The Home Finance Company Limited in Ghana, West Africa

by Stephanie Baeta Ansah

INTRODUCTION[1]

Any system of housing finance is sustainable only if it is relevant to the economic, social, political and regulatory environment of the country concerned.

In the United States, where the secondary mortgage market first emerged following the Great Depression, the housing finance system was built on a foundation in which depositors could confidently invest their money in federally insured savings and loans institutions, then the dominant source of mortgage lending. These institutions, in return, could offer home buyers longer term, amortizing mortgage credit at reasonable rates.

Whether intentionally or not, this emerging new system of housing finance was highly dependent on an economy with only minor changes in interest rates. To profitably provide a continuous flow of mortgage funds, savings and loan institutions needed interest-rate stability to fund long-term mortgages with short-term deposits. For about three decades, the process worked extremely well.

During the 1960s the U.S. faced severe regional capital shortages, as newer regions had more demand for mortgage credit than the regional savings available could reliably mobilize. At the time, savings and loans experienced debilitating competition as depositors sought other higher yielding investments. As a result, wide differences in mortgage rates appeared.

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New Institutions Created

In the following decades, secondary mortgage institutions like Fannie Mae and Freddie Mac stepped in to mobilize new sources of conventional mortgage funding, chiefly through securitization. The mortgage-backed security then developed and fundamentally changed the course of housing finance by linking mortgage finance directly to the capital markets. Functioning as pass-throughs, mortgage-backed securities proved to be a remarkably effective way to provide liquidity while minimizing interest-rate risk to the mortgage lender and the secondary market.

In the 1980s higher and more volatile interest rates presented a different set of challenges to the U.S. housing finance system's ability to keep affordable mortgage funds flowing. Despite the gains from securitization, funds continued to flow out of savings and loans as investors sought higher yielding investments. At the same time, these savings and loans experienced an interest-rate squeeze between the relatively low yields of their mortgage portfolios and the substantially higher yields they had to pay for large deposits.

As a result, this second interest-rate squeeze in two decades placed a premium on a mortgage lender's ability to sell far more mortgages —many of which were by then under water (below market)—to the secondary market and other investors, and to better match their assets and liabilities. In short, the economic environment spurred the industry, including savings and loans, to adopt new mortgage banking practices.

HOUSING FINANCE PROBLEMS IN AFRICA

The problems of housing finance in Africa, many of which are unique to the continent, are even more spectacular. Most of our countries have since the early 1980s been in a state of prolonged economic, social and political difficulty. There have been wars, domestic problems and unfavorable climatic conditions. In addition, external shocks, such as declines in commodity prices, unfair trade cartels, abrupt drops in external resource flows, high inflation and steep increases in interest rates, have led to rapid decline in incomes and economic growth. This has resulted in high poverty levels and adverse housing conditions.

Ghana shares these problems, but it is managing the situation systematically. Habitat I called for integrated planning and provision of shelter, infrastructure and services. Under the Ghana Government's Urban I, II and III projects, all these issues are being addressed. It is under the Urban II program that the Home

Finance Company (HFC) was created in May 1990 to implement and manage a pilot housing finance program that is not subsidized and which is attempting to create a secondary market, while at the same time reviving housing finance in the country.

THE HOME FINANCE COMPANY

Incorporated initially as a private limited liability company, HFC's mandate is to promote a two-tiered, sustainable housing finance system in Ghana and address major barriers such as:

1. High inflation;
2. High variable rates of interest;
3. Declining real incomes;
4. Absence of a long-term household repayment of loans culture; and
5. Weak foreclosure laws.

Under the pilot housing finance program, it was proposed to establish a housing finance system indexed to inflation, based on Consumer Price Index (CPI) figures. Under this price indexation formula, both mortgages and bonds are adjusted monthly on the basis of the three-month average change in the CPI.

HFC functions as a second-tier lender, extending loans to qualifying borrowers through approved originating and servicing institutions (OSIs). The mortgages are in the joint names of HFC and the OSIs. As stated in the project and other documents of the pilot scheme, the mortgage default risk is shared on a 90% HFC and 10% OSI basis. The mortgages are on HFC's balance sheet. Currently OSIs view themselves as purely originators (or "post office boxes").

Special Mortgage Terms

The mortgages made by HFC are a variant of the dual index formula.[2] Mortgage repayments are fixed at 35% of the verifiable income of the borrower. This is paid by the employers through payroll deductions. As the borrower's income rises, repayments also are expected to increase proportionally. From experience, borrowers prefer declining loan balances and are often prepared to pay up to 50% of their income towards homeownership.

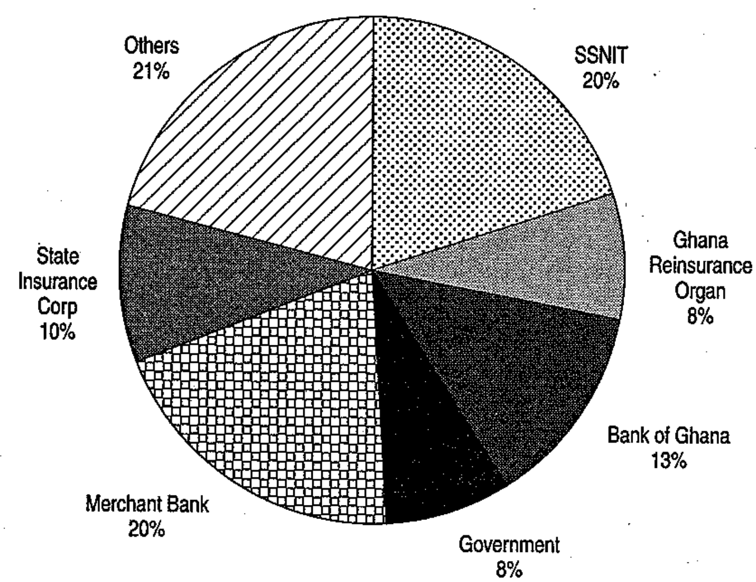
The interest rate on the mortgages is fixed at a 1% real rate. The term is initially 20 years. If real wages increase by more than 1% per year, the loan will amortize in less than 20 years. If real wages do not increase by 1% per year, the loan will take more than 20 years to pay off.

Initial plans were for HFC to finance about 2,000 new, private-sector-built one-, two- and three-room units. Houses were to be designed, marketed and built by private developers operating on the basis of commercial criteria. Construction financing was to be provided by the banks who were also to originate mortgages for sale to HFC.

HFC Structure and Ownership

HFC initially was a shell company, with very little stated capital, owned on an equal basis by government of Ghana (GOG), Social Security and National Insurance Trust (SSNIT) and Merchant Bank (Ghana) Limited (MBG). The shareholding was subsequently broadened to include three large insurance companies, namely State Insurance Corporation (SIC), Ghana Union Assurance (GUA) and Vanguard Assurance. Two of these companies are private. SIC is the largest corporation engaged in life and hazard insurance, now state-owned, but about to be divested. HFC opened up 25% of its shareholding to public subscription on the Ghana Stock Exchange (GSP) in 1995. This offer was over-subscribed by 15%, the first over-subscription on the GSE. The company is now owned by 300 shareholders with 12 institutions controlling over 98% of the capital. (See Figure 1.)

Figure 1. Shareholding Structure



HFC Objectives

The objectives of HFC include, among other things:

1. The overall program development and management of a new housing finance system, which involves indexation and securitization of mortgages.
2. The creation of a two-tiered financial system whereby mortgages are originated and serviced at the primary level by Originating and Servicing Institutions (OSIs), (banks and other primary mortgage lenders); and at a secondary level, funds are managed and made available by HFC to approved OSIs for relending to mortgagors under certain clearly defined limits.
3. Mobilization of funds from various sources, including:
   a. Issuance of long-term bonds of various maturities to SSNIT and other institutional investors.
   b. Issuance of long-term bonds to the government of Ghana and/or Bank of Ghana under the special pilot housing finance scheme, financed through an International Development Association (IDA) development credit extended through the government of Ghana to HFC under the Urban II project.
   c. The bonds are 30 years in maturity and will be repaid periodically through the repayments of principal on the mortgages. The bonds purchased by SSNIT and other institutional investors receive repayments prior to the bonds purchased by the government.

The total funding available under the pilot scheme is US$25.5 million, including the IDA portion of 40% which is the seed capital provided to HFC under the pilot scheme and made available for 40 years. By adopting price indexation, the company has been able to access funds amounting to US$16.5 million from the country's main pension fund, SSNIT, which previously (like other institutions) was reluctant to invest in long-term instruments. HFC has raised and continues to raise on its own, additional funds as follows:

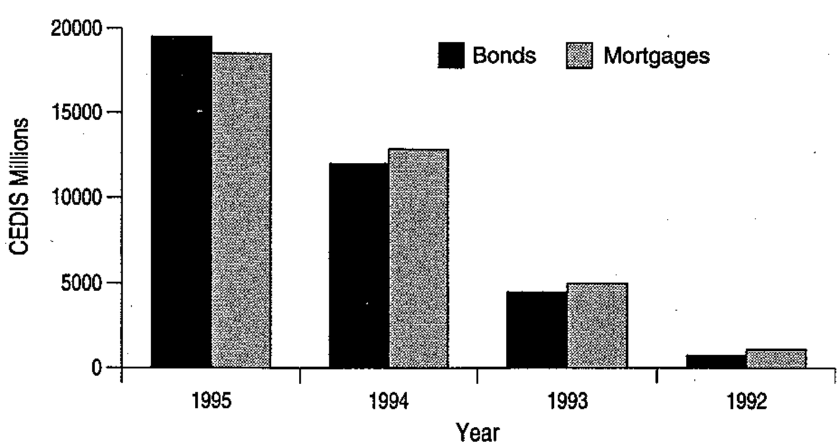
1. Through the medium of the country's first licensed collective investment scheme, the HPC Unit Trust established in 1991, the equivalent of US$4.2 million owned by approximately 2,000 individuals and staff provident finds.
2. Through the medium of the HFC Real Estate Investment Trust (REIT), also the first of its kind in Ghana, since December 1995, almost US$1 million equivalent for investment in housing and related real estate projects such as shopping centers and cluster housing development. Under a pilot program, REIT's first cluster housing development, comprising 14 three- and four-bedroom houses has been recently commissioned.
3. Through the sale of housing bonds, the first public sale of housing bonds is expected to raise an initial sum of US$2 million to refinance a mortgage portfolio that benefits foreign exchange-earning Ghanaians. Local currency (Cedi) denominated bonds also will be sold.
4. Through its capital and deposits, another US$5 million as of March 31, 1996.

Figures 2 and 3 show the progress of HFC in raising funds. The HFC-Unit Trust and the HFC-REIT are both open-ended tax exempt funds. Recent marketing efforts have targeted the corporate as well as so-called informal sectors.

The company is managed by three executive directors and a total staff of 41, mostly professionals. HFC has since its inception been managed entirely as a private commercial concern under the authority of its board of directors, comprised of experienced bankers and other professionals.

As part of the Urban II program, the government established the Housing Finance Institutional Reform Committee (HFIC) under the chairmanship of the Governor of the Bank of Ghana, to coordinate the relevant ministerial

Figure 2. Bonds and Mortgages Outstanding



activities to provide HFC with the needed public sector support and enabling environment. HFIC has been of immense help to HFC in its development.

Furthermore, the Home Finance Mortgage Law 1993 (PNDCL 331) was promulgated to reform foreclosure remedies available to HFC without the need to go to court, unless more than a certain percentage of the loan has already been paid by the borrower. Under this congenial regulatory environment, HFC's repayment record has been in excess of 98%, thus generating additional funds for mortgage lending. The company has since its inception been entirely self-supporting.

PROBLEMS AND THEIR SOLUTIONS

The following solutions to problems with the pilot program have been identified:

1. *The price indexation concept has been reviewed due to an unexpectedly high environment of inflation.* Following the election in 1992 and payment by the government of salaries not budgeted for (under pressure of unions and other staff groups); the negative effect of introducing VAT at a high level of 17% and then withdrawing it under political pressure; and bad harvests in 1994 and 1995, inflation took a sharp upward turn in 1995. From the previous position where adjustment to the inflation-indexed mortgages resulted in interest rates which were at least 8% to 9% below bank lending rates, 1995 was characterized by inflation in excess of 60%, whereas bank lending rates hovered around 40%. To avoid a severe credit shock that would have affected borrowers repayment of loans, an agreement was reached between HFC and its bondholders to provide a "cap and floor" on the interest rates charged to the company's pilot scheme portfolio. An adjustable ceiling of 2% below the average lending rates of three major banks operating in the country has been adopted and will continue until the economic situation improves. Currently the "cap" is 38%. The relationship between the mortgage rate and other rates is as follows:

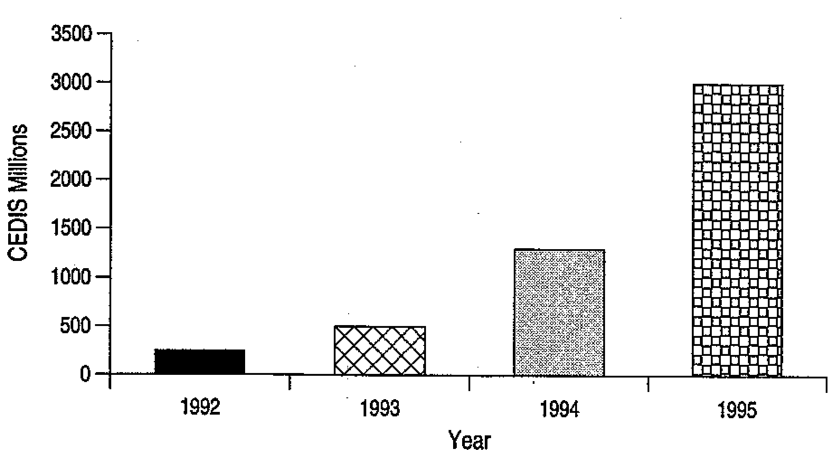
   - 91-day Treasury bill rate: 45%
   - 1-year Treasury bond rate: 39.45%
   - 2-year Treasury bond rate: 45%

   There is no fixed "floor," but in accordance with the agreement with the bondholders, they will recover any "losses" later when the economy stabilizes.

2. *The primary market has been slow to respond to the opportunity of refinancing under an emerging secondary market.* The banks have continued, despite incentives, to be unwilling to lend for construction financing and to originate mortgages for sale to HFC. Investment in Government Treasury bills provides the easiest way out for most banks, who are also required to maintain high levels of investment in Treasury bills as part of measures by the central bank to reduce liquidity in the system. The banks also have been slow in developing individual (consumer) banking relationships because of high personnel and other transaction costs, making it less profitable than the readily available corporate business. HFC, therefore, has had to rely heavily on its non-bank OSIs such as State Insurance Corporation of Ghana (SIC), who have the incentive to originate and sell mortgages to HFC. At least two private sector mortgage companies have been formed recently and have applied for licenses under the Financial Institutions (Non-banking) Law 1993. They are expected to undertake mortgage origination and servicing for HFC.

3. *Clarification of policy issues.* The central bank is soon expected to issue clear guidelines on HFC's apex secondary mortgage status. The risk weighting of mortgages, however, has been reduced from 100% to 50%, in line with the international convention which provides a good incentive for increased mortgage lending activity. HFC has prepared guidelines for its proposed secondary mortgage lending activity. These are to be refined under proposed "twinning" arrangements with a Malaysian mortgage financing company to provide

Figure 3. Shareholders Funds



practical assistance in developing the secondary mortgage system in Ghana. The Malaysian secondary mortgage system seems to be the most relevant model for HFC to follow.

4. *Inadequate supply of houses.* This continues to be a problem inhibiting the development of a secondary market. Under the auspices of the Ministry of Works and Housing, the Ghana Real Estate Developers Association (GREDA) was formed about the same time as HFC and is comprised mainly of private companies. GREDA is now a self-regulatory body which has just acquired vast acres of land around the suburbs of Accra. Infrastructure is being pre-financed by SSNIT. HFC is having to look into complaints by developers of inadequate construction financing.

5. *Prevailing high interest rates.* Prevailing high rates, particularly of Treasury bills, make it difficult to mobilize appropriate financing, particularly for low-income housing. A draft policy statement by the government to address this issue is being considered. The mortgage downpayment required of low-income borrowers is 10%, as compared with 20% or 30% for other categories of borrowers.

6. *Construction financing is inadequate.* HFC is taking steps to address this problem through two major local banks. Furthermore, additional funds are being raised by HFC through the HFC-REIT to augment the funds available for construction financing, an absolute requirement for a thriving housing industry.

7. *Land title and registration procedures are still inordinately slow.* Another component of the Urban II project is tackling this issue and aims to remove the bottlenecks in this system and merge the authorities of the Land Title Registry with the Lands Commission Registry.

8. *Inadequacy of serviced lands on which adequate infrastructure is provided.* This is being undertaken by site and service schemes commissioned by Tema-Development Corporation (TDC), one of the largest parastatals, and Social Security and National Insurance Trust (SSNIT), the largest fund available for long-term investment in Ghana. These schemes are being provided on a full cost-recovery and profit oriented basis.

9. *Low-income earners and rural housing are not provided for under the present HFC program.* The government's draft low-income housing policy document, however, is looking at ways to facilitate mobilization of appropriately priced funds for extending a housing finance scheme to these sectors.

10. *The informal sector accounts for over half the money supply in the country.* Many borrowers in this sector are still outside the tax and social security network and lack basic accounting know-how to enable the financial institutions to assess income for extension of credit on a long-term basis. HFC is tackling this sector with the assistance of HDFC of India and the Grameen bank of Bangladesh.

11. *Low-income levels continue to constrain the ability to pay for realistic loan amounts that would finance appropriate urban housing for the majority.* Through the implementation of a graduated payment method under the pilot housing scheme, HFC has been able to make homeowners of persons in regular employment with an average monthly "take-home" pay of c280,000—i.e., approximately US$186. By recognizing other household incomes and providing the facility for joint application by spouses, siblings and parent/child, it has been possible to extend the net wider. The requirement of the downpayment of 20% has provided the opportunity to mobilize household funds through the medium of the HFC Unit Trust and the company's deposit scheme, in respect of which realistic interest rates are paid by HFC.

12. *High cost of houses.* Efforts are continuing to address the high cost of houses, as a means of further reducing the affordability threshold. This is being done through the core house concept, which includes terraced houses. The use of alternative construction technologies is also being encouraged. More intensive use of land has resulted in infrastructure costs being spread over a larger number of homeowners, thus reducing the impact on house prices. The company sets aside yearly funding from profits to promote efforts in this respect.

Diversification into mortgage schemes for high net worth individuals, corporate bodies and the non-resident Ghanaian population has provided a better balance of profitability and sustenance of the new system.

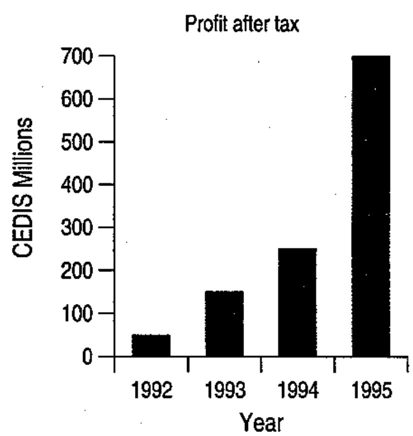
A total of approximately 1,800 new homes has been funded by HFC between January 1992 and March 1996. The opportunity also has been provided for two major parastatals to sell off unprofitable rental accommodation provided in the past to many employees and others who were paying less than an economic rent. This policy is meeting with some resistance but seems to be working. HFC's profit after tax for the past four years of active business is shown in Figure 4.

Because of the government's pragmatic policies on housing finance, fresh foreign investment recently has come into the country, but the housing deficit remains rather daunting, as the backlog of at least 300,000 is growing at 50,000 every year.

CONCLUSION

An effective secondary mortgage market operation requires and indeed develops out

Figure 4. Other Financial Highlights for 1995



	% Increase	1995 c'000	1994 c'000
Total assets	92%	22,698,133	11,792,628
Capital employed	128%	3,028,120	1,324,086
Gross income	120%	2,697,057	1,225,734
Net profit before tax	196%	944,753	316,943
Administrative expenditure	93%	852,776	440,084
Total expenditure	93%	1,752,304	998,791
Debit equity ratio		6.5:1	9.4:1
Return on shareholders funds		41%	36%
Return on assets		4.1%	2.9%
Interest cover		2.24 times	2.1 times
Earnings per share		c19.88	c7.67
P/E ratio		6.36	13
Dividend par		c6.93	c2.30

of an active primary market. In Ghana, the attempt is being made to jump-start primary market activity by making available the convenience of a secondary market, providing needed long-term funds. The response of primary operators has been slow, largely due to competing business interests This is particularly due to the availability of low-risk high returns on Government bonds and Treasury notes, as well as other short-term trade financing activity.

The key role of government in ensuring the survival of secondary market operations through the provision of support, granting of necessary concessions and funds mobilization is recognized and is being actively pursued.

NOTES

[1] This section is based on Glenn, David, "Pivotal Periods," *Mortgage Banking*, May 1995, pp. 20-25.

[2] Editor's Note: For a discussion of the dual indexed mortgage, see the articles by Barry et. al. and Lea in the March 1995 issue of *Housing Finance International*.