "user value" - in this case the extent to which housing finance terms satisfy borrowers' requirements. The product or service with the highest user value commands the highest price. In other words: borrowers will pay most for finance given on terms that best suit their ability to repay.

Less than that lowers effective demand at a given price. Conversely, it raises the price at a given supply, thus creating the best conditions for increasing supply. Moreover, it is only by pricing goods and services realistically that resource allocation can be optimal and economic growth maximised.

The more important of the misconceived approaches to housing finance in today's market will now be examined:

Affordability

The large HFIs still use the old "rule of thumb" of assessing a borrower's ability to afford a loan as either:

(a) cost of house not to exceed 3 times annual income, or

(b) monthly payments not to exceed 30% of present income.

Since interest rates in many countries have gone up dramatically (a) hardly applies, because monthly payments would be unaffordable. As mentioned earlier, a fixed rate is not realistic, because poor people spend relatively more on housing than the rich. Also, using "present" income makes no sense when payments are to be made from future income.

Fixed Annuities

Most HFIs employ this approach to repayment of loans. It has no relevance to the terms of their funding and is incompatible with the income profile of borrowers over time, particularly those with low and moderate income. It can undermine a family's ability to take a loan they could afford if they were given a different repayment schedule. HFIs acknowledge that most defaults occur during the first three years, but do not use flexible repayment schedules to alleviate this problem, although repayment tables for this are now available. The two main objections to graduated repayment systems: That they reduce the borrower's equity and create negative cashflows for the lender during the early years of the loan, can be allayed by referring to capital appreciation (if not a higher deposit) and that once the system has run for a few years, cashflows are similar to those of fixed annuities.

Maximum Age of Borrower

Even if applicants for loans have cleared the first two hurdles, (because they have saved for many years and/or finally have a well paying job) they may lose out on the grounds of age. Persons over 45 need not apply! The reason is that HFIs will not take the risk of the borrower dying before the loan matures. The argument that the house, not the person, represents security is not accepted, but in some cases an insurance is offered to get around this bind (making the loan more expensive). When was there ever a wife, a son or a daughter, or any other person, who would not take over the house from the deceased and continue the payments ? The paternalistic attitude of wanting to protect the borrower's family is misplaced and may prevent them from getting a house in the first place.

Fixed Interest Rates

Surveys have shown that borrowers prefer to have a fixed rate of interest in order to avoid surprises. The fact that variable interest rates are still the rule rather than the exception is due to HFIs's funds being subject to the same condition. But this situation can and should change. The mechanism is, of course, securitisation. This concept has been around for more than a hundred years and does not require a sophisticated capital market, simply a secondary one.

Other Restrictions

In addition to the above constraints there are a number of real bottlenecks. One is that most HFIs are not allowed to lend for housing which (a) does not meet official standards or (b) does not have a clear title. This rules out many potential borrowers in both rural and urban areas. Another complaint from HFIs is that their ultimate weapon against defaulters - to repossess the property- is often blunted by a court injunction, or by a "bond boycott" by a whole community.

Market Imperfections

One imperfection stands out among all others: Controlled interest rates. We shall limit ourselves to this one, because it is the "price of money" which brings demand for and supply of funds into equilibrium. Where it exists, rent control is largely ineffective.

When looking at the wide variety of interest rates that make up the "interest level" of a country, those for housing finance are typically not among the highest. This is particularly true in public sector institutions. But why should this be so also for HFIs in the private sector ? The question is even more pertinent when it is apparent from the Annual Reports of many of them that significant amounts of money have been placed with other financial institutions. Some of it may be working capital or required liquidity placed on call with commercial banks. But when return on funds invested with other financial institutions is as high or higher than on normal mortgage loans, there is reason to wonder whether housing loans are priced high enough. The standard answer given by HFIs is that people cannot afford to pay more for housing finance. This is hardly an acceptable reason, when the same people are quite often willing to pay a much higher price for financing of cars, for instance. But the real proof of what people are prepared to pay for housing finance lies in the return they make on housing investments.

By keeping interest rates below their optimal level, whether by decree or by choice, a "sellers market" is created which can be exploited by (a) negotiating up-front fees, (b) retaining rigid but administratively convenient affordability criteria, and (c) reducing work load and risk while still earning the same income. As a result:

- accessability is more of a problem than affordability
- there is no incentive to innovate on the lending side of business
- administrative costs (measured by interest margins) are twice as high as in countries with much higher staff costs, and
- resources are directed away from housing towards consumption goods

The implications of this situation for the economy in general and for housing in particular are devastating.

3. VIABILITY OF HOUSING INVESTMENTS

In the previous section we argued for market rates of interest on housing loans. Many would object to that for different reasons. The crux of the argument, however, is that if return on housing investments in nominal terms are higher than market rates, there is no reason to subsidise interest on mortgage loans. What the rate of return on housing is in a particular country is determined by such factors as: opportunity cost of renting equivalent space, income generated from the property, investment risk and the rate of inflation. Below is an example of how the rate of return on a typical housing investment should be calculated.

The enormous shortage of housing in Africa's large cities have forced up rents to a point where the return on habitable space makes it an attractive investment. But viability is not only a question of *profitability* for just as important for a poor family is *liquidity.* By definition a poor family cannot afford to cover shortfalls in cash-flows of even the most profitable investment. So, if monthly repayments exceed rent propensity and revenue generated from the house, the investment is not viable. Taken together, these two aspects of viability will determine the potential borrower's "willingness to pay" - a much more useful concept than "affordability".

An example:

A house with four habitable rooms can be built by a small contractor for $7000 inclusive of a serviced site. Initially, the owner could occupy one room and let the other three for $30 each per month, thus generating $90 monthly. At 19% over 20 years the monthly repayment of a loan of $7000 is $113. This leaves the owner with a shortfall of $23 plus $7 for maintenance and services i.e.$30 which represents "own rent". Any person earning $85 per month would find this investment very attractive provided it was financed as described.

If inflation is 12% per year (for rents as well as owner's income), the owner's cashflow allows him to take over an additional room after just over 3 years, another 3 years after that, etc. so that within 9 years there need be no tenants. Liquidity is not a problem and profitability is better than in most other investments available to this income group i.e. over 35% over the 20 years of the loan and disregarding any capital gains.

As pointed out earlier, lack of access to housing finance - more than affordability - is the critical constraint. The above scenario also indicates that even with higher interest rates the investment would still be attractive. And raising interest rates is the most effective way to mobilise more capital.

There are, of course, alternatives to the "forced" letting of rooms. One is the incremental expansion of the house as in site-and-services schemes. This is a much less attractive option, because it involves years of struggle to find money and to negotiate with and supervise contractors. And incremental construction substantially disrupts residential areas.

Another option to the borrower, though rarely available, is to be offered a graduated repayment loan, or PAL (Progressive Annuity Loan) so that repayments increase in step with inflation, making the early payments much lower than they otherwise would be. However, the rate of progression would have to be very high to be as attractive as in the example above.

But if four habitable rooms are sufficient to make ends meet, why not build 5,6 or more rooms. Presumably, this would be an even better investment, so that at a certain point we could house the "no-income" group ! The question is legitimate. The answer depends on how one views urban development. Issues of densities, management and of the social and physical environment are important. The implications of carrying the principle to extremes should therefore be considered carefully. In fact, many architects and planners would argue that structures to be built in low income areas should be designed so that they transform easily from multi-family units to integrated one-family dwellings. Utilising the maximum allowed built-up area from the outset avoids the unsightly developments so typical of Sites and Services schemes. True, this approach requires more investment capital to start with, but if that was a constraint, the scheme would just have to be phased accordingly. There is even an obvious opportunity to make loans with a shorter maturity, because cashflows after the 10th year can accommodate them.

The example also illustrates the point that "low income" housing is not synonymous with "low cost". It also demonstrates how cash-flow-based lending can be applied to advantage by HFIs as it is by banks.

4. CREATING AN ENABLING ENVIRONMENT

Housing Finance Institutions do not work in isolation. The national legal, political and economic environment is of paramount importance. For instance, if there is political unrest the investment climate becomes negative, reducing the capital base. Africa, unfortunately, has more than its share of examples. Still, housing will remain one of the best investments even in those circumstances, because population keeps growing and most, if not all, inputs are local.

In contrast to prevailing political and economic conditions, on which HFIs have little or no influence, the legal framework is much more within the ambit of those who operate major institutions. This influence becomes that much stronger when these operators join forces in national and international associations. It is therefore most appropriate to take a look at some of the legal and administrative constraints affecting the housing finance industry and how one would create an enabling environment.

The regulatory system provided by legislation and public sector institutions should be supportive of the building and finance industry. This is not always the case. In Africa, examples abound where the public sector is in direct, though unequal, competition with private HFIs. This is typically done by offering market rates of interest with tax waivers for deposits and/or loans at subsidised interest rates.

Even if policy calls for housing subsidies for reasons of affordability, subsidized interest rates is the worst possible method by which to optimise cost-benefit ratios. For reasons outlined above, subsidies distort the market for funds, create power-bases for individuals thus encouraging corruption, and end up in the wrong pockets. Perhaps Africa should not be held to higher standards than Europe and North America where housing subsidies are used extensively. The guideline, however, should be to subsidize the needy directly not their houses.

Land assembly, tenure rights, foreclosure procedures, building regulations and the whole machinery for conveyancing with its corresponding cost in time and money, are hopelessly out-dated in most African countries. Housing is considered as having a high tax propensity, but taxing it at the time of production or purchase is counterproductive in the extreme and raises capital requirements. On the other hand, once houses are occupied they can and should pay for their consumption of public services.

One kind of property tax is particularly effective: Progressive tax on undeveloped land in urban areas. However obvious this kind of taxation is, it is rare and, if it exists, is only implemented with the greatest reluctance. Problems with evaluation and lack of sanctions are the most often cited reasons. Lobbying against it by powerful landlords may be yet another explanation. This issue leads us to the next point: Land tenure.

Tenure rights in Africa present a confused mixture of traditional rights, freehold, leasehold systems. These have direct bearing on the ability of HFIs to provide housing finance. In particular, the choice between freehold and leasehold has given rise to stormy political confrontations. Without discussing the costs and benefits of each, suffice it to point out that to issue leaseholds on a fixed-term jeopardizes housing finance for those with leases expiring in less than 30 years. Here there is indeed scope for some enabling changes in legislation.

It should, however, be recognized that some form of legislation and corresponding machinery is necessary to regulate the housing market. HFIs are normally fully aware of what it takes to create an enabling environment. One cause for alarm, however, is that HFIs take a narrow view of what is good for them, for instance, arguing for tax relief on interest on savings and on loans. If ever there was a case of subsidies going to the rich, this is it.

It does not take a sophisticated capital market to introduce a way of buying and selling existing mortgage loans. A secondary market of this kind is one of the most enabling mechanisms for the housing finance industry. The two main advantages are:

1. Securities can be disposed of in order to offer fixed interest loans and create liquidity

2. An optimal portfolio can be established in terms of security and maturity

In addition, secondary markets allow institutional investors to engage in housing finance in a flexible way at little cost. Were individual loans to be securitized and issued in smaller denominations, even individual small savers could enter this potentially vast market and bring the lending and borrowing rates of interest closer together.

On the international scene, public bilateral and multilateral agencies can provide valuable inputs in support of national housing finance markets. Regrettably, their track record in terms of appropriate and replicable housing schemes has been less impressive than the amount of time and money invested. One reason is that they have mainly catered to public housing agencies. This has neither made it easy for them to innovate nor to streamline existing bureaucracy.

Fortunately, there is now a tendency for these agencies to be more open-minded about how and whom to help. This is therefore the right time for HFIs to make their ideas known. To ask for technical assistance rather than capital would be one way to approach international agencies. Loans in foreign currency are too risky when local inflation rates run high and devaluations are common. But it is a sign of maturity to seek outside expertise in areas where in-house problems persist.

It is not unusual to hear leaders in local HFIs say when foreign aid to housing is discussed: *"Just give us the money, we know how to use it."* This attitude reflects negatively on their abilities to get their house in order and their prices right. For international agencies to become interested in assisting private HFIs the old paradigms must change. "Low cost" must give way to "low income" housing, affordability to willingness-to-pay, fixed annuities to flexible repayment schedules, and secondary market instruments must be created.

5. INNOVATIONS IN HOUSING FINANCE MOBILISATION

We have just alluded to some of the innovations to be considered. How they work and how other concepts and techniques have resulted in generation of capital and increased lending is the subject of this section. Fortunately, there is a wealth of documented examples to draw from.

Following our initial hypothesis on demand-generated capital, the obvious place to start is at the bottom. Community based co-operatives formed for the purpose of extending credit to members for all kinds of purposes, from school fees to housing, have generated hundreds of millions of dollars in savings. Such co-operatives do not necessarily aim at providing completed houses for their members. Most often they assist by giving short-term loans for building materials or for a down-payment on a house.

Specific "Housing Co-operative Societies" often struggle, because they need a much bigger capital base to offer long-term loans. Their salvation is to go to HFIs and demonstrate their ability to save and to prepare their projects. To this end so-called TSOs (Technical Service Organisations) have been formed with international assistance. When projects are properly prepared and costed, they can be assessed for loans through the normal channels. The advantage these projects have over individual loans, whether they are for housing schemes or individual houses around town, is that members are collectively responsible for servicing the loans.

Community based mortgages also ease administrative work, because payments can be made from one source. The natural place for such co-operatives to form is therefore places of work, church congregations, neighbourhoods, etc. where there is a strong common bond among members.

Public and private provident funds are important sources of capital for housing. But only if members demand it will they stand to benefit directly. Otherwise, funds may be placed with HFIs for shorter or longer term with no strings attached, thus missing the target, which in this case is contributing workers. There is a natural tendency for HFIs to resist conditions on their funds. One way around this problem is for HFIs to be reimbursed directly from the provident fund for money lent to members. A word of caution against subsidies in this connection. Although members - and the provident fund itself - may prefer that funds be made available at lower-than-market rates, this will be at the expense of non-borrowing members. It goes without saying that "construction finance" can be chanelled in the same way through a commercial bank, and then ultimately transferred to the HFI.

A unique combination of housing finance and pension/provident funds is the arrangement where members who take mortgage loans on normal terms pay only 25% of their monthly income towards the loan. The difference is made up by the pension fund. The size of the loan is calculated on the basis of a member's income over time, so that early shortfalls are recovered through later surpluses. This way the pension amount remains intact and members are assisted in getting a house long before retirement.

The most reliable source of funds for housing is the repayment of existing loans. Whatever can be done to speed this up will directly benefit new borrowers. Conversely, anything that delays repayment will reduce the granting of new loans. Some techniques have been tried to influence the flow of funds. Some work, others do not. For instance:

In order to penalize borrowers whose loans fall into arrears, some HFIs add an extra percentage to the interest rate. This practice could have the immediate effect of raising the monthly repayment, a counterproductive outcome, if the reason for falling behind is genuine liquidity problems. Alternatively, such practice increases the loan balance and the loan term from, say 20 years to 23 years. This is no real incentive to avoid arrears. Instead, an incentive could be created whereby a reduction in interest is offered to those who service their loans on time. In such cases the benefit of a reduced monthly payment would work much better than reducing the repayment period from, say 20 to 17 years.

HFIs will allow borrowers to repay their loans early, but at best, no incentives are offered to do so. In fact, notice of early repayment is often required several months in advance. It is understandable that a HFI would want to know its cash flows some time in advance, but it must be a very small institution which can not cope with the odd borrower who wanted to pay off his/her loan in part or in full without notice. Likewise, there are arguments for not speeding up repayments, because the funds are already placed at the same rate of interest as new loans would be granted. Although administrative costs are to some extent covered in up-front fees, it still makes for "extra work for no more funds". However, it makes for more new loans and more houses, if borrowers could be given an immediate reduction in their monthly payment for any (lump) sum which substantially reduced their loans. The technique is simply to recalculate new repayments on the reduced balance over the remaining period of the loan. In effect, this means that a borrower gets the benefit of the higher interest rate on loans instead of the lower one for savings. This is a very strong incentive.

Contractual savings is a time-honoured incentive for generating funds for housing finance. It works well if there is substantial backing for funding the loan contracts, otherwise confidence can easily be shaken and savers withdraw. Governments can assist without giving subsidies. However, in Africa, this may still be premature. Instead, "Housing Loan Guarantee Programmes" established by international agencies could

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lend their support by underwriting such contractual arrangements up to a certain maximum (for individual loans and for total commitment) using debt-swap arrangements should the guarantee become effective.

The UNCHS (Habitat) is now producing another paper on innovative housing finance methods (the first was in 1978). The paper outlines a number of non-conventional case histories, including some from Africa, which may or may not apply in other circumstances. Still, it is worth perusing. The danger of trying to copy success stories from other places is that legal conditions and economic circumstances are not similar. The best approach is to spot local talent and nurture local initiatives, generally train staff to be more competent in existing systems so they have time to learn and think of new ways of doing things. Technical assistance, seminars and study tours are invaluable aids in this regard. Both the *African Union of Housing Finance Institutions* itself and the *International Union* are appropriate instruments for facilitating this assistance. ■

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