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International Union for Housing Finance
6th Floor, York House, 23 Kingsway, London, WC2B 6UJ,
United Kingdom
Tel: +44 (0)20 7440 2210 Fax: +44 (0)20 7836 4176
http://www.housingfinance.org

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Editor's Introduction

by Friedemann Roy

Recent research and comments on the global credit crunch has played with a quote of Winston Churchill's speech on the progress of the war. Do we see "the beginning of the end" or "the end of the beginning"?

The breakdown of the securitisation market makes it still hard for lenders to securitize their loan portfolios. Worst of all, a forthcoming accounting change known as FAS 140 may force banks to take previous securitisations back onto their books. According to *The Economist*, it is estimated that about USD 5 trillion of assets will return to banks' balance sheets.[1]

Do these appallingly high figures mean that securitisation has any future? It still has! Notwithstanding the current developments, it will remain an instrument for lenders to manage their portfolio risks. Regulators will have, however, a stronger impact on the design of the individual instruments. It is likely that securitisation will appear in much simpler form, centred on traditional lines of business, such as creating mortgage-backed bonds. Securitisation structures, such as mortgage bond CDOs or so-called single tranche CDOs may become more instruments of the past. In addition, it can be expected that lenders will be forced to keep a greater chunk of credit risk in their books but are able to manage more effectively interest rate risk through securitisation.

This Housing Finance International's edition offers a broad variety of different articles. The first article is by Joachim Dübel and deals with state involvement in the US mortgage market. He concludes that the private mortgage sector has been confined by public intervention to business models that were never sustainable in themselves, due to the self-defeating character of targeting risky (variable-rate, high margin) products to low-income households, and never able to deliver a long-term perspective of capturing any market share that was both sizeable and promising stability at the same time.

The author of the second article is Dr Barbara Drexler who explores the importance of central bank transparency for housing finance in central and eastern Europe. Transparent monetary policy decisions, ie better communication of expected interest rate movements, would allow lenders to hone their long-term planning horizon and product portfolios, thus increasing overall competitiveness in the housing finance sector. The first part of her article concentrates on the measurement of central bank transparency and its effects on housing finance. The second part assesses the significance of central bank policy to housing finance markets in central and eastern Europe as an example.

Carol Rabenhorst and Sonia Ignatova are the authors of the third article on condominium housing and mortgage lending in emerging markets. Although condominiums often represent a substantial portion of the potential market for mortgage lending, a number of constraints impede lenders to offer financing for this market segment. In their article, you find suggestions how these constraints can be remedied, as means to expand the link between condominium housing and mortgage markets in developing countries. Furthermore, it offers a comparative analysis of emerging mortgage markets in several countries and the developed mortgage sector in two countries – the United States and Australia, with focus on the role of the condominium sector in development of mortgage markets.

The next two articles deal with two emerging housing financing markets in Sub-Saharan Africa – Ghana and Uganda. The first article is by Dr Noah Kofi Karley, dealing with an analysis of the constraints in the Ghanaian residential property market. First, it assesses the current house types and conditions and then discusses factors affecting housing delivery. It assesses housing affordability by taking into consideration house prices, household incomes and the mortgage products. The second part comments on how this affordability and mortgage market potential may grow in light of the improving macro economic conditions observed in Ghana over the last few years.

The second article by James Kanagwa is about the impact of servicing on the performance of mortgage lenders in Uganda. Based on the mortgage operations of Housing Finance Limited as an example, the author looks at all the areas that affect the servicing of mortgage loans within this organisation. His findings confirm that there is a positive correlation between the quality of servicing and a lender's profitability. The paper finishes with recommendations on improvements of the servicing function.

Our last article is by N O Jorgensen. In the June 2007 edition, he came up with ideas to improve access to housing for low-income groups ("Housing the No-income Group"). The article presented in this edition on the role of housing finance in alleviating poverty goes further into this topic.

I hope you will enjoy reading these articles. I am confident the articles will inspire you to come up with comments and recommendations. They are more than welcome!

[1] See *The Economist*, "Buttonwood: Recovery? What Recovery?" – the credit crunch looks far from over.

Obsessed with public mortgage banking – the US should give the private sector a fair chance

By Hans-Joachim Dübel[1]

When the author of these lines, an international mortgage sector consultant, was invited for a job interview on a bright fall morning in 2000 to Armonk, upstate New York, he was unsurprised that the meeting did not take long. MBIA, the giant municipal bond insurer, so the discussion concluded quickly, would not have a chance to compete in the US mortgage market dominated by semi-public mortgage banks and bond insurers Fannie Mae and Freddie Mac. As a courtesy to the company he decided to stay for lunch before taking the 45min cab ride back to Manhattan to look for safer job options. MBIA, on its part, went on to put its AAA rating and reputation as one of the icons of the American finance industry on Red – in the grand casino called US mortgage market.

Or better: what had been left by Fannie Mae and Fannie Mae and other public institutions in the US to the private sector – the so-called 'non-conforming' market. As we all know now, this $2 trillion private large 'niche' in a $7 trillion market over the past decade or so went economically berserk. Over the years, any imaginable type of product or institution had became part and parcel of 'non-conforming' – from super-safe (but rather rare) high-income 'jumbo' loans to the toxic waste of subprime option ARMs, from the anything-goes of almost unregulated finance companies and investment banks to the thrifts put into a super-tight corset after the 1980s crisis. With the subprime crisis in full swing, the 'niche' now has the connotation of a dump, and the reputation of the American private financial sector has become badly tarnished as a result. Yet, if even stellar performers in their core markets, like MBIA – famous for its almost real-time monitoring technique of municipalities' finances, had no chance to establish themselves in the mortgage market, was there something wrong with them as a business, or rather with the system setup? How much responsibility lies with the 'conforming' segment for the failure of the 'non-conforming', and what should be the conclusion for America's future mortgage sector design?

To see the depth of the psychological and real barriers to entry to the mortgage market existing in the US, a brief historical tour is recommended. America's obsession with public mortgage banking dates back to the New Deal, the acclaimed era of financial sector direction that is credited to have laid the foundation for the country's rise to an economic and military superpower during the second half of the 20th century. The New Deal actions in the mortgage arena were indeed an apt response to two pressing problems: avoidance of an imminent financial meltdown during the Great Depression, which saw 40% mortgage default rates, and the overcoming of the legacy of America's segmented state banking systems that was unable to produce new mortgages, requiring large (ie national) capital pools, efficiently.

To address the first problem, the Roosevelt administration started with a vast public bailout operation: defaulted loans were transferred to the Home Owners' Loan Corporation (HOLC), an organization that was unwound in the 1950s even with a small net profit for the US government. To encourage new lending the administration in 1934 created a splendid world innovation: long-term pre-payable fixed-rate mortgages insured by a new public agency, the Federal Housing Administration (FHA). To address the second issue, insufficient cross-(state) border lending, a private wholesale mortgage bank charter was established, the National Mortgage Association (NMA). When nobody in the private sector picked up the idea as the country's economic woes continued, the administration by 1938 went ahead and created a Federal NMA, today's Fannie Mae.

These steps taken together meant nothing less than a Fordistic revolution in mortgage finance, which for much of the last century globally was characterized by rather makeshift closed savings and loan systems with limited product and funding options. The American product, the 30-year fixed-rate mortgage, in contrast, is still

[1] Hans-Joachim Dübel is founder of FINPOLCONSULT, offers independent economic, market and legal-regulatory analysis and advice at the intersection of both sectors - in mortgage capital markets, mortgage lending and insurance, and housing policy.

globally almost unrivalled today – due to its supreme protective properties for consumers it can be seen as the Mercedes Benz of mortgage finance. Even the good old thrifts received their place in the new system, although thanks to FHA they would not take much credit risk on their books for a long time.

The drawback, yet, was that henceforth the US mortgage market was almost completely guaranteed by government.

In the subsequent decades several administrations tried to reduce the level of public guarantees, but every such attempt ended in failure.

In 1968, under fiscal pressure due to the costs of the Vietnam war, Fannie Mae was privatized in name in order to enable the Johnson administration to reclassify public into formally private liabilities. Since a single wholesale bank would have looked funny named as 'private', in a parallel move the thrifts became allowed to create their own Fannie Mae, called Freddie Mac in 1970. Fannie at the time was primarily working with loan brokers while Freddie would be working with the thrifts. Yet private in wording was not private in meaning: the real difference made was between 'implicit' public guarantees – backing now Fannie and Freddie, which received a special charter, special credit lines with government, special treatment with investors – and explicit public guarantees which now became reserved to low-income housing finance under a new mandate for FHA.

15 years later, the thrift crisis rendered any semantics about the character of guarantees superfluous, as now Fannie and Freddie were becoming too big to fail. The thrifts, which had been shouldering much of the funding for mortgages still by the 1970s had been lulled into risk amnesia by decades of public interventions and as a result had produced the Mercedes Benz (fixed-rate lending) with tools and materials rather suitable for building a Volkswagen (short-term deposits). As they exited production and sold their assets in pools to the so-called secondary mortgage market, Fannie and Freddie – who assisted the process by providing their guarantees to the pools (called MBS – mortgage-backed securities) – took over the housing finance system. A public regulator was created in 1992 to oversee the two giants (OFHEO), albeit with limited competences.

The Reagan administration of the 1980s watched the re-nationalization of the mortgage market, and this in parallel to Britain's admired big bang liberalization, with desperation. In order to give private lenders something - outside the small high-income market beyond the reach of Fannie and Freddie – a series of laws was promulgated that overrode state consumer protection laws, including interest rate usury limits. This initiative created the so-called subprime market. Contrary to the 1968 reforms which had planned a split of the market into low- ('public') and high-income ('private') under Reagan it was accepted that the new, truly private market would exist in direct competition with the public insurer FHA. It's chance for survival lay in the area of variable-rate products that FHA was not allowed to offer, provided at high margins to risky clients, especially 'minorities'.

With the big monetary cycles of the Greenspan era that lowered the costs of funds for variable-rate loans, more and more private lenders became attracted to the new niche. The first big subprime crisis happened predictably rather soon - during 1998/2000, in the so-called manufactured housing market (mobile homes). Already then, a new instrument class called CDOs that had wrapped such loans into bonds made a dubious appearance with the investor community. The second subprime crisis that unfolded since 2006 on the back of a new monetary cycle, the deepest so far, was characterized by a participation by almost the entire private financial system of the US, from investment banks to bond insurers like MBIA, trying to prop up their profitability by building high margin mortgage books. The result is known - as of 2008 not only many of these players have shattered balance sheets: another re-nationalization of the US mortgage market is taking place, with the lending limits of Fannie and Freddie being massively expanded and earlier growth limits imposed being removed. FHA once again is becoming the dominant player in the low-income market.

The short summary from this amazingly long story of successful nationalization and failed de-nationalization is that the private mortgage sector in the US has been confined by public intervention to business models that were never sustainable in themselves, due to the self-defeating character of targeting risky (variable-rate, high margin) products to low-income households, and never able to deliver a long-term perspective of capturing any market share that was both sizeable and promising stability at the same time. Addressing the latter, fundamental problem would clearly presuppose a move of the public sector out of its dominant position in subsidized safe (fixed-rate, low margin) mortgages to the middle class. With the private sector able to move into the middle-income market, the first problem – reliance on short-term, niche-focused business models - should be expected to disappear, or at least be mitigated. Without exonerating the private sector from the excesses of subprime, much responsibility for their appearance lies in the nationalization of vast parts of the American housing finance system.

How should the US government move from such a diagnosis? The first key reasons why the American housing finance system so far has not really been reformed is conflict of interest – Fannie Mae and Freddie Mac can earn duopoly profits in middle-income market guarantees without being politically forced to go downmarket – the classical public agency rent-seeking problem. The second key reason is that Americans – politicians and consumers alike – fear that the Mercedes Benz product, the 30 year pre-payable fixed-rate mortgage, might disappear in the process of privatization due to intrinsic constraints of private sector funding. I argue that the latter concern is valid, but can be addressed, eg in the way Denmark's private wholesale mortgage banks create the product by issuing callable bonds (passing through prepayments) to savvy investors. If Copenhagen can replicate the American product, Wall Street should be able to do so as well, rather than wasting its energies on finding always new regulatory arbitrage niches in 'non-conforming' markets. Perhaps public guarantees should stay around for a while in middle-income, available to all issuers of mortgage bonds backing such complex products, before being removed, but regulatory preferences to safe products could do just as well. Certainly public guarantees will continue to play some role in low-income lending, together with a renewed focus there on safe products.

The problem of rent-seeking of US public and semi-public entities in mortgage finance, frankly, is a political scandal that warrants urgent attention by the next Presidency – even if the President should come from the same party that 70 years ago - in good intention - created the problem. Despite the politically overwhelming homeownership doctrine, and despite a natural angst before fundamental changes, America's political system should be mature enough going forward to give the private sector a fair chance in mortgage lending.

Does Central Bank Transparency matter for housing finance in Central and Eastern Europe?

By Dr. Barbara Drexler[1]

Transparency, no doubt, is en vogue. Politicians, shareholders, stakeholders, regulators, bureaucrats, journalists and members of the public widely demand that hedge funds, charities, sports clubs, company boards, political parties, financial institutions and governments openly disclose their organizations' assessment methodologies, incentive structures and decision making mechanisms to the public. The underlying rationale is that transparency provides an effective, principles-based way in which organizations can be held accountable for their actions without infringing their decision making freedom.

In the 21st century, the call for greater transparency has even reached the traditionally deeply secretive realms of central banking. This paradigmatic shift is illustrated well by juxtaposing the following interpretations of the manner in which central banks ought to guide public expectations regarding future monetary policy decisions. At the end of the 1980s, mystery was still considered an essential ingredient of effective monetary policy. Alan Greenspan, the Federal Reserve's former chairman, famously quipped that "[He] had learnt how to mumble with great coherence. If [I appear] unduly clear to you, you must have misunderstood what I said"[2] A decade later, Mervyn King, governor of the Bank of England, assured his audience "we want monetary decisions to be boring[3]". According to Dincer and Eichengreen "Transparency is the most dramatic difference between central banking today and central banking in earlier historical periods"[4] Transparency in central bank decision making matters to lenders because it reduces information asymmetries that prevail between central banks and private financial agents, thereby reducing risk of interest or exchange rate mismatch as well as inaccurate pricing of real estate collateral.

This paper seeks to address the following set of questions. First, how does monetary policy influence housing in general and specifically with respect to the Central and Eastern European countries? Second, why is monetary policy important for lenders and what are the benefits of projecting monetary policy impulses accurately? Third, what is central bank transparency, how is it measured and how does it matter to lenders? And finally how do Central and Eastern European central banks fare in terms of transparency and what should be the policy consequences?

How do monetary policy impulses affect housing?

There are four channels through which monetary policy impulses affect the conditions of housing finance. The interest rate channel, the credit channel, the wealth channel and finally the exchange rate channel. The interplay of expectations, money market interest rates, asset prices, overall lending volume, money supply and the exchange rate are summarized in the graph on page 7.

The interest rate channel describes the following transmission mechanism. Lowering key interest rates, for instance, will cause economic agents to expect long term interest rates to decrease as well. This reduces the cost of funds, which tends to increase the demand and subsequently the prices for housing, prompting an increase in housing construction and through secondary effects an increase in overall aggregate demand. The shorter the duration of the loan, the stronger the effect of the monetary policy council decision on the mortgage rate. As Geregely Kiss and Gabor Vadas from the Magyar Nemzeti Bank point out, changes of the key interest rates have a larger impact on short term rates. As a result, mortgages price adjustment occurs more quickly.

The wealth channel predicts that expansionary monetary policy in the form of lower key interest rates will stimulate the demand for housing, leading to higher house prices. This increases homeowner wealth, which according to the life-cycle hypothesis of saving and consumption,

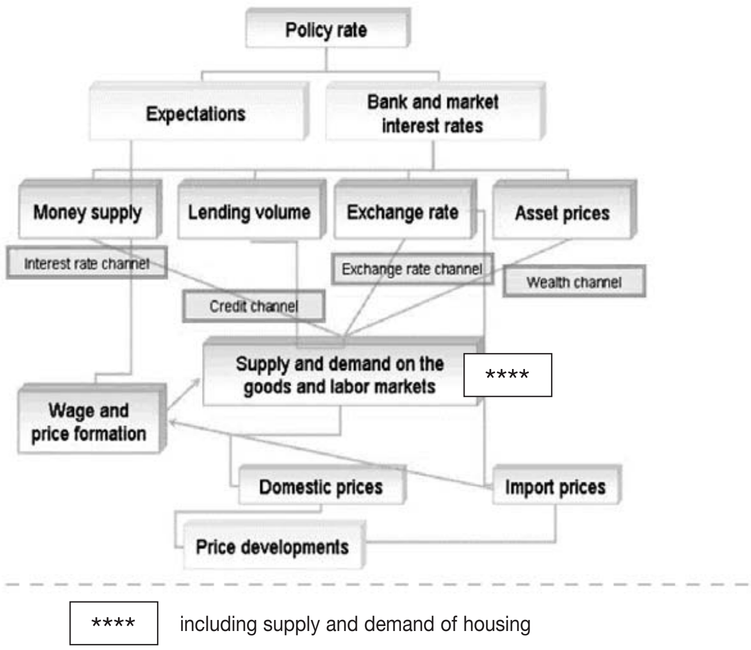
[1] Programme Manager, Frankfurt School of Finance and Management

[2] Greenspan 1987

[3] King 2006

[4] Dincer/Eichengreen 2007

Figure 1: Four key channels of Monetary Policy Transmission

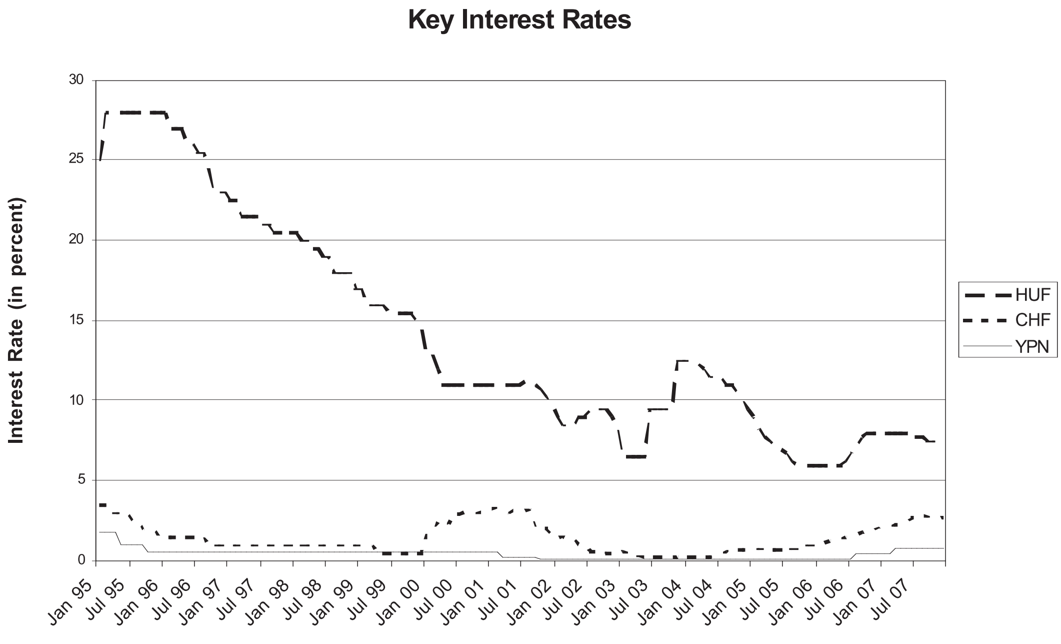


Source: OENB.

first developed by Modigliani and Brumberg (1954), stimulates consumption and thus aggregate demand. Since equity and property are part of wealth, a rise or a fall in housing prices triggered by monetary policy actions results in increasing or diminishing lifelong wealth and thus lead to an increase or a decrease in consumption. Two specific features must be born in mind when assessing the importance of the wealth effect with respect to Central and Eastern Europe. First, the wealth effect is positive in countries where the owner occupancy rate is higher and clearly negative in countries where tenant residency prevails and second, increases in housing prices affect household consumption less in countries where overall growth and price developments are volatile.

The credit channel describes the pass through of monetary policy impulses via the credit markets. Collateral reduces information asymmetries. Good collateral significantly decreases losses to the lender if the borrower defaults. Good collateral also reduces the incentives of the borrower to take excessive risks because the

Figure 2: Key Interest Rates



Source: Bank of Japan, National Bank of Hungary, National Bank of Switzerland (own graph).

borrower now has something to lose. A rise in house prices necessarily leads to more potential collateral for the homeowners, which may improve both the amount and terms of credit available to homeowners.

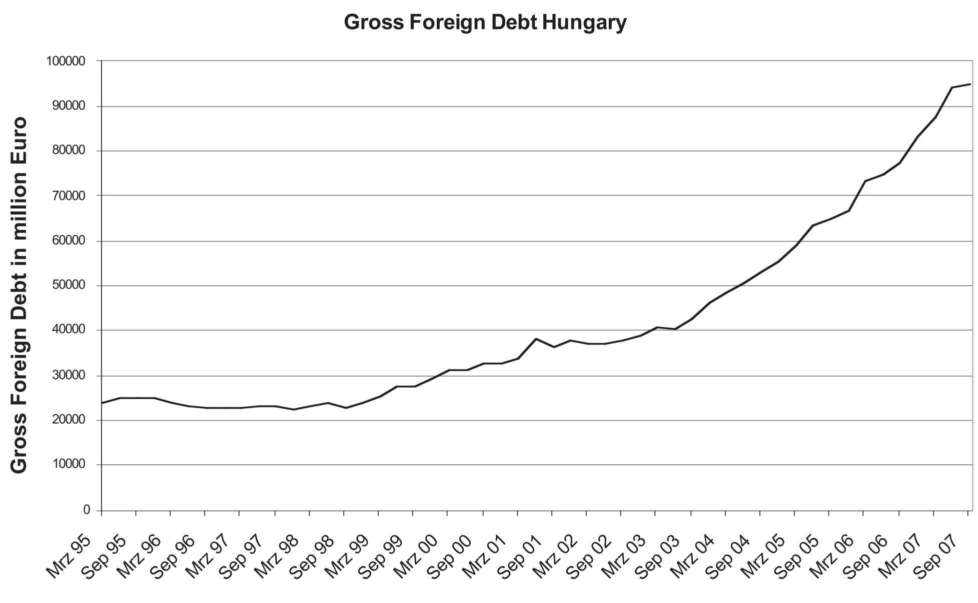
Expansionary monetary policy also affects the real economy via the exchange rate channel. Lower interest rates imply that deposits denominated in domestic currency become less attractive than deposits denominated in foreign currencies. Consequently, the value of deposits denominated in domestic currency declines relative to that of foreign currency-denominated deposits. As the domestic currency depreciates, domestic goods become relatively more affordable than imported goods, causing demand for domestic goods to expand and aggregate output to augment.

In small open economies, such as for instance Hungary, the effect of the exchange rate channel on the housing markets is particularly pronounced. According to the Hungarian national bank, a substantial number of Hungarian mortgage debtors redeployed their outstanding debt by taking out an additional loan to cover the mortgage denominated in domestic currency in foreign currency. As can be deduced from Figure 2 and 3, the interest rate differential between Hungarian Forint and Japanese Yen (similarly Swiss Franks) was indeed substantial during the period concerned 2000-2006[5]. Consequently, according to Kiss and Vadas, many Hungarian households were prepared to incur an imminent exchange rate risk in order to loosen their liquidity constraint. The growing number of mortgages denominated in foreign exchange strengthens the transmission effect of the exchange rate channel.

To sum up, there are four key transmission channels that describe how monetary policy decisions by central bank decision making councils reach the real economy and housing markets: interest rate, credit, wealth and exchange rate. While the interest rate and the credit channel are of substantial importance to developments in housing markets in the CEECs, the wealth channel effects are not particularly pronounced. The most plausible explanation is that in a setting of volatile growth and price developments, consumption is less affected by house price developments. Due to the high amount of debt denominated in foreign currency, particular attention must be paid to the effects of exchange rate fluctuations. In the CEECs, the relevance of the exchange rate channel to housing markets is particularly pronounced.

Overall, the pass through rate[6] of short term interest rate decisions is rather high in CEECs. In their seminal paper 'Monetary Transmission Mechanisms in Central & Eastern Europe: Gliding on a Wind of Change' Coricelli, Egert and MacDonald (2006) argue that this is due to a high proliferation of short term mortgages, which makes housing and mortgage

Figure 3: Gross Foreign Debt in Hungary



Source: National Bank of Hungary (own graph).

5 Foreign exchange mortgages were particularly attractive because of currency pegs.

6 The pass through rate measures the estimated impact of a 1% change in the key interest rate on the ‚other' listed rates.

Table 1:
Average Long Run Pass Through Rate of Key Interest Rate Changes

Type of Rate	Av. long-run pass-through
Money Market Rate	1.01
Short Term Deposit Rate	0.72
Long Term Deposit Rate	0.69
Short-Term Lending Rate	1.01
Long-Term Lending Rate	0.91
Consumer Lending Rate	0.51
Housing/mortgage lending rate	0.73
Government security yields	0.92

Source: Coricelli, Egert and MacDonald 2006

lending rates more susceptible to key interest rates determined by central banks. The high correlation between monetary policy triggers and real economy reactions is summarized by the table below. In short, as table 1 shows, monetary policy decisions matter in the CEECs.

[The table above shows how a 1 % change in short term key interest rates 'filters through' to the real economy. In the CEECs, a 1 % monetary policy impulse alters the housing and mortgage lending rate by 0.73%.]

What are the benefits of predicting the key interest rate accurately?

So far, this paper has shown that short-term monetary policy impulses affect housing developments in the CEECs rather substantially, be it through the interest rate, credit and / or the exchange rate channels.. To the macro economist, this assertion is fascinating enough on its own. But why does it matter, one might ask, for the housing finance practitioner?

The key normative benefit for housing finance providers (mortgage institutes, banks, cooperatives etc) of predicting central bank short term interest rate decisions accurately lies in the reduction of information asymmetries[7] that prevail between the central bank and lenders. Logically, central banks themselves know best how strict or lenient they wish to be in their pursuit of price or exchange rate stability. Central banks also devote substantial resources to monitoring overall price level developments. For this reason, central banks bear an intrinsic informational advantage in comparison to private financial institutions about monetary impulses.

This inherent informational disadvantage experienced bears risks for lenders. First, there is the risk of interest rate mismatch. When offering long term fixed rates to their customers, housing finance providers are often exposed to risks of short term key interest rate fluctuations. This risk is particularly pronounced if lenders do not have access to funds of similar maturity from alternative sources. There is also an exchange rate risk in case lenders offer mortgage loans denominated in foreign currency but borrowers earn their salary in the local currency. But there are also more indirect risks such as the degree of accuracy of predicting overall house price developments. Whether monetary policy takes a loose or a restrictive stance on inflation matters to the long-term development of house prices. Lenders, who put a price tag on estimated value of the housing object in their calculation of collateral, risk over- or under-estimating overall price level developments.

Lenders, therefore, have an incentive to guess as accurately as possible where key interest rates are headed. The more aware the lenders are of where key interest rates are going, the less they are exposed to risk of interest rate, exchange rate mismatch or estimation of collateral. Given better knowledge of the expected key interest rate projectiles, housing finance providers will also be able to increase their long term planning horizon, their product portfolio, pricing strategies and therewith overall competitiveness.

While the normative benefits of accurate prediction of interest rate projectiles are certainly intuitively appealing, the big question that must be addressed now is how lenders will manage to reduce the inherent information asymmetries that prevail between him or her and the central bank. One strategy is to engage in costly central-bank watching activities. Central-bank watching can range from interpreting the meaning of the often cryptic utterances of central bank governors[8] to reading lots of newspaper interviews. Engaging in these activities, lenders will incur substantial monitoring costs. A viable alternative to engaging in costly central – bank watching is to assess whether or not a central bank is transparent.

What is Central Bank Transparency?

According to a recent comprehensive survey by Fry, Julius, Mahadeva, Roger and Sterne (Fry et al 2000), as many as 74% of central bankers consider transparency "vital" for the successful conduct of monetary policy. This strong

[7] Stigler 1961, Akerlof 1970, Stiglitz 2000

[8] (e.g. "the upward risks to price stability ought to be monitored", "the situation is characterized by frothiness").

normative assertion reflects a relatively new consensus amongst central bankers and academics, which Columbia economist Michael Woodford has summarized in his paper 'Central Bank Communication and Policy Effectiveness': "Central banking is not like a steering an oil tanker or guiding a space craft that does not depend on the vehicle's own expectations where it is headed. Because the key economic decision makers are forward looking, central banks affect the economy as much by guiding expectations as through any effects of central bank trading in the market for overnight cash" (Woodford 2005).

Directly, central banks are able to influence interest rate development at the very short end, that is weekly or monthly (Walsh 2005). Yet, monetary authorities can influence the development of long-term interest rates only indirectly: by disclosing parts or all of its exclusive information to the private sector. Openness should persuade economic agents that the bank's short term actions are well thought out, calmly planned and part of an overall, coherent, long-term policy approach. If the public believe the central bank is sincere, rational individuals will formulate their expectations and subsequently adjust their behaviour according to the utterances of the central bank.

Petra Geraats, the most prominent author on central bank transparency differentiates between 'information effects' and 'incentive effects'. "Information effects are the direct, ex post effects of information disclosure" (Geraats 2005). Information effects occur when the central bank shares private information, which it chooses from a clearly defined set of available data such as inflation prognosis, real economic developments, velocity and/or supply shocks, and inflation preference. The public benefits from being realistically informed and the central bank benefits because the public is more likely to formulate its expectations according to the central bank's – rather than other people's – information. Incentive effects occur because under transparency, the monetary authority no longer has the opportunity to make use of its intrinsic informational advantage in a manipulative way. Thus, transparency increases the likelihood that the information the public sector receives is truthful. "Incentive effects are the indirect, ex-ante structural changes in economic behaviour that result from the different information structure under greater transparency (Geraats 2005). Through transparency, the private sector's expectations - and consequently behaviour - are brought in line with the central banks' strategy. According to the 'expectations argument', transparency matters because it is one of the most effective, albeit indirect, monetary policy tools.

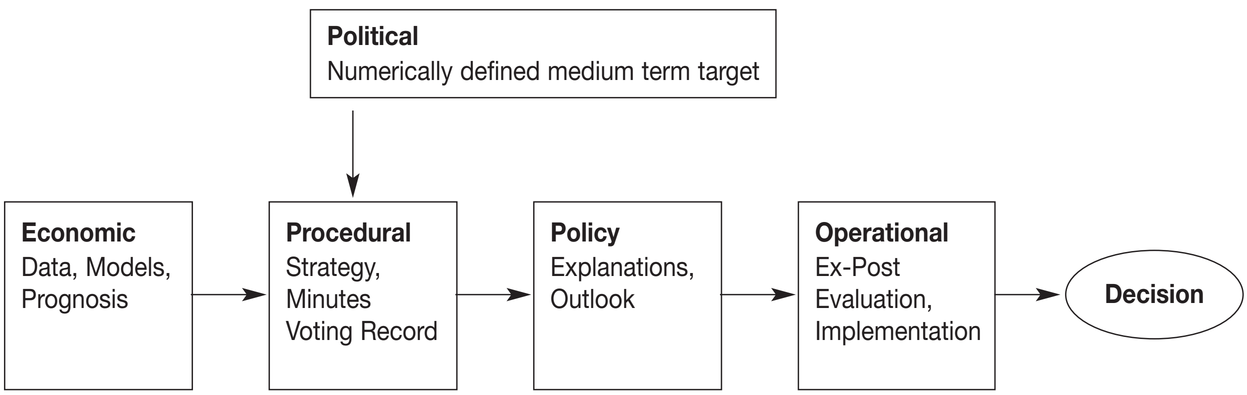
How is Central Bank Transparency measured?

Geraats, who has constructed the most widely used transparency indicator[9] isolates five distinct aspects (see figure 4). She differentiates between political, economic, procedural, policy and operational transparency (Geraats 2002). Each stage is weighted equally. Geraats' model serves not only as a 'quality badge' in terms of ranking an institution according to five distinct aspects, but also as a very useful model for external agents, such as for instance lenders. Especially the central bank's 'right' target function and its communication may be important for housing finance because a good sound knowledge thereof provides a useful guideline for where key interest rates might be headed.

Figure 4 provides a useful summary of the five features of central bank transparency.

(i) Political transparency refers to a clear commitment to and a distinct and numerical prioritization of monetary policy goals.

Figure 4: The five stages of transparency



Source: Own graph, adopted from Ladwig 2004.

9 Cruijsen/Eijfinger 2007

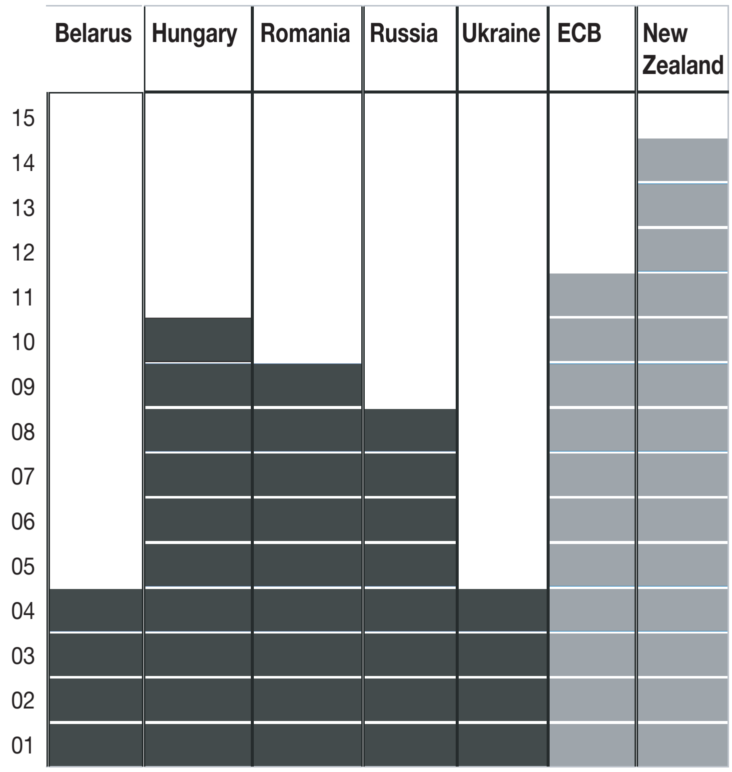
(ii) Economic transparency means that central banks publish the macroeconomic data upon which their particular monetary policy decisions are based.

(ii) Procedural transparency describes the road to the monetary policy decision itself. It encompasses the clarity of the monetary strategy, whether or not the minutes of the governing council sessions are published, and whether these councils reached decisions individually or collectively.

(iv) Transparency in policy means the way a monetary policy decision is publicly justified. Do central bankers explain for which reasons a certain decision was or wasn't reached? Do they provide an analytically meaningful outlook for the next period?

(v) Operational transparency refers to the clarification of the transmission mechanism. Does the central bank explain which effects monetary policy impulses are thought to have on the real economy and through which channels it believes adjustment to occur?

Figure 5 Transparency of Central and Eastern European Central Banks



Source: Own Database

Assessment: Where do CEEC central banks stand today?

So far, this paper has argued that monetary policy decisions have an impact on housing markets via four transmission channels: interest rate, credit, wealth and exchange rate. In Eastern Europe, the impact of monetary policy decisions on housing market developments is substantial, as can be seen - for instance - in the strong 0.73 pass through-rate on mortgage rates (as shown in table 1). In addition, we have seen that lenders stand to gain substantially from predicting monetary policy impulses accurately.

A viable alternative to costly central bank watching is to use the criteria employed for assessing transparency as a roadmap. Petra Geraats' model above is a useful indicator where to look inside a central bank to start trying to predict future monetary policy moves. Figure 5 shows that central banks in Central and Eastern Europe are actually doing quite well in terms of transparency. The inflation targeter New Zealand is often called the most transparent central bank of the world. Yet, Hungary – who are in the middle range of a global transparency league - manages to pick up 10 transparency points, Romania comes a close second with 9 and Russia still gathers as many as 9.[10] These scores are quite high up on a global transparency scale. Stakeholders should find it quite straightforward to anticipate central bank interest rate decisions and to act accordingly. Ukraine and Belarus, on the contrary, cannot really be labelled transparent just yet. Picking up 4 points each does not really suffice for steering inflationary expectations in a predictable manner.

To conclude, while central banks in Central and Eastern Europe appear to do quite well in providing an anchor for interest rate expectations, some central banks still have some homework to do. The less transparent a central bank is, the more difficult it will be for external agents, such as lenders to gauge risks arising from inherent information asymmetries between the external agent and the central bank. More transparent decision monetary policy decision making will make housing markets more efficient both in the short and the long term. Since efficient and stable housing markets are also in the best interest of monetary policy makers themselves, those central banks that have scored suboptimal transparency points so

[10] The author developed a transparency scale index from 0 to 15 whereby 15 means the highest scale to be achieved in terms of central bank transparency. See figure 5 for more details.

far, should aim to improve their transparency ranking.

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Appendix

1. Transparency Indicator

This first section describes the construction of Petra Geraats' transparency indicator. The index is the sum of the scores of the answers for the fifteen questions below.

Political Transparency

a) Is there a formal statement of the objective(s) of monetary policy, with an explicit prioritisation in case of multiple objectives?
No formal objective (s) = 0
Multiple objectives without prioritization = 0.5
One primary objective, or explicit prioritization = 1

b) Is there quantification of the primary objective (s)?
No = 0
Yes= 1

c) Are there explicit contracts or other similar institutional arrangements between the monetary authorities and the government?
No central bank contracts or other institutional arrangements = 0
Central bank without explicit instrument independence or contract = 0.5
Central bank with explicit instrument independence or central bank contract = 1

Economic Transparency

a) Is the basic economic data (money supply, inflation, GDP, unemployment rate and capacity utilization) relevant for the conduct of monetary policy publicly available?
Quarterly time series for at most two of the five variables = 0
Quarterly time series for three or four of the five variables = 0.5
Quarterly time series for all five variables = 1

b) Does the central bank disclose the macroeconomic model(s) it uses for policy analysis?
No = 0
Yes = 1

c) Does the central bank regularly publish its own macroeconomic forecasts?
No numerical central bank forecasts for inflation and output = 0
Numerical central bank forecasts for inflation and / or output published at less than quarterly frequency = 0.5
Quarterly numerical central bank forecasts for inflation and output for the medium term = 1

Procedural Transparency

a) Does the central bank provide an explicit policy rule or strategy that describes its monetary policy framework?
No = 0
Yes = 1

b) Does the central bank give a comprehensive account of policy deliberations within a reasonable amount of time?
No, or only after a substantial time lag of more than 8 weeks = 0
Yes, comprehensive minutes including a discussion of backward and forward looking arguments = 1

c) Does the central bank disclose how each decision on the level of its main operating instrument or target was reached?
No voting records = 0
Non-attributed voting records = 0.5
Individual voting records = 1

Policy Transparency

a) Are decisions about adjustments to the main operating instrument or target announced promptly?
   No, or only after the day of implementation = 0
   Yes, on the day of implementation = 1
b) Does the central bank provide an explanation when it announces its policy decisions?
   No = 0
   Yes, when policy decisions change, or only superficially = 0.5
   Yes, always and including forward looking assessments =1
c) Does the central bank disclose an explicit policy inclination after every meeting or an indication of likely future policy actions?
   No = 0
   Yes = 1

Operational Transparency

a) Does the central bank regularly evaluate to what extent its main policy operating targets (if any) have been achieved?
   No or not very often (at less than annual frequency) = 0
   Yes, but without providing explanations for significant deviations = 0.5
   Yes, accounting for significant deviations from target = 1
b) Does the central bank regularly provide information on (unanticipated) macroeconomic developments
   No or not very often = 0
   Yes, but only through short term forecasts or analysis of current macroeconomic developments (at least quarterly) = 0.5
   Yes, including discussion of past forecasting errors (at least annually) = 1
c) Does the central bank regularly provide an evaluation of the policy outcome in light of its macroeconomic objectives?
   No, or not very often (at less than annual frequency)
   Yes, but superficially = 0.5
   Yes, with an explicit account of the contribution of monetary policy in meeting the objectives

Condominium housing and mortgage lending in emerging markets – constraints and opportunities

By Carol S. Rabenhorst[1] and Sonia I. Ignatova[2]

Introduction – The Link between Housing and the Overall Economy

The link between a vibrant housing market and the overall health of a nation's economy is well-established in developed countries – construction and manufacturing jobs, wholesale and retail sales, population mobility and other factors are directly affected. In many countries, housing data is used as an economic indicator that changes before the economy starts to follow a particular pattern or trend, and predicts the health of a country's overall economy. In the United States, for example, a leading economic indicator is the *New Residential Construction Report*,[3] known as "housing starts" on Wall Street, a monthly report issued by the US Census Bureau jointly with the US Department of Housing and Urban Development (HUD). A downward trend in housing data was an early harbinger of the current economic upheaval in the United States.

On the other hand, a well functioning housing market can provide large external benefits to the overall economy, including the following:

- Better overall living conditions for families who can access and improve their shelter.
- Improved urban infrastructure, since housing demand stimulates utilities, schools, transportation and the like.
- Enhanced economic and social mobility within urban markets and regionally.
- Improved labor market mobility, diversity and accessibility.
- Increased motivation to save.
- Increased consumer spending.
- Increased spending and investment by homeowners who borrow against the value of their homes.
- More capital for entrepreneurs who borrow against the value of their homes.

International experience suggests that there is a strong causal link between housing demand, housing finance, financial sector development and economic growth. Through urbanization, the development process generates sharp increases in mobility and relocation, and housing investment increases as a share of GDP.[4] A housing market cannot flourish without mortgage finance, which allows all but the poorer segments of the population to purchase, expand or improve their homes, or to use the equity in their homes for other purposes, such as major purchases, college education, travel or investment. There is now growing recognition of these connections among policy-makers in developing countries, and among international development donors who wish both to strengthen financial markets and to improve the economic well-being of citizens in their client countries.[5]

Condominium Housing Markets in Developing Countries

In developing countries, mortgage markets start first in the largest cities, usually the capital city, where the commercial banking

[1] Carol S Rabenhorst is Senior Legal Advisor in the International Activities Center at the Urban Institute in Washington, DC. The Urban Institute has over 15 years experience with condominium housing in developing countries, beginning with the privatization of state-owned rental apartments in the early 1990s, and has played a leadership role in projects that prepared Condominium Laws, created condominiums as a legal regime of home ownership, established associations of owners in condominiums and helped owners access financing for renovation of their properties.

[2] Sonia Ignatova is a former Research Associate at the Urban Institute and a current JD student at the Georgetown University Law Center.

[3] See http://www.census.gov/const/www/newresconstindex.html. The data is derived from surveys of homebuilders nationwide, and three metrics are provided: housing starts, building permits and housing completions. A housing start is defined as beginning the foundation of the home itself. Building permits are counted when they are granted.

[4] Framing the Issues: Housing Finance, Economic Development, and Policy Innovation, Joint Center for Housing Studies of Harvard University, May 2005.

[5] See, eg, B Gwinner, Housing Finance in Developing Countries, World Bank, June 2006; IFC Access to Finance – Highlights Report, October 2007.

sector takes root, where there are enough potential borrowers to launch mortgage lending on a cost-effective scale and where housing units usually have the highest value. Condominium housing often represents a substantial portion of the potential market for mortgage lending in large cities; in many countries it is the largest segment of the market. Across Central and Eastern Europe (CEE) and the former Soviet Union, large-scale privatization of state-provided and owned apartment buildings in the early 1990s resulted in mass owner-occupied housing markets.[6] The new owners acquired ownership in the form known throughout the world as condominium – individual ownership of a unit and an interest in the common property (the entrance, stairways, roof, etc). In addition to the hundreds of thousands of formerly state-owned apartments that have been privatized, construction of new apartments in more recent years has added to the stock of condominiums in these countries. There are now 9 countries from the former Soviet bloc that are members of the European Union[7]; in most of them owner occupancy rates reach 90% or above, and at least 75% of the urban populations live in owner-occupied apartments.[8]

Other developing countries that have not undergone mass privatization programs also have growing condominium housing markets concentrated in the new construction sector rather than resulting from apartment privatization. In large cities in South Africa, Kenya, Tanzania, and in Thailand, Indonesia and India, many buyers with middle class and higher incomes regard condominium housing as highly desirable, especially in buildings with a high level of security and other services. Purchasers are the rising middle class, and sometimes members of the African or Asian Diaspora who have substantial funds earned in other countries and who wish to invest in and visit their homeland but are not able to reside there fulltime. Most new construction of condominiums must be financed by the purchasers themselves since there is little or no institutional finance available for multi-family housing development.[9]

Privatized condominiums in Eastern Europe and the former Soviet Union are often in extremely poor condition because low construction standards and years of deferred maintenance under the socialist regimes. The renewal, management and maintenance of multi-family residential buildings are regarded as one of the most critical problems in the region.[10] While the interior of the individual apartments were often kept in good condition by the residents, the common areas were usually grossly neglected. The owners have equity (that is, some “capital” that they can use as collateral) in their own apartments that could be used to secure financing for the renovation of their current home – either through individual loans for their own apartment or jointly with other members of the owners’ association for common area repairs or upgrading. Individual owners could also use their equity for the purchase of a larger or more desirable apartment or single-family home. Therefore, mortgage loans secured by condominiums should in principle be an important segment of mortgage lenders’ portfolios, and contribute substantially to the financial health of the housing sector, financial markets, the economic well-being of citizens and to a country’s economy of as a whole.

Constraints on Financing for Condominium Development and Purchase

Why then are we not seeing more robust development of new financing products, particularly for the development and purchase of units in condominiums in newly constructed buildings, and for renovation and repurchase in older buildings?

Three principal constraints account for the difficulty of making loans secured by apartments and for hampering the growth of developing mortgage markets. These are:

1. Inadequate, or non-existent, laws and procedures for registering title and other ownership interests in condominium housing;
2. Lack of experience among lenders with financing the development of condominium housing; and
3. Poor management of common areas of condominiums and inability to enforce the obligations of individual apartment owners.

This article discusses these three issues in turn – the constraints they pose and how they can be remedied, as means to expand the link between condominium housing and mortgage markets in developing countries. It offers a comparative analysis of the emerging mortgage markets in several countries and the developed mortgage sector in two countries – the United States and Australia, with focus on the role of the condominium sector in development of mortgage markets.

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6 In the majority of cases, ownership was transferred to the sitting tenants, generally with a legally mandated right to purchase under extremely favorable terms (e.g., below market price, small down payment, minimal or no interest rate, etc.)

7 Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

8 Schweinichen, Christina, UNECE, “Challenges in the Housing Sector – Experiences from Western and Eastern Countries, Paper Presented at ENHR Conference, Ljubljana, Slovenia, July 2006.

9 See Rabenhorst et al., Concept Paper: Mortgage Finance Legal Reform in Moldova, for EBRD, December 2006.

10 United Nations Economic Commission for Europe, Achievements and Challenges, 2006-2007.

ISSUE 1: REGISTRATION LAWS AND PROCEDURES

When property offered as collateral to secure a loan is not properly defined and registered in the land registry, it is impossible for the lender to register a mortgage on the property. In a condominium, the apartment and the share of common property appurtenant to the apartment should be registered as a separately identified parcel of real estate, and the mortgage should be registered against that. Procedures for such registration should be included either in a Condominium Law or the Law on Real Property Registration.

Land and buildings attached to land account for between half and three quarters of the wealth of most countries,[11] making secure property rights a key element of market-based economies, sustainable economic development, poverty reduction and good governance. Wealth represented by land cannot be effectively realized without effective registration systems. "Good land registration promotes an active land market and productive land use. It makes possible the security of tenure and the development of a mortgage market on which a functioning economy depends."[12]

In many developing countries and emerging markets, a large proportion of property is not registered, and the registry systems that exist do not afford adequate security. However, the last several decades have seen an enormous increase in property values and, partly as a result, a strong impetus for sound registration systems.[13] International donors have invested large sums in improving registration systems in large scale projects that often take from five to 10 years or more. However, in many transition countries, even those where property registration has undergone substantial reform, condominium housing is still not properly registered – making tenure insecure and the property less attractive to mortgage lenders.[14]

In the registration of condominiums, the respective components of the ownership – individual ownership of the apartment unit and co-ownership of the common parts of the building – must be clearly denoted in the land registry, including the percentage or share of ownership of the common property appurtenant to each apartment. This allows ownership and other rights, including contract rights, to be established and made enforceable, since some of the most important rights and obligations of the individual owners are measured by the percentage or share of the ownership interest in the common property. The amount of each owner's respective fee to maintain the common property, for example, is usually determined by the size of the individually owned property – the apartment – in relation to the other apartments, ie, the owner of the largest apartment pays the most to maintain the common property, owners of apartments that are equal in size pay equal amounts, and so on.

The condominium registration system in the United States is itself only 50 years old. The first condominium legislation in the US or its territories the Puerto Rico Act dated from 1958.[15] Three years later, the Federal Housing Association (FHA) enacted Section 234 of the National Housing Act of 1961 based upon the Puerto Rico model,[16] and also drafted a model statute–the FHA Model Condominium Act (1962) – in order to provide guidelines for the states in adopting their own condominium laws and at the same time ensure that they comply with the requirements of § 234.[17] The typical statutory scheme establishes a legal structure for the condominium development based on three organizational documents: (1) declaration or master deed; (2) bylaws; and (3) unit deed. The declaration or master deed is required for creation and registration of the condominium, and is also the document by which the condominium is established as a legal entity.[18] The information that a declaration must contain includes the name of the association for the condominium, the name of the condominium itself, the name of every county or district in which the condominium is situated, the largest number of units that the declarant reserves the right to build, etc.[19] The declaration also contains information on the allocation of common elements interests, votes, and

[11] Ibbotson, Siegal, and Love, *World Wealth: Market Values and Returns*; Journal of Portfolio Management (1985).

[12] *Guidelines on Real Property Units and Identifiers*, UN Economic Commission for Europe, 2004.

[13] In some countries registration itself has increased the value of property significantly. In Thailand, for example, since land registration and tenure reform began in the 1980s, titled land has become between 75-197% more valuable than comparable non-titled land. Burns, "*Thailand's 20 year program to title land*," World Development Report (2005).

[14] In Croatia, for example, virtually all of the former state-owned rental apartments have been privatized, but 90% of them are not properly registered in the deed registry, despite the fact that the World Bank loaned 25 million USD to Croatia in 2002 for improvements in the cadastre and land registration system.

[15] PR LAWS ANN. Tit. 31, § 1291-1293(k)(Supp. 1968)

[16] 12 USCA § 1715 (1988). This statute, or one of its descendants, was adopted in every American state.

[17] Most state enabling statutes followed this model initially, with some variations, as the drafters of the model statute had envisioned. *See* 1 and 2 Ferrer & Stecher, Law of Condominiums (1967) (providing the verbatim text and comparative analysis of the FHA Model Condominium Act and the state statutes.)

[18] Uniform Condominium Act (1980), § 2.101 ("A condominium may be created pursuant to this Act only by recording a declaration executed in the same manner as a deed.")

[19] Uniform Condominium Act (1980), § 2.105

common expense liabilities.[20] The unit deed is the instrument by which the interest in each unit, along with an appurtenant interest in the common areas, is conveyed to each unit owner. The bylaws contain information on how the condominium is to be governed – usually through a legal entity called an owners' association, and sections on election of officers and their responsibilities, election of members of the board of directors and their responsibilities, meeting and voting procedures, rules regarding payment of fees for regular and special assessments, and the like. The unit deeds are similar to any deed for individually owned property, but also contain a reference to the condominium common property and the share appurtenant to the unit.

Condominium laws in transition countries in CEE, especially those with EU membership, such as Hungary, Slovakia and Romania, generally follow the US model with regard to allocation and registration of interests. Many countries, however, particularly in Africa and Asia, have inadequate condominium laws and property registration; some have no condominium law at all. Kenya and Moldova are examples. Under their laws, it may not be clear how the common property is allocated among the owners of apartments, and what the responsibilities for maintenance and operating expenses are. In those places, registration records may not be correct and title to condominium property is often not considered adequately secure for mortgage lending purposes.

ISSUE 2: FINANCING THE DEVELOPMENT OF CONDOMINIUMS

Demand for housing in newly developed apartment buildings is very high, but mortgage lenders are constrained from tapping into this market. In many places, the usual way to finance the construction of apartment buildings is for the apartment buyers to pay a substantial portion (sometimes all) of the sales price to the developer before the building is built. The mortgage system is bypassed, and the owner takes the risk that the apartment will never be built or not built to the expected standard. In addition to providing for the establishment of condominiums as a form of real estate, a Condominium Law also should regulate the activities of developers, by providing for the shift from developer to owner control of the building, warranties against construction defects and preparation by the developer of proper legal documentation for registration of the property and the owners' association

In countries with developed housing markets, there is a tested scheme for financing multi-family, owner-occupied housing. Construction loans are available to the developer, on commercial loan terms, coupled with "take-out" loans to purchasers of apartments on mortgage loan terms. The individual mortgage loans may be used to reduce the developer's obligation on the construction loan as the apartments are purchased, or may simply be paid to the developer.[21]

In the US, for example, many buildings are financed by two different loans before and after completion of the project. During the construction phase, a construction lender provides the money that the developer needs to finance the actual construction in the form of a construction loan. This is a short-term loan that gets paid in full upon completion of the building(s). At that point, the financing for the project is provided by a long-term loan – the permanent financing. In order to ensure the existence of permanent financing and minimize their own risks, construction lenders require that a developer seek and obtain a takeout commitment from the lender who will provide the long-term financing for the project before they release the construction loan. The takeout commitment, usually in the form of a letter, guarantees to the construction lender that at the time of completion of construction, there will be another lender to take over the long-term financing of the project. It does not, however, remove all other risks associated with construction loans that construction lenders must bear in mind. On the other hand, the long-term lender, by making a loan for a building that has already been constructed, need not be concerned that the developer might abandon the project prior to completion.

One important protection for construction lenders is the requirement that a developer invest a substantial amount – at least 5%, more often 15-20% – of its own funds in the project in order to reduce the risk to the construction lender if the developer fails to complete the building. Virtually no commercial lender today would fund 100% of a development; in fact, regulations may require that the maximum loan-to-value ratio be limited to a certain percentage.[22] In addition, the loan is advanced to the developer in several payments, each following the satisfactory completion of a phase in the construction as stipulated in the construction loan agreement. Further

[20] Uniform Condominium Act (1980), § 2.107

[21] The Uniform Condominium Act permits each of these allocations to be made on different bases and to be unrelated to value. The bylaws of the condominium association set forth matters related to the operations of the association and the internal management of the condominium. They provide for the number of members of the executive board, the election of various board members, their qualifications, powers, and duties, which of the officers may prepare, execute, certify, and record amendments to the declaration on the behalf of the association, and the method of amending the bylaws.

[22] In the US, there is almost no secondary market for construction mortgage loans. Fannie Mae piloted a construction loan pilot program where the mortgage on the ultimate units would be under the conforming loan limit, but suspended the program in 2006 after concerns about the security of the secondary market instruments were raised by Fannie Mae's regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), after an OFHEO safety and soundness audit. Freddie Mac has been even less involved in the housing production market, due to charter restrictions that limit Freddie Mac to dealing only with loans associated with a completed residence.

protection for the lender from default, which can include anything from shoddy work to abandonment of the project as well as nonpayment, is provided by the purchase of a performance bond by the contractor, which guarantees that the contractor will satisfactorily complete its obligations under the construction contract. The bond may also be used in the event that estimates exceed the actual costs of completion of the project.

These requirements and conditions for making a construction loan, while applicable to condominium financing, are not unique to condominium projects and apply to construction financing in general.[23] However, due to the specific risks[24] associated with the condominium type of ownership, condominium construction loan documentation may receive more scrutiny that other construction loans. Special areas of concern include: (1) the underwriting analysis; (2) compliance with state and federal regulation; (3) presale and resale requirements; (4) condominium document review; (5) availability of permanent financing (multiple unit end loans); and (6) assignment of developer rights.

How does a scheme like the one in the US develop and how long does it take? The condominium enjoys wide acceptance among American home buyers today and perhaps this is why we tend to forget that condominium as a form of home ownership are of quite recent origin. An account of the history of the development of the US condominium market reveals that some of the issues that arose in the United States as the market was developing are the same ones faced by market participants in countries with developing mortgage markets today.

In the 1960s and 1970s, lenders in the United States had significant concerns as to whether this new type of ownership known as condominium would gain market acceptance among buyers. Construction loans for the financing of condominium development came with an attached pre-sale condition, which required the developer to have pre-sold a certain percentage (typically 60-70%) of residential units in a condominium project to qualify for a construction loan.[25] Because the demand for condominiums at the time was high, developers were easily able to sell units in buildings that were yet to be built and to meet the lenders' pre-sale requirement Lenders, previously overly cautious, became overly confident when they saw the large profits from the sales of condominiums and started making construction loans that financed virtually 100% of the developers' cost of acquiring the land, constructing pre-sale models to show to prospective buyers and the common areas of the projects. But when the oil embargo by the Organization of Petroleum Exporting Countries (OPEC) triggered dramatic increases in the cost of construction materials in the mid-1970s, and developers found themselves unable to complete their projects for anywhere near the initially contemplated cost, many of them walked away from the unfinished condominium projects. Since almost all the financing had come from construction loans, rather than developers' own money, the lenders were left to bear the financial burden and to foreclose on a large number of unfinished projects. This episode repeated itself once more in the mid-1980s when borrowers had once again been able to negotiate loans on a fully exculpated basis[26] in the context of a booming real estate market and lenders once again had to foreclose on the projects when the market collapsed in the late 1980s. The lenders ended up with condominium units that were worth far less than the amount of the loan and the owners of units in unfinished condominium projects found themselves having prepaid for units that would never be built (at least not at the initial cost). And both had no recourse against the developers and no claim for the developers' assets other than the unfinished condominiums.

The current problems in the US mortgage market have affected the security of construction loans for condominiums as well as individual mortgage loans, with commercial banks and real estate investment funds bearing the losses. The percentage of condominium construction loans that are in default have been steadily increasing from 2.6 at the end of 2006 to 10.1 at the end of 2008.[27] Increases are attributable to slow sales and broken sales contracts, as the value of condominium property decreases. It remains to be seen whether lenders will learn from this history and avoid the no-recourse and no equity lending allowed in the past.

ISSUE 3: MANAGEMENT OF COMMON AREAS AND ENFORCEMENT OF THE OBLIGATIONS OF INDIVIDUAL OWNERS

In the aftermath of privatization in CEE, large numbers of new owners were required by law to assume management responsibility for their buildings but did not

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[23] Many apartment buildings in the United States are built for the rental market, which includes all income levels, as well as for owner occupancy. The same loan structure could apply to rental buildings, with a mortgage on the entire property used to secure the permanent financing.

[24] Because owners of individual units share the common parts of buildings – such as common entrances, elevators, and stairs, - the value of the individual units depends both on the maintenance of the units and the maintenance and upkeep of the common areas. The maintenance of the common parts and the good management of the entire building are thus crucial in condominium-type developments.

[25] Kane, Richard J "The Financing of Cooperatives and Condominiums: A Retrospective." 73 St John's L Rev 101, Winter 1999, p 3. It is also generally true today in many countries with developing mortgage sectors that developers have to pre-sell the units in a condominium project before construction has even began yet in order to secure financing for the project.

[26] In the event of default, the lenders' only recourse would have been to foreclose on the security, with no right to pursue any of the borrowers' other assets.

[27] The rates were 4.2% at mid-2007 and 6.0% at the end of the third quarter 2007. Foresight Analytics, Oakland, CA, February 2008.

have the financial, legal or technical tools to fulfill their obligations. Today, condominium owners in transition countries continue to face problems such as unclear delineation of their rights and responsibilities, lack of meaningful choices in contracting for management and maintenance services and inadequate financial resources to make needed repairs to their apartment building. This is also the case in other emerging markets in Asia and Africa. Without a well-drafted Condominium Law, there is no system for managing the common areas of the apartment building and for enforcing rules and obligations imposed on the apartment owners.

Clear condominium rules and obligations are important in the mortgage context. Inadequate maintenance and management practices result in diminution in value of apartments, which makes it difficult to underwrite a long-term loan for an apartment and increases the lender's risk of loss of value of the collateral. If there is no owners' association constituted as a legal entity, buildings in poor condition cannot obtain mortgage financing to renovate, since an association is necessary to organize the individual owners and enforce their obligations to pay debts. Minimum quality standards for mortgage lending should require establishment of a condominium owners' association, and evidence of an appropriate governance and rules enforcement structure. The Condominium Law should set out the fundamental rights and obligations of ownership, with specific rules relating to the operation of a particular building adopted by the owners in the form of bylaws.

Australia is often looked to as a model legal regime for condominiums, particularly by Asian countries such as Singapore, Indonesia, Indonesia, Malaysia, the Philippines and Fiji. The current legislation in Australia, the Strata Schemes (Freehold Development) Act 1973, was enacted to resolve the most common problems in condominium-type developments – the rights and responsibilities of unit owners, the management of common areas and the resolution of disputes. The 1973 Act repealed earlier enabling legislation, the Conveyances (Strata Titles) Act of 1961, and contained new provisions to deal with the problems. It introduced more stringent by-laws defining the obligations of individual owners, detailed the functions of the "body corporate" (the owners' association) and required the developer to conduct a meeting with the body corporate within a month of selling one-third of the units in a building. This avoids leaving the development without effective management at any given point in time, and provides a system to expedite the resolution of disputes.[28]

In the 1960s and 1970s, in Singapore, a strong economy led to an increased pace of construction, particularly condominium-type developments, spurred by local demand as well as by demand from foreigners. Before the introduction of legislation, there was no way to regulate the behavior of owners of individual units in a subdivided building, no platform for the informal adjudication of disputes, and resort to the courts was expensive and slow. Singapore passed a Land Titles (Strata) Act in 2001, basing registration of condominiums on the Torrens system similar to that used in Australia, and a Building Maintenance and Strata Management Act in 2004.[29]

How detailed should the rules on condominium management and governance be? Cultural norms often dictate what is and what is not included in condominium bylaws and in house rules. House Rules, which relate to operation of the building and relationships among owners, need not be registered with the other documents and tend to be easier to adopt and amend than bylaws. Two rules of a condominium association in Singapore are particularly interesting and reflect the values of that particular community/culture: "(g) when upon the common property to be adequately clothed;" and "(l) ensure that the part of the floor is sufficiently covered where chillies are being bounded to prevent transmission of noise likely to disturb the peaceful enjoyment of another subsidiary proprietor or occupier."[30] In the US, it is said that condominiums house rules often relate to The Three P's – parking, pools and pets. Examples include what kinds of vehicles can be kept in the parking garage, supervision of children at the swimming pool, whether pets are permitted and if so their maximum weight.

In the United States, the rights and obligations of unit owners with regard to property management are generally stipulated in bylaws passed by the owners by majority rule. In Singapore, the by-laws are set forth in Schedule 1 to the Act.[31] While rules in one building may seem irrational to residents of another, the point is that good management and governance – and maintenance of property values – require clear and reasonable rules and the means to enforce them.

Conclusion

Condominium markets are expanding all over the world, especially in large cities, as more people see owner-occupied apartment housing as an attractive alternative to single-family housing – more affordable, secure, easily serviced by urban infrastructure, energy and resource friendly. As mortgage markets continue to develop apace, lenders will find ways to solve the problems of financing construction and purchase of apartments, as long as laws on property registration and operation of condominiums are

[28] See Christudason, "Subdivided Buildings: Developments in Australia, Singapore and England," International and Comparative Law Quarterly (1996), 45:343-364 Cambridge University Press p 348.

[29] Christudason, p 350

[30] Christudason, p 361

[31] Christudason, p361

carefully drafted and enforced. This will require collaboration between the private sector and government legislators and policy makers. With good example provided by the US and Australia, already adopted in some of the more advanced markets in Europe and Asia, the future looks bright for condominium housing mortgage lending.

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Ghana Residental Property Delivery Constraints and Affordability Analysis

By Dr. Noah Kofi Karley[1]

1.1 Quantity and quality of housing

Residential property makes up a significant component of the stock of property in Ghana. But Ghana faces a housing shortage which has worsened due to rapid population growth and increasing urbanisation. Notwithstanding recent improvement in urban housing development activities, increasing overcrowding, declining quality and access to services characterise much of housing stock in the country. The most common method of residential building is the incremental building, where owners become self-developers and rely on small crafts and trades to build their own units (World Bank 1993). Construction is executed gradually, according to the available sources of funds to owners. But the main feature of this method is the time to complete the house. This trend has implications on the quantity and quality of the dwellings. The informal construction industry is also not capable of meeting demand and providing large quantities of houses, especially in urban centres.

The total housing stock consists of formal and informal housing. The housing backlog is simply the difference between the housing need (effectively, the number of households) and the total housing stock at a time. The shortage of housing in Ghana grew faster during the intercensal period 1970 to 1984. For the country as a whole, the average number of persons per dwelling unit fell from 10.57 to 9.05 from 1960 to 1970, but by 1984 it had increased again to 10.11 and was 5.1 by 2000 (GSS, 2000), an indication that some improvement had taken place in the housing situation. The 2000 Population and Housing Census indicate that total Ghana housing stock is about 2.2 million. The data suggest that the existing housing backlog in Ghana exceeds 500,000 units and whilst the supply figures vary between 25,000 and 40,000 units per annum, the annual requirement is estimated at 70,000 per annum. The inability of the housing delivery system to meet housing needs over the years has created strains on the existing housing stock and infrastructure, especially in urban areas.

Additionally, the housing environment is characterised by haphazard development, inadequate housing infrastructure, poor drainage, erosion and high population concentrations (TASC 2005). In Accra, the biggest urban centre in the country, although the housing conditions are better, the overall housing conditions can best be described as poor quality material such as mud, untreated timber and zinc roofing sheets for walling. Further evidence of poor quality relates to roofing materials. Asbestos roofing sheets are considered injurious to health and therefore illegal in certain countries eg in the UK. About 46% of buildings in Accra are roofed with this material. Moreover, households per house in excess of 2.2 for greater Accra and most cities is extremely high density. However, the active formal real estate development in urban areas especially in Accra is helping to improve the quality of urban housing stock.

1.2 Housing delivery and constraints

The housing problems in Ghana are characterised by both backlog in the provision of formal housing and the resultant sprawl of informal settlements. The informal construction industry is not capable of meeting demand and providing large quantities of houses. The formal sector therefore has a role to play in provision of housing especially in the urban areas. Formal housing construction was in the past undertaken by government through state agencies (Karley and Akomea 2007). But government realised that its housing financing policy was not sustainable and that it would rather facilitate construction by encouraging the private sector to participate. This changed the role of its agencies to becoming market players and competing with the private real estate developers. But housing delivery process is characterised by high costs. Attempts to resolve the housing problem requires seeking solutions to the problem of land availability. Other constraints faced by housing developers include the lack of capital, utility infrastructure issues, inability to procure materials at low cost and inadequacy of labour. For most private sector developers, the typical housing unit cost breakdown is as shown in Table 1. Depending on the location and

[1] Dr Karley is Lecturer in Urban Real Estate Management at, School of the Built Environment, Heriot Watt University, Edinburgh, United Kingdom. The author is grateful to the Royal Institution of Chartered Surveyors Education Trust for funding this study.

Table 1: Housing unit cost breakdown in Accra, Ghana

Cost item	Proportion of cost
Land	15%
Financing	20%
Infrastructure	13%
Material & labour	36%
Overheads and profit	16%

Source: Interview with NTHC Properties and ISADA Homes, August 2007

circumstances, costs for similar housing units in the UK are for land (up to 50%), finance (up to 10%), material and labour (up to 40%) and overheads and profits (about 20%).

1.2.1 Land cost

Land acquisition and registration constitutes about 15% of the cost of housing unit. This normally includes costs associated with the extremely time consuming, expensive and cumbersome process involved in land acquisition and registration. The country's land market is concentrated in Accra and other major cities. Land prices are extremely high in upscale residential areas in Accra such as Cantonments, Labone and the Airport Residential Area with price range from US$120,000 to US$200,000 for a 0.4 acre plot. According to NTHC Properties (2007) source serviced 100x70ft plot in areas near the capital such as East Legon, Tema and Sakomono is for sale at between US$12,000 to US$18,000. A study of informal urban land transactions in Accra also shows that whilst the land price is often artificially over priced, the willingness to pay a high price for a plot of land is influenced by several factors including the level of development, water and electricity nearby, access road availability, litigation and layout approval. But location has been the strongest determining factor.

1.2.3 Finance cost

One of the biggest problems facing housing construction is the lack of funds for developers of all sizes. Finance constitutes one-fifth of cost of a housing unit. But lending terms in Ghana in the last few years have been extremely onerous for developers. The interest rates were about 40% in the early 2000s, but went down to a still high 29% in 2004 when inflation had fallen from 30% to about 15%. Currently, development loans from financial institutions, if granted, are often at very high rates, in the region of 25% to 30% but maturities in the market are very short - from a few months to a maximum of two years in most cases (ISADA 2007). Banks appear to be interested in investing in relatively low risk financial instruments such as government bonds and treasury bills. The high development cost means housing construction is often undertaken incrementally through personal savings. But some large developers pool funds from other sources including overseas. For example, Regimanuel Construction Ltd is one of the successful developers to attract investors from Texas in the US to invest in Regimanuel Company and now changed the company name to Regimanuel Gray Ltd in 1991. Other real estate developers raise capital by selling housing products to potential buyers off plan. But this often proves difficult in view of the fact that not all potential buyers are able to keep to the payment schedules.

1.2.4 Infrastructure provision and cost

A key attraction to a housing estate is the infrastructure available in the area. Access roads, water, sewerage and electricity connections are the most important utility services which needed to be provided. But the lack of development of these facilities by municipalities in the country means that real estate developers have to ensure that these infrastructures are developed to ensure that the end housing product will be purchased. Real estate developers wanting to connect their residential projects to this infrastructure must bear the full costs of connectivity to the main system, which can be very expensive. It is estimated by developers that investment in infrastructure varies from 10% to 30% of the price of a housing unit depending on the location of the site in relation to existing utilities' infrastructure. All these charges are, however, passed onto the ultimate house purchaser. Owing to recent increases in government investment in infrastructural development, there has been a reduction in infrastructure cost in the overall cost of housing unit to about 13% for major real estate developers.

1.2.5 Materials cost and labour

In Ghana there appear to be an overdependence on external markets particularly for building materials for which local substitutes can be developed and for which there is comparative advantage for local production. Iron rods, cement, tiles, paint and a host of other materials are imported. Although there are no capacity constraints, the level of material prices can have a negative impact on housing programmes. The average price increase for cement between 2005 and 2007 was excessive, at roughly 100%. Also, the high cost of credit has had adverse effects on the cash flow of building materials enterprises. Thus, a common factor cited for low plant capacity utilization was the lack of working capital to purchase raw materials.

Housing delivery is also limited due to the fact that real estate developers do not have enough capacity. Mass housing programmes will require more and skilled construction companies. The unavailability of construction companies with the required skills and expertise for the development of significant real estate projects highlights market failures which hinder housing market development.

1.3 Housing Affordability

Despite the fact that affordability is frequently mentioned as an important factor in discussions about housing market prospects, it is something which is rarely defined. In reality commentators, analysts, policy-makers and others tend to have in mind a fairly wide range of concepts. In the late 1980s housing affordability was the focus of national housing programmes in many countries. In the USA and Britain, for example, concerns were heightened about the growing number of homeless, rising rent-to-income or mortgage-to-income ratios for lower and middle income households. Studies (Fallis 1993; and Bramley 1994) have revealed that affordability became an issue in housing as countries moved towards a more market oriented housing sector.

Whilst affordability has been viewed from different standpoints, it is clear that in expressing affordability, account is taken of the relationship between the level of housing expenditure and household income. The view taken in this paper concerns households' ability to 'reasonably' meet the consumer costs of housing suitable to their needs (Bramley and Karley 2005). Affordability in this case refers to the ability of the household to meet the monthly mortgage or rent payment which is generally approximated as a third of the total household income. This view incorporates both elements of housing with acceptable standards without imposing unreasonable burden on the household income. Affordability is influenced by a range of factors including wealth, fiscal and monetary policies, house price and financial market characteristics. For any individual, the affordability of housing will change over time, depending on such factors as salary progression, number of dependants, age, job security, and changes in interest rates and so on. But generally, the affordability of mortgage loans is dictated by three main factors namely, house price, income and the mortgage product available.

1.3.1 Housing types and prices

Typically, the range of current housing products available in the formal residential property sector in Ghana can be categorised as shown in Table 2 (a). However, it must be noted that the product range and prices depend on the type of developer. For government construction companies and agencies such as the State Housing Company (SHC) and the Social Security and National Insurance Trust (SSNIT) they tend to deliver housing with a focus on affordable housing and so their products are arguably developed to suit this market. Since the SHC was established in 1955 it has delivered a total of about 20,773 housing units, 8,417 of which are in Accra. This is a fairly low number, considering over 50 years of operation. Over the years SSNIT has been involved in a number of housing schemes including built to rent; approximately 12,000 housing units were built under this scheme but later most were offered for sale to sitting tenants. The products and average price range of these parastatal development institutions can be seen in

Table 2(a): Typical house type and prices in Ghana

House type	House price (GH¢)
Low income housing	Up to 50,000
Mid income housing	50,000 – 100,000
Mid – high income housing	100,000 – 150,000
High income	200,000 -300,000
Executive housing	Over 300,000

Table 2 (b): Typical house type and price range delivered by parastatals

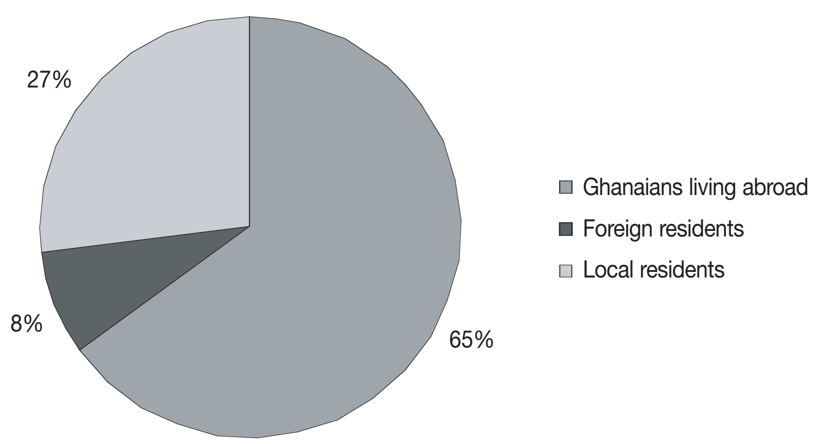
House type	House price (GH¢)
1 bedroom semi-detached	Up to 30,000
2 bedroom semi-detached	35,000 - 42,000
2 bedroom detached	48,000 - 50,000
3 bedroom detached	60,000 – 75,000
4 bedroom detached	Over 80,000

Table 2 (c): Typical house type and price range delivered by private developers

House type	House price (GH¢)
2 bedroom semi-detached	Up to 48,000
3 bedroom semi-detached	60,000 - 80,000
3 bedroom detached	80,000 - 120,000
3/4 detached Executive house	150,000 - 200,000
Two Storey Semi detached	200,000- 250,000
Two Storey detached	Over 300,000

Source: Derived from Websites of NTHC Properties, ISADA Homes, Regimanuel Gray
NB: Exchange rate £1.00 = GH¢1.85 = USD$2.00, October 2007

Figure 1: Client profile of private real estate developers in Ghana



Source: Interview with NTHC Properties and ISADA Homes, August 2007.

Table 2(b). Table 2(c) also shows the housing products and average price range of residential property developed by private developers such as Regimanuel Gray Ltd (current market leader), Manet Ltd, NTHC properties Ltd, ISADA Homes Ltd etc.

Generally, houses priced at GH¢50,000 and above in 2007 comprised 70% of the total development/sale volume by private developers (GREDA 2007). Besides, most transactions above the GH¢100,000 category were in the Tema and Accra metropolis. But sales over GH¢250,000 were predominant in the city of Accra. By type, detached houses are the most preferred house type capturing over 50% of units launched by most real estate developers in Accra and Tema during the past 5 years. However, there has been an increasing trend towards, and popularity of, semi-detached houses that have relatively lower construction cost and are also attractive to smaller families. High rise units were introduced by SNNIT in major regional capitals in the country as part of their housing schemes mainly for letting but most of these units have been sold to sitting tenants. High rise buildings appear to be unpopular because of their small sizes and for reasons including cultural factors.

In spite of this range of prices, most of the delivered housing units are in the mid to high income range. Most customers of private developers tend to be Ghanaians living abroad as demonstrated in Figure 1 that shows client profile of the major real estate developers.

Distribution of households by occupancy status in urban areas in 2000 as shown in Figure 2 suggests a high share of rentals in Ghana. In 2000 only 24% of urban population was owner occupiers and nearly 40% were renting. The high level of housing relative to income and unaffordable mortgages contribute significantly to the high share of rentals. This phenomenon was also encouraged by certain tax advantages. Currently, the tax code (Internal Revenue Act, 2000 (ACT 592) section 17) provides a five-year tax exemption to a person earning rental income, residential or commercial but this does not apply to owner occupation. A five-year tax exemption status is also provided to real estate developers (who construct for sale) and rental management companies (that manage residential premises only), during the first five years of existence (Internal Revenue Regulations, 2001 (LI 1675) section 16). These types of residential properties for commercial purposes are growing in popularity but still make up a small element of institutional portfolios compared to offices and other types of commercial properties (SSNIT 2007).

In the rental market, most cities in Ghana registered growing rentals between 2005 and 2007. But in the Accra and Tema metropolis higher rental increases of 30% to 40% were reported across all types of residential properties. Monthly rentals are normally quoted in US dollars. For a typical three bedroom house in a good location in Accra depending on facilities such as furnishing, air condition etc, the monthly rent ranges from US$400 to US$600 per month. Rents for a one bedroom flat or bed sit accommodation in down town Accra and other suburbs are between GH¢40 and

Table 3: Estimates of average income according to expected tax return for 2007*

Number of employees	% out of total	Monthly household income ranges (GH¢)
245,881	17	30-85
354,679	28	85 – 415
781,623	52	415 – 835
32,881	2	835 - 1,665
17,710	1	Above 1,665

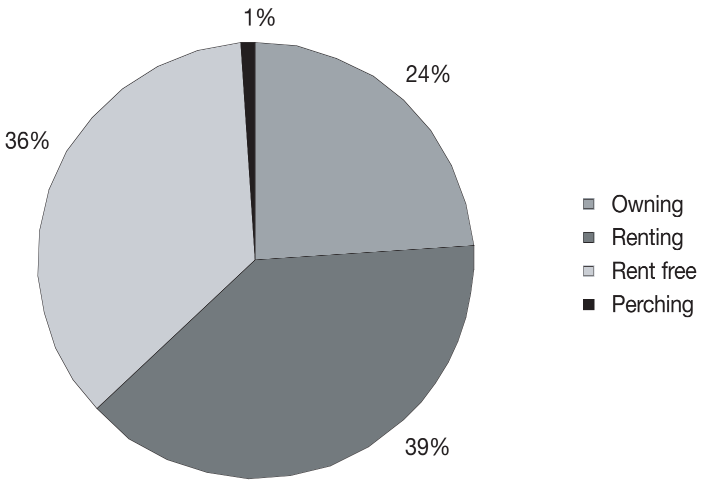
*Source: *Own estimates based on Internal Revenue Service (IRS) expected tax return for 2005 and inflation; NB: Exchange rate £1.00 = GH¢1.85 = USD$2.00, October 2007.*

Table 4: Characteristics of housing loans in Ghana mortgage market

Loan types	Loan Characteristics	
	Resident Ghanaian (Cedi Loans)	**Non resident Ghanaian (Foreign currency loan)**
Home purchase mortgage		
Maximum loan	US$120,000 or cedi equivalent (revised upward)	US$120,000 (revised upward periodically)
Minimum down payment	20% of proposed loan	20% of proposed loan
Maximum term	20 years	20 years
Processing fee	1.5% of proposed loan	US$250/£150
Deposit against statutory fees (towards registration of legal documents)	3.5% of proposed loan	3.5% of proposed loan
Home Completion Mortgage		
Maximum loan	US$120,000 or cedi equivalence	US$120,000 or cedi equivalence
Minimum contribution	50% of cost, construction at lintel level	50% of cost, construction at lintel level
Maximum term	15 years	15 years
Processing fee	1.5% of proposed loan	US$250/£150
Facility fee	Nil	1% of proposed loan
Management fee	2.5% of proposed loan	2.5% of proposed loan
Legal fee	1% of proposed loan	1% of proposed loan
Home Improvement Mortgage		
Maximum loan	50% of the value of the property and not exceeding the ceiling of US45,000 or its equivalent in cedis	
Maximum term	15 years	15 years
Processing fee	1.5% of proposed loan	US$250/£150
Facility fee	Nil	1% of proposed loan
Deposit against statutory fees (towards registration of legal documents)	2% of proposed loan	1% of proposed loan
Home Equity Mortgage		
Maximum loan	80% of the forced sale vale of the property or US$120,000 its equivalent in cedis (whichever is lower)	
Maximum term	15 years	15 years
Processing fee	1.5% of proposed loan	US$250/£150
Facility fee	Nil	1% of proposed loan
Deposit against statutory fees (towards registration of legal documents)	1% of proposed loan	1% of proposed loan
Buy, Build and Own a Home		
Maximum loan (BUY LAND)	US$15,000 or its equivalent in cedis	US$15,000
Minimum loan (BUILD)	US$35,000 or its equivalent in cedis	US$35,000
Maximum term	10 years each for a total of 20 years	10 years each for a total of 20 years
Minimum down payment	10% of total cost of the land	10% of total cost of the land
Processing fee	1.5% of proposed loan	US$250/£150 per each proposed loan
Facility fee	Nil	1% per each proposed loan
Design and inspection fee	1% on Build and Own portion of loan only (3.5% of loan on new plots)	

Source: Derived from Website of Main Mortgage lender in Ghana, Home Finance Company Bank (HFC Bank), website last accessed on 27 Jan 2008.

Figure 2: Distribution of households by occupancy in urban areas, 2000



Source: Derived from 2000 Population and Housing Census

GH¢60 per month. These are often with limited or shared facilities. In most situations tenants are required to make advanced payment equivalent to a minimum of one year full rent.

1.3.2 Household incomes

Mortgage affordability is also affected by income levels. Income levels directly affect the capability to afford the down payment required for a mortgage and the subsequent ability to afford the monthly mortgage payments. The economy of Ghana and for that matter the labour force is mainly involved in informal activities. The informal sector includes all workers that work in private establishment without any records such as salary, employment conditions etc regarding their employment. In view of the fact that this sector is the dominant sector holding majority of the labour force in Ghana it is difficult to make realistic estimate of incomes. Moreover, many households in formal employment have additional jobs in the informal sector. Nevertheless, we used expected tax return data for 2005 from IRS to estimate formal sector household income levels for 2007 as shown in Table 3.

1.3.3 Mortgage products

The problem of affordability is among others synonymous with the lack of end user finance and emerges as a major constraint to the housing delivery effort in Ghana (Asare and Whitehead, 2006). The main housing loan products being offered in Ghana by the main lenders are described below. They range from conventional mortgage loans in the high-income market to small loans designed to address incremental housing investment. The products are categorised into five as shown in Table 4 namely, Home Purchase Mortgage (HPM), Home Completion Mortgage (HCM), Home Improvement Mortgage (HIM); Home Equity Mortgage; and Buy, Build and Own a Home Mortgage (BB&OH). In all cases the mortgage rate varies between 10% and 14% for foreign currency denominated loans and from 19% upwards for cedi denominated loans. But this also varies between borrowers depending on individual credit rating.

Home Purchase Mortgage: The Home Purchase Mortgage is designed to assist individuals and companies to purchase residential properties for their own use or for investment purposes. The maximum loan amount is US$120,000 or its equivalent in cedis. The maximum term for this facility is 20 years for both flexible repayment loans and standard conventional reducing balance loans.

Home Completion Mortgage: This product is intended to assist applicants to complete the construction of their houses. The amount required from the lender to complete the house must fall within the maximum loan limit of US$120,000 and must not exceed 50% of the total cost of construction of the property and the property must have reached at least the lintel level. The maximum term for this facility is 15 years for both cedi and foreign currency loans. Applicants are required to submit duly registered, clear and undisputed title to the property. A development permit, building permit and approved building plans are also necessary requirements. The loan is disbursed in three stages. The lender will inspect the property after each stage of disbursement to ensure that the funds are utilised as agreed.

Home Improvement Mortgages: This mortgage product is designed to assist applicants to undertake renovation and extension works on their existing houses. The target group for this product are existing homeowners and companies with properties. The maximum term for this facility is 15 years for both cedi loan and foreign currency loan. The applicant is to provide clear and undisputed title to the property, which must be duly registered.

Home Equity Mortgage: This facility is designed to enable applicants who own homes or may have already invested in residential properties to release the equity in those properties to improve their liquidity position. The target group for this product are existing homeowners and companies with properties. Loans must not exceed a maximum of 80% of the forced sale value (FSV) of the property. The maximum term for this facility is 15 years for both cedi and foreign currency loans. There must be clear and undisputed title to the property. The title must be duly registered.

Buy, Build and Own a Home: This facility is designed to enable applicants with, usually, low incomes who can acquire

Table 5: Affordability analysis

House type	House price (GH¢)	Down payment (20%) (GH¢)	Monthly repayment (GH¢)
Low income housing	40,000	8,000	450
Mid income housing	70,000	14,000	800
Mid – high income housing	120,000	24,000	1,200
High income	150,000	30,000	1,800
Executive Housing	Over 350,000	75,000	2,500

NB: Exchange rate £1.00 = GH¢1.85 = USD$2.00, October 2007

homes only by buying land now and developing it over time. There are two features of the product. The "Buy" land portion and the "Build and Own" portion. Beneficiaries will contribute 10% of the cost of the land. The maximum amount for the "Buy" portion of the loan is US$15, 000 or the cedi equivalent. After 50% payment on the initial loan, the customer qualifies for the "Build and Own" portion of the product. The customer selects one out of six designs from the Bank to construct a house. The maximum loan amount for the "Build and Own" (Construction) is US$35, 000 or the cedi equivalent. The maximum term for each portion of the facility is 10 years making a total of 20 years. There must be clear and undisputed title to the land which must be duly registered. Development permit, building permit and approved building plans are also necessary requirements.

1.4 Affordability analysis

Given the house price range in Table 2 (a), household income in Table 3 and the various mortgage products and loan characteristics, a snapshot of mortgage affordability is set out in Table 5.

For instance to purchase a low income housing a borrower is required to make a down payment of 20% of the house value that amounts to GH¢8,000 and make a monthly repayment of GH¢450. On the basis of our earlier definition of affordability, a third of household income is assumed to be the affordable amount of household income that must go into housing expenses. Thus, for a low cost house as shown above a minimum monthly household income of GH¢1,500 is required to afford the monthly repayment. This is simply above the household income of over 97% of Ghanaian households as shown earlier in Table 3.

1.5 Final Remarks

The affordability analysis has clearly shown the reasons behind the total absence in demand for the mortgage products currently in the market. At current interest rates, mortgages are not affordable and rental as an alternative is much more attractive. The paper has further shown that if mortgage interest rates come down as a consequence of, among other things, a more stable macro economic environment the demand for mortgages will increase. The lack of reliable income data makes a good estimation of the market potential difficult. However, if only a part of the population, currently renting formal housing properties, decide to purchase a property using a mortgage the mortgage market may increase by several thousands. For a further growth in the mortgage market it will be necessary to address a number of other issues, in part to bring house prices down.

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The Impact of Mortgage Servicing on the Performance of Mortgage Banking Institutions in Uganda: A Case Study of Housing Finance Company (U) Ltd.

By James Ronnie Kanagwa[1]

Background: role of mortgage servicing

Mortgage servicing, also called loan administration, is the performance of the administrative duties associated with the loan from the time it is closed until it is paid off at the end of the loan term. Mortgage servicing facilitates the day-to-day operations of a mortgage bank. It comprises the following activities:

Mortgage Accounting. The servicing of mortgage loans requires transfer of moving mortgages, accounting collection and the recording of monthly mortgage payments from borrowers, and the transfer of funds to investors.

Customer Administration. Servicers are responsible for answering any questions borrowers may have about the loan; officers in the servicing function answer questions, solve problems, and correct most errors in borrower records.

Taxes, Insurance and Escrow Administration. To protect the investor's interest in the property, the servicer usually requires that the borrower makes monthly deposits to an escrow or impound account. The servicer then uses the money in the escrow account to pay property taxes and insurance premiums when they come due.

Asset Management. Servicers are also responsible for taking action when accounts become delinquent. The aim is to work with the borrower to bring the account up to date and avoid lengthy and costly legal action.

Mortgage servicing is where the bulk of a mortgage banker's net income is produced. In fact the mortgage-servicing group is charged with the responsibility of safeguarding the mortgage banker's most valuable asset, and usually it maybe appropriate to call it the "backbone" operation of the mortgage banker.

In a sense all the activities in the mortgage lending cycle are preparatory to setting up a profitable financial asset in the servicer's books.

Origination is a necessary cost to mortgage banking. While origination fees are collected and applied against lender overheads, origination expenses usually exceed such fees. The income from servicing pays for the losses incurred in mortgage origination (Jess et al, 1997).

Origination is the securing of a completed application from a prospective borrower and beginning the process of gathering supporting loan documentation. The link between origination and servicing is that origination, being the initial assessment of the mortgage process, will impact on the servicing function; wrong assessment will create high default rates on the mortgage portfolio.

Problem Statement

In mortgage servicing the mortgagee: issues demand letters, makes phone calls, effectively communicates mortgage terms, visits property of defaulters, and ensures proper and timely entries on the mortgagor's account. The servicing function is vital to a mortgage firm because it makes the largest contribution to net income. Poor servicing results directly impact on performance of an institution negatively.

It is the researcher's opinion that if not properly managed mortgage servicing will stifle performance and can lead to bank

[1] James Kanagwa previously set up the mortgage operations for Barclays in Uganda. He is now with Eccobank in Ghana. The article is based on a survey he did in 2006 and updated for the HFI readers in 2008.

closure. Housing finance companies in Uganda have, on average, failed to manage the servicing function well, as shown by the example of HFCU, which eventually leads to the poor performance. This can be evidenced from the company records (Table 1 below), which indicate disappointing trends for the total arrears of mortgages as at the end of the year for the periods 2002-2005.

1.2 Overall structure and financial depth of Ugandan economy

The IMF Financial System Stability Assessment (April 2003) commented: "The financial system in Uganda is small, underdeveloped, and dominated by the commercial banks. The financial sector is relatively small, with total assets equivalent to 29.5 percent of GDP in June 2002. It is underdeveloped, with indicators. For example, broad money's share of GDP is only 13 percent; bank branch penetration is low at one branch per 13,000 Ugandans and most of those branches are urban based, despite the fact that 90 percent of the population lives in rural areas; and financial system, accounting for over 82 percent of financial saving. Other financial assets and traditional bank deposits represent the major form of financial saving. Other financial intermediaries are limited in number, small in size and relatively ineffective. These include pension funds, insurance companies, micro finance institutions and other non-bank financial intermediaries."

It is worth noting that figures from the Economic Commission for Africa show a significant deepening of the financial markets in recent years. Between June 2001 and June 2002 M2/GDP increased from 8 percent to 15 percent, private sector deposits as a share of GDP from 5 percent to 11 percent and banking system assets as a share of GDP from 12 percent to 27 percent.

The IMF assessment also noted that the financial system was not interconnected with the banking system's equity investments in, and lending to, non-bank financial institutions being negligible.

The IMF report summarized the financial structure in June 2002 as follows-

a) 15 commercial banks, mostly foreign owned, which between them have 128 branches and total assets of Ush2, 450 billion ($1,440 million).
b) 7 credit institutions (including Post Bank and the Housing Finance Company of Uganda), all locally owned, with 22 branches and total assets of Ush200 billion ($118 million).
c) The National Social Security Fund with assets of around Ush254 billion ($150 million).
d) 100 deposit taking micro financial institutions with assets of Ush30 billion ($18 million).
e) 4 life insurance companies with assets of Ush60 billion ($35 million).

The size of the housing finance market

At the end of 2003, outstanding mortgage advances were Ush 54 billon ($32 million). The number of outstanding mortgages was around 1,500. There are 4.5 million houses in Uganda with a total value well in excess of $30 billion. The formal housing finance mechanism has financed around 0.1 percent of the total supply of housing. This is low even by the standards of developing countries, although by no means unique. Diamond (2000) points out that there are few emerging markets where the mortgage finance system is larger than 10 percent of GDP; in Uganda the figure is under 2 percent. In industrialized countries there is a wide range from under 20 percent in Austria, Italy, Greece and France to over 50 percent in Germany, the USA and the UK.

Table 1 Mortgage Arrears As At End of Years (2002-2005)

Year	2002	2003	2004	2005
Mortgage Arrears As At End of Year (Figures in Millions of Uganda Currency)	4,372	6,105	2,964	5,398

Source: Housing Finance Records, Central Corporate Branch (2002-2005)

Major players in the mortgage market

Housing Finance Company of Uganda (HFCU). Until recently, the Housing Finance Company of Uganda (HFCU) was the only formal mortgage lender in Uganda and in effect was synonymous with mortgage lending. The Company was established in 1967 through the acquisition of the business of the former first permanent building society, a British style institution that had been established in the colonial times. Until recently, shares in the Company were held equally between two public sector institutions, the National Housing and Construction Corporation and DFCU for Ush3.8 billion ($2 million).

The Company operates to an extent on traditional building society lines and offers a number of savings, deposit and cheque accounts. However, its main source of funds has been the "Pool House Collection Fund". Civil servants have been allowed to buy the housing they occupied which had been owned by the State. The house price paid was recorded as a mortgage on the books of HFCU, the repayments on which would in due course provide further funds for lending.

The main terms on which HFCU will lend are-

a) Construction, purchase, extension or improvement of residential and commercial property and purchase of plots in urban areas.
b) Monthly repayment not exceeding 35 percent of ascertainable monthly income, or, in the case of the self-

employed, audited accounts for two financial years.

c) The property must have a valid title and building plans with local authority. Approval construction must have a valid land title and building materials and the plans must have water and electricity.

d) The minimum loan size is Ush5 million ($3,000) and a maximum loan to value ratio is 70 percent for residential units in Kampala, 60 percent for urban plots and 50 percent for residential units in other towns.

e) Repayment term of a maximum of 20 years for residential units, 10 years for commercial properties and 5 years for urban plots.

f) The current interest rate is 16 percent for residential units and 18 percent for commercial properties units and for urban plots. The rate is variable.

g) The loan is repaid on an annuity basis.

h) The borrower must have a bank account with HFB.

In Uganda, Housing Finance Bank (HFB) is the only well established mortgage bank serving an array of clients and customers with over 60% of the market share. Mortgage servicing in Housing Finance Bank impacts on its performance as measured by its NPL (non-performing loans) position.

The performance usually oscillates between 4-12%. The higher the percentage, the poorer the performance and vice-versa. When the NPL percentage is high it means the provisions for the non-performance in the books is high and the profitability of the entire institution is reduced.

For the past five years housing finance's performance has on average been satisfactory. The provision for non-performing loans is seen to be reducing and foreclosures are high.

DFCU Bank. DFCU (formerly the Development Finance Company of Uganda) has over the past two years joined HFCU as a formal mortgage lender. DFCU has recently offered shares to the public. The Government of Uganda and the Commonwealth Development Corporation established DFCU as a private limited company in 1954. In the same year, DEG, the German investment group, became a shareholder. In 1984, the company took over CDC shareholding in HFCU and IFC became a shareholder in it. The Company changed its name to DFCU Ltd in 2000 and it commenced mortgage lending in 2002. In 2003, DEG sold its 50 percent stake in HFCU to the National Social Security Fund, this holding having become inconsistent with its own direct mortgage lending activity. In 2004, the company sold 40 percent of its issued share capital, 18.5 percent being Government of Uganda shares and 21.5 percent being IFC shares. Following the share sale, DFCU is 60 percent owned by the CDC group and 40 percent owned by private investors.

Mortgage loans outstanding at the end of 2003 were Ush 11.4 billion ($7 millions, an increase from Ush 2.5 billion ($ 1.5 million) at the end of 2002. The increase in its mortgage assets during the year of Ush 9.81 billions compares with Ush11.7 billions for HFCU. Mortgage loans accounted for 15.4 percent of outstanding loans at the end of 2003. DFCU is seeking to fund its mortgage portfolio through the wholesale markets. It has raised over Ush20 billion for development partners including NSSF, FMO (the Netherlands development finance company) and OPEC (Organization of Petroleum Exporting Countries Fund for International Development). DFCU already has plans to securitize its mortgage portfolio through creating a special purpose vehicle to hold mortgage-backed securities, which would then be listed on the Uganda Stock Exchange. However, it's recognized that a lot of preparatory work is required before this can be achieved and hence an issue is not expected in the immediate short term.

The National Social Security Fund. The National Social Security Fund is the only substantial holder of long term savings. It sees housing loans as a proper use for its funds and sees the wider benefits to the economy of a more effective housing market. NSSF acquired an interest in HFCU as a vehicle for its lending in to the hosing market. This may well be because it could see no other vehicles rather than because of any wish to own the company in the longer term. It sees mortgage securities as being appropriate in the longer term and believes that these would be attractive to international investors.

NSSF will lend to HFCU on commercial terms over 10 years and it is also willing to lend to other housing lenders on similar terms. It anticipates that insurance companies will also be willing to enter the market, partly because of the spin off for other forms of insurance business.

The commercial banks. In 2007 three new players entered the mortgage market; Stanbic, Standard Chartered and Barclays banks. They are mainly funding home purchases with rates of interest varying between 16 and 18 percent for a period of 20 years.

Until recently high interest rates meant that long lending was not considered viable for the banks and in any event they could earn a good return on treasury bills. Now, the banks are actively looking at the mortgage market mainly as a customer retention tool and as a means of cross selling other products and services. Banks have relatively low loan/deposit ratios. Furthermore, lending is highly concentrated in Kampala. Diversification into well-secured mortgage lending would address these issues and longer term would help them increase their retail business generally.

The banks do not regard mortgages as an incremental product but rather see the need to invest in the necessary systems and expertise. They are likely to draw on their experience from neighboring countries.

Micro finance institutions. Micro finance organizations seem to play little or no part in financing house construction. A recent study of the industry by Nannyonjo and Nsubaga (2004) did not mention housing. However, it is probable that smaller rotating credit societies are used to a limited extend to help finance incremental building. Some of the larger organizations are beginning to experiment with loan products for housing improvement and construction.

The Central Bank of Uganda. The central bank is the sole supervising authority of all financial institutions in the country. The Bank has strict provisioning requirement. There must be a 25 percent provision where a loan is three months in arrears, 50 percent where a loan is six months in arrears and 100 percent in case a loan is 12 months in arrears. At first sight this is fairly harsh but it is probably a useful discipline while the market is developing. International rules typically permit a 50 percent risk weighting for residential mortgages.

Challenges, Issues and Concerns

- The delays at the Land Registry. The banks will want the mortgage to be registered at the time they make the loans so they have the necessary security.
- Consistency of valuations coupled with the validation of valuations by the Government Valuer.
- The absence of large-scale developments in which a significant proportion would be pre-sold. Such developments would give the banks greater security than developments built as individual buyers could afford to pay. The banks would however prefer to share the risk on such developments.
- The difficulty of accessing long term funding.
- Mortgage loans have the same risk weighting as other loans
- No legal framework is in place to specifically regulate the real estate market.
- Ineffective regulatory framework to ensure planned developments in all areas of the country.
- Low enforcement mechanism to administer the quality of products and services used in the construction sector.
- Ineffective mortgage laws to protect the mortgagee in terms of default administration

Purpose of the study

The study has the following objectives:

1. To assess the mortgage bank performance situation

2. Review the situation of mortgage servicing at Housing Finance Company Limited. For easy reading, the company is referred to “Housing Finance”

3. Explore the relationship between mortgage servicing and bank performance

4. Factors leading to poor mortgage servicing

Applied research methodology

The study adopted a quantitative cross-sectional survey design. Self-administered questionnaires were distributed to the targeted groups of the respondents ie current and former loan officers of Housing Finance (U) Limited. Personal interviews were direct and the researcher was very available to offer respondents clarity when they were unsure of what responses to give for any given item in the instrument.

The study population comprised of ten Housing Staff persons who are (or have occupied) the office of loan officers.

At the time of the study, the Housing Finance Mortgaging Department has only ten individuals who have the experience of a loan officer. For this cause, the researcher deemed it fit to use purposive sampling [Krejcie and Morgan (1970)] and have all the respondents interviewed.

Data collection and the instruments

Sources of data. The researcher mostly used self-administered questionnaires accompanied with oral phone inquiries to confirm some of the unclear responses (see Appendix 1). The analysis used the primary data collected from the loan officers’ personal responses to the items in the research instrument (primary data). Secondary data was obtained from a review of various journals and Housing Finance’s documents.

Measurement of variables

1. Mortgage Servicing. Questions were designed on the various elements of mortgage servicing. A set of questions was posed to the respondents on each of the elements ie Timeliness, Default Rate and Mortgage Terms; Interest Rates and Turnaround Time.

Using a 5-point anchor ranging 1-5 where 1-Strongly Disagree, 2-Disagree, 3-Not Sure, 4-Agree and 5-strongly Agree, the researcher was able to generate the descriptives to discuss the study variables in a very detailed fashion. Descriptives were used to generate means for each item and if a mean is close to 1 or 2 (for instance 2.375), then the respondents were generally in disagreement with the statement. On the other hand, a mean close to 4 or 5 for instance 4.6 would indicate that the respondents are in agreement with what the statement says.

2. Bank performance. As in the case of mortgage servicing, items were designed on the key elements of Bank Performance ie Profitability and Market Share. For this construct, items were adopted and modified. These also featured the five-point likert scale anchored on “strongly disagree” through to “strongly agree”.

3. Data validity and reliability. Cronbach’s alpha tests were performed to check for the reliability and validity of the instruments used.[2] The findings were based on the Sekaran’s (2000) scale to check for usability.[3] The tests showed that the instruments had acceptable validity and reliability coefficients (ie above 0.5).

[2] Cronbach is a statistic that is used to measure the reliability of a psychometric instrument.

[3] This is a measure that is used to check the interdependency of different variables in the survey instrument

4. Data processing and analysis. The data collected was coded, entered and analyzed with a computer using statistical package for social scientists (SPSS Version 11.0) software. Sample characteristics were presented using Cross-Tabulations and figures such as clustered bar graphs. Means with were used to gauge the relative position of the credit officers on the various items of the research variables. With these, both the minimum and maximum values of each of the items were indicated. The relationship between mortgage servicing and bank performance was established using zero order correlations (specifically the Pearson (r) correlation coefficient).

Results of survey: data analysis and discussion

The study delivered the following results, some of which are shown in the following tables. Using descriptives, (table 2) the researcher observed that Housing Finance clients are expected to keep the time schedules within which to service their mortgage agreements (Mean = 4.6000).

It was further indicated that clients discuss with Housing Finance management about the time within which to service their mortgages (Mean = 4.2222). However, even when Housing Finance clients are unable to service their mortgage transactions, they are treated gently (Mean = 3.5714). Descriptives were further used to describe the various attributes of the default rate in the mortgage transactions that Housing Finance undertakes with clients (Table 3).

The researcher observed that Housing Finance staff respond almost immediately when a client has got some difficulty in servicing his or her mortgage transactions (Mean = 3.8000). Furthermore, the company has few clients on record who have failed to service their mortgage transactions granted them by the financial institution (Mean = 3.8000).

On the other hand, the researcher observed that Housing Finance's mortgage department is ever worried that clients will not service their mortgages (Mean = 2.3750).

On interest rates with Housing Finance's mortgage transactions, the results revealed that a fresh mortgage can be issued even if a client has not completed servicing the previous mortgage (Mean = 4.3000) in Table 4 below.

However, respondents disagreed with the fact that clients have any say when it comes to negotiating interest rates (mean = 1.7778).

On turn around time results (table 5 below), the mortgage department normally updates clients on the progress of their mortgage applications (Mean = 3.6000) though however the researcher observed that there was uncertainty as to whether Housing Finance considers the urgency of issuing the mortgage to a client (Mean = 3.4000).

Descriptives on profitability (Table 6 below) revealed that though Housing Finance's profitability has been growing for the past 5 years (Mean = 4.1000), loan officers also agreed that Housing Finance's NPL Position has been declining for the past 5 years (Mean = 3.8889) and Housing Finance's provisions for non-performance have been declining (Mean = 3.7000).

On market share (Table 7 below), the researcher observed that Housing Finance's loan portfolio has been growing (Mean = 4.1000), Housing Finance is favorably competing with other institutions in the industry (Mean = 4.1000)

Loan officers also agreed that customer confidence in Housing Finance has improved (Mean = 4.2000).

The items on timeliness tapped the speed at which these loan officers at Housing Finance actually play their part of the mortgage transaction with clients, all the while observing how beneficial the transaction can be for their clients. Some items on mortgage servicing were used on the default rate to measure the level of this default in various aspects. This section also considered issues to do with the time schedules that clients are offered within which to service their mortgages, and the status of the company's record of defaulters. On interest rates, the researcher considered such issues as client participation in setting the interest rates, the credit officer's opinions about the interest rates and how profitable these have been for the company.

MORTGAGE SERVICING Descriptive Statistics			
Table 2. Timeliness of the Mortgaging Transaction Process	Minimum	Maximum	Mean
Housing Finance Clients get/are treated gently even when are not able to service the Mortgage transaction	2.00	5.00	3.5714
Few clients are complaining about the many installments within which to service the mortgage	2.00	5.00	3.5000
Housing Finance clients are expected to keep the time schedules within which to service their mortgage agreements	4.00	5.00	4.6000
Clients discuss with Housing Finance management about the time within which to service their mortgages	4.00	5.00	4.2222
Housing Finance delivers its mortgage services within the time periods that it projects	2.00	5.00	3.4444

Table 3. Default Rate In the Mortgaging Transaction	Minimum	Maximum	Mean
Once clients fail to service their mortgage transactions, they easily resolve these cases with Housing Finance	2.00	4.00	2.7000
In case of failure to service the Mortgage, Housing Finance policies are favorable for her clients	2.00	5.00	3.5000
Housing Finance has few clients on record who have failed to service their mortgage transactions granted them by the financial institution	2.00	5.00	3.8000
We feel that the time within which to service mortgages is favourable to the ends for which clients acquire mortgages	2.00	5.00	4.0000
Conditions of mortgage servicing are all set by Housing Finance though client participation is highly welcome	1.00	5.00	3.8000
Increasingly, more clients of Housing Finance are servicing the mortgages acquired from this institution	2.00	5.00	3.8000
Many individuals are willing to access Housing Finance Mortgage services without fear of the consequences of failure to service the mortgages	2.00	4.00	3.3000
Housing Finance's mortgage department is never worried that clients will not service their Mortgages	1.00	4.00	2.3750

Table 4. Interest Rate of the Mortgaging Servicing	Minimum	Maximum	Mean
Clients are free to negotiate for interest rates.	1.00	2.00	1.7778
Mortgaging is very profitable for Housing Finance because of Interests charged	2.00	5.00	3.4444
Interest rates can be varied by Housing Finance	2.00	5.00	4.0000
A fresh mortgage can be issued given if a client has not completed servicing the previous mortgage	4.00	5.00	4.3000

Table 5. Turn Around Time for Mortgaging Transactions	Minimum	Maximum	Mean
Housing Finance considers the urgency of issuing the mortgage to a client	2.00	4.00	3.4000
The Mortgage process is simple	2.00	4.00	2.5000
The Mortgage department normally updates clients on the progress of their mortgage applications	2.00	4.00	3.6000

Table 6. Review of Profitability at Housing Finance	Minimum	Maximum	Mean
Housing Finance's profitability has been growing for the past 5 years	4.00	5.00	4.1000
Housing Finance's NPL Position has been declining for the past 5 years	3.00	4.00	3.8889
Housing Finance's provisions for non-performance have been declining	2.00	4.00	3.7000

Table 7. Market Share of Housing Finance	Minimum	Maximum	Mean
Housing Finance introduced several new products in the past five years	2.00	5.00	3.6000
Housing Finance constantly devises means and strategies of reaching out to its clients.	2.00	4.00	3.5000
Housing Finance's loan portfolio has been growing.	3.00	5.00	4.1000
Our clientele is growing.	4.00	5.00	4.2500
Housing Finance's share of total loans has been increasing in the banking industry	3.00	5.00	3.9000
Housing Finance is favorably competing with other institutions in the industry	4.00	5.00	4.1000
Customer confidence in Housing Finance has improved.	4.00	5.00	4.2000

Conclusions and recommendations

Nature of the mortgage servicing transaction. The researcher reviewed the nature of the mortgage servicing at Housing Finance Bank and observed that clients discuss with Housing Finance Bank management about the time within which to service their mortgages. However, even when Housing Finance Bank clients are unable to service their mortgage transactions, the company treats them gently.

At the same time, however, respondents reported an uncertainty as to whether Housing Finance Bank can deliver its mortgage services within the time periods that it projects for the clients. The turn-around times are quite irregular varying between one month to six months or even more. From the findings of chapter four, the researcher further noted an uncertainty as whether the clients who fail to service their mortgage transactions can easily resolve these cases with Housing Finance. The results further indicated that loan officers are worried whether clients will service their mortgages and they are also not sure if individuals are willing to access Housing Finance Bank mortgage services without fear. Potential clients' fears may include, though not be limited to; embarrassment and loss of surety assets such as land titles and other items at stake due to a client's undertaking of the mortgage transaction.

Housing Finance's Mortgage transactions are also characterized by the company's dictation of the interest rate terms and the company can vary the interest rates as it deems fit. The institution expressed uncertainty as to whether mortgaging is very profitable because of interests charged.

The results further revealed that Housing Finance Mortgage department does not consider urgency in processing client's mortgage transactions in spite of the fact that Housing Finance endeavors to update clients on the progress of their mortgage applications.

The relationship between mortgage servicing and performance. A positive and significant relationship between mortgage servicing and performance indicates that if mortgages are professionally and efficiently handled, this can result into a significant improvement in the performance of Housing Finance Company.

Implication of the findings of the survey. Basing on the available literature and the results of this study, the following are some of the possible implications of this research to the institutions in the banking industry in Uganda and other countries in Africa.

i) Loan officers' uncertainty as to whether their department can actually deliver the mortgage transactions in the time that it promises speaks of inefficiency at the work place. This can result in loss of potential clients as they learn from others through negative word-of-mouth thus leading to a poor performance of the company.

ii) Results indicate that in case clients are unable to service their mortgages it is not easy to resolve these cases with Housing Finance. This creates a negative corporate image for the company although the corporate image has a positive relationship with the performance of an institution.

iii) The mortgage department is unsure as to whether the clients of Housing Finance are very willing to access these mortgage transactions of the bank without any fear. On the other hand, the clients have their own fears they attach to these mortgages. This creates a very low turn-up for the mortgages, implying the bank will realize less from the mortgages.

iv) Housing Finance dictation in matters of the interest rates without any client participation may not always be convenient for the client depending on the nature of economic activity they engage in. The interest installments may be set so as to hinder the progress of the client since the client participation is not entertained.

v) Results also indicated that the Mortgage department is slow at processing the Mortgage transactions with its clients. This can lead to dissatisfaction of the clients or make them look for alternative institutions to help meet their needs and hence Housing Finance loses out.

In conclusion, a positive relationship between mortgage servicing and performance implies that efficient and skillful handling of mortgage servicing transactions will lead to a better performance of Housing Finance.

Recommendations

In close relation to the research findings the following recommendations are suggested to firms in the banking industry in Uganda and any other related ones:

i) Housing Finance Bank mortgage department should train its loan officers so as to ensure that they attain skills to enable them process the mortgage transactions in time to meet the client needs.

ii) The Company should implement friendly policies for the clients who fail at servicing their mortgage transactions so as to avoid a negative corporate image with the public. Handling the clients who are unable to fulfil their part of the mortgage deal roughly would discourage other potential clients.

iii) To have adequate knowledge of clients' views on their mortgage transactions, the mortgage department should conduct a market survey so that it can get the actual views of the clients.

iv) Due to the varying capabilities of clients in servicing their mortgage transactions, Housing Finance should allocate mortgages to clients all the while allowing them to have an input on the interest rates to be charged.

v) The Mortgage Department needs to come up with various work-out options for clients as a measure of effective customer administration and management of defaults.

vi) The servicing function to be out sourced as an alternative to other companies that are professionally competent in that area. This will enhance the bank's performance and corporate image.

vii) Housing Finance Bank should take advantage of technology and innovatively introduce electronic products and processes that will ease the servicing function roles, increase efficiency, increase the market potential, and increase customer satisfaction and profitability.

viii) New products and more innovative ways in terms of the interest rate to be charged should be introduced and adopted. For example Housing Finance Bank should segment the market in terms of earning capacity and introduce the graduated payment mortgage, where the interest rate is gradually increased with the level of income for a defined period. This will increase the number of borrowers especially from the untapped market and effectively control the number of defaults especially for the business community whose incomes usually fluctuate.

ix) A more proactive approach to enhance the performance of the servicing function would be to separate it from the other section of the mortgage department under a specialised manager with a well-remunerated workforce with measurable performance measures.

x) Housing Finance Bank should institutionalise a customer management system so that customized communication is channelled to clients individually. This will introduce a people friendly approach especially when dealing with defaulters and also establishing reasons for default individually.

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Appendix 1. Research Instrument

Dear respondent,
This questionnaire is intended to **facilitate** the study on **"The Impact of Mortgage servicing on the Performance of Mortgage banking institutions in Uganda; Case of Housing Finance Company of Uganda"** The study is for *academic purposes and is carried out as partial requirement of the award of Masters of Business Administration Degree*. As an employee of **Housing Finance** your responses will also be treated with *utmost confidentiality*. Thank you very much for your valuable time.

SECTION A: BACKGROUND INFORMATION

1. Gender Male ☐ Female ☐

2. Age of respondent in years

Tick under one of the options	18 – 30	31 – 40	41 – 50	Over 50

3. Highest level of education

Qualification	Ordinary Level	Advanced Level	Diploma	Degree	Post Graduate	Other (Please specify)

4. How would you rank your position at **Housing Finance**

Tick under one of the options	Top Management	Middle Management	Lower Management

5. How long have you been working with **Housing Finance**

Tick under one of the options	0-2 years	3-5 years	Over 5 years

	SECTION B: MORTGAGE SERVICING **For this section, please indicate your level of agreement to the statements by ticking**	*Strongly Disagree*	*Disagree*	*Not Sure*	*Agree*	*Strongly Agree*
	• Timeliness					
1	**Housing Finance** Clients get are treated gently even when are not able to service the Mortgage transaction					
2	Few clients are complaining about the many installments within which to service the mortgage					
3	**Housing Finance** clients are expected to keep the time schedules within which to service their mortgage agreements					
4	Clients discuss with **Housing Finance** management about the time within which to service their mortgages					
5	**Housing Finance** delivers its mortgage services within the time periods that it commits.					
	• Default Rate					
6	**Housing Finance** staff respond almost immediately incase a client has got some difficulty in servicing his or her mortgage.					
7	Once clients fail to service their mortgages, they easily resolve such circumstances with **Housing Finance**					
8	In case of failure to service the Mortgage, **Housing Finance** policies are favorable for her clients					
9	**Housing Finance** has few clients on record who have failed to service their mortgages advanced to them by the company					
10	We feel that the time within which to service mortgages is favourable to the ends for which clients acquire mortgages					
11	Conditions of Mortgage servicing are all set by **Housing Finance**, though client participation is highly welcome					
12	Increasingly, more clients of **Housing Finance** are servicing the mortgages acquired from this institution					
13	Many individuals are willing to access **Housing Finance** Mortgage services without fear of the consequences of failure of default on repayment.					
14	**Housing Finance's** mortgage Department is never worried that clients will not service their Mortgages					
	• Mortgage Terms					
	• Interest Rates					
1	Clients are free to negotiate for interest rates.					
2	Mortgaging is very profitable for **Housing Finance** because of Interests charged					
3	Interest rates can be varied by **Housing Finance**					
4	A further Mortgage can be advanced to a client before complete redemption the previous Mortgage					
	• Turn Around Time					
1	**Housing Finance** considers the urgency of issuing the Mortgage to a client					
2	The mortgage process is simple.					
3	The Mortgage department normally updates clients on the progress of their mortgage applications					

	SECTION B: BANK PERFORMANCE **For this section, please indicate your level of agreement to the statements by ticking**	***Strongly Disagree***	***Disagree***	***Not Sure***	***Agree***	***Strongly Agree***
	• Profitability					
1	**Housing Finance's** profitability has been growing for the past 5 years					
2	**Housing Finance's** NPL position has been declining for the past 5 years.					
3	**Housing Finance's** provisions for non performance has been declining					
	• Market Share					
1	**Housing Finance** introduced several new products in the past five years					
2	**Housing Finance** constantly devises means and strategies of reaching out to its clients.					
3	**Housing Finance's** loan portfolio has been growing.					
4	Our clientele is growing.					
5	**Housing Finance's** share of total loans has been increasing in the banking industry					
7	**Housing Finance** is favorably competing with other institutions in the industry					
8	Customer confidence in **Housing Finance** has improved.					

Who's for Low-Income Housing? The role of housing finance in alleviating urban poverty

By N O Jorgensen

Consultant in urban economics and finance, Kenya

Introduction

The question posed above appears rhetorical. There would be nearly no-one who would be against housing for the poor. But if everybody is for low-income housing, why is there always such a shortage? This paradox will be addressed in a future article. However, if the "headline" question is understood to mean: "who qualifies for low-income housing?" the query becomes crucial with respect to the allocation of low-income housing through the selection of beneficiaries. Furthermore, the allocation process can be an effective instrument in alleviating urban poverty. Housing finance, in turn, is the mechanism by which the gap between the target group and its shelter-need is bridged.

Because governments, corporations, financial institutions as well as society at large all subscribe to what is nowadays called "social responsibility" it is only reasonable that alleviation of poverty should figure high on their list of goals. Housing, and particularly housing for those otherwise not in the position to acquire a decent dwelling, is arguably the most effective way of improving their income, wealth and their standard of living generally. That is why it is crucial to use housing as a means of exercising social responsibility.

This article, as its precursor in the June 2007 edition[1], deals with the problem of housing for poor families while at the same time enhancing their income. Both issues are fundamental to social and economic development, which are the goals of a multitude of national and international efforts like the UN's "Millennium Development Goals", the "Habitat Agenda" the "World Economic Forum" among others, - all of them with very laudable intensions, but with little chance of reaching their ambitious targets, because they fail to deal with the difficult problems of implementation.

"Housing for the Poor" has therefore been chosen as the focus for this series of articles. The intention is to demonstrate how appropriate finance can assist in reaching those most in need of improved living standards which is what development is all about. The selection criteria and allocation methods for needy families to benefit from low-income housing schemes are crucial elements in this process.

Present scenario

Most readers are familiar with the typically inequitable allocation process in existing and new housing schemes intended for poor families both in developing and in some developed countries. In spite of declared intentions to support those most in need, the end result is often that those with the best connections, most clout and money, etc become the owners, if not the occupiers of public housing schemes for the poor. This happens again and again, because of weak institutions or lack of political will, or both. Market forces also play their part, as do direct and indirect subsidies which practically always distort the market and end up in the wrong pockets.

Housing finance institutions are generally not very interested in low-income housing or in poor families, because there are plenty of high-income families applying for loans for expensive houses. In short, it is a "sellers' market". Financial institutions cannot easily make business sense of small loans which are as costly to process as large ones, if they cannot charge a higher interest rate for such loans. This dilemma will be revisited later on in this article.

The result is well known: Poor families are being left out. They become "defaulters before the event" ie they will not be considered for an adequate loan because their present income does not qualify them for one. Moreover, the fact that they typically cannot find the 20% - 25% down-payment just adds to their predicament.

[1] "Housing the No-income Group" by N O Jorgensen in *Housing Finance International*, June 2007

How private financial institutions can deal with this is problem is dealt with under "Appropriate Finance" below.

Public housing authorities may in some instances provide finance on special terms, such as "tenant purchase"[2] loans, 100% loans, subsidised interest loans, selling at or below cost price, etc. However, as soon as there is a built-in advantage compared to market based conditions, speculators will exploit these advantages, and the better-offs will soon defeat the less-better offs who were the original allottees. This is not necessarily a catastrophe, because if the houses are built they are at least an addition to the housing stock, and they will, by definition, be occupied by low-income families, albeit as tenants, not as owners. But the incomes of the original allottees will at least have received a boost.

It must be added here that rather than aim for the ideal ie owner-occupation of all low-income housing schemes, however desirable, suffice it to try to accommodate this ideal as far as possible through non-negotiable incentives, such as personalised finance arrangements (more on this later). The more rules and regulations are introduced the bigger the problem of enforcement will be. In fact, weak institutions and corruption may render enforcement irrelevant. To have non-enforceable regulations and clauses governing the sales document is worse than having none, because it adds to the culture of "it is OK to cheat as long as you are not caught". Even if regulations were just sporadically enforced, it can lead to endless litigations and massive expenses for only the lawyers to enjoy. But for housing to have an impact on the alleviation of poverty it is imperative that improvements are made to the allocation procedure.

Improvements

The remainder of this article will concern itself with improvements to the allocation process. For the sake of comprehension the following four topics will be treated separately:

1. Defining target groups
2. Selection criteria
3. Allocation procedures
4. Appropriate finance

Defining Target Groups

For any new housing scheme, whether individual houses or flats, the starting point must be the "user". At times the location of schemes is a determinant of the target group, ie the income groups who would want or need to live in that particular area. Even so, the requirements of this income group and its preferences must be design criteria for planners, architects and those who structure finance arrangements, particularly the loan repayment schedules. This latter issue will be dealt with in the section on finance below.

The definition of "target groups" becomes fairly simple when a new scheme is built to cater for families being removed from their existing housing, such as it happens in the case of forceful removal of squatters or resettlement of refugees. But even in these cases the diversity of family size and composition must be taken into account. This is normally done by providing different seizes of the same quality dwellings (same prices per sq m) Similarly, when groups with a "common bond" such as co-operatives, clans, extended families, workplace-related associations, etc for are chosen for good reasons of coherence and mutual support, they must be accommodated in different size dwellings.

However, if the median income for the target group is very low, the housing units may have to be designed for sub-letting, in order for the allottees to generate extra income to help them repay their loans. This concept is explained in detail in "Housing the No-income Group",and is based on the fact that extra rooms can generate sufficient income to repay their financing cost.

In other housing schemes the target groups are most likely those below a given income. But to define target groups by income is invariably difficult because:

- Is it total family income, formal and informal, or just that of the head-of-household?
- Is it gross or disposable income? Surely, fixed expenditure is as important as income itself.
- What about wealth/assets which can be monetized eg a house which can be sold or rented? Again, those who already own a house should not be dropped from the target group because the house may be far away from work, unsuitable for the family, owned jointly with others, etc.
- Is present or future income the most realistic criterion? From a financing point of view, the latter is the most relevant (though regrettably not typically used by financial institutions).
- If exclusion from the target group becomes a disincentive to obtain honest answers to questions on income, the applicants' current housing condition is the best criterion for a family's inclusion in the target group.

In fact, current housing conditions rather than income is the simplest definition of who should be included in the target group for a new housing scheme. Realizing that the ideal is unobtainable, it is likely to be as good a criterion as any because families generally live according to their income or more precisely: to their rent propensity. A realistic scenario for any new housing project is that demand will far outstrip supply .The correct approach will therefore be to define target groups by disposable family income together with current living conditions. Social workers or a well-established NGO (Salvation Army, Save the Children, etc) can be called upon to verify and /or recommend families for selection.

[2] The buyer/borrower is a tenant till the monthly rent has amortised the cost/loan or reduced the balance to the point where the lender is satisfied that the tenant is a safe risk and can be given title.

Another typical case where defining target groups become fairly simple is when an employer builds houses for staff. In principle, all employees are therefore eligible for a unit. Problems are most likely to be with the lowest paid staff who may not be able to buy a non-subsidised unit. If renting the unit is not an option, because owner-occupation is the company's objective – then ownership can be made possible through the design concept and the financial arrangements.

Whether dealing with public or private sector projects, the definition of target groups should always have the objective of owner-occupation in mind. The scheme may start out as a tenement, but the possibility of subsequently selling it to sitting tenants or others must always be kept open – because in some circumstances it can become favourable or necessary to sell units. Another argument In favour of ownership is that it avoids the regrettable situation which arises in company-owned housing where 'if you loose your job, you loose your house'.

A final word on target group selection by income: After present disposable family income has been established, future income prospects should be taken into account, because housing obligations will be paid by future, not present, income. If (young) family members are about to enter the labour market or if the income from sub-letting of rooms is to be considered, then future, rather than present, income becomes a much better measure of rent propensity (affordability).

Selection Criteria

Very much in line with definition of target groups are the selection criteria. Given that demand exceeds supply within any definition of a target group, it is important that additional criteria for selecting beneficiaries should be introduced. These can roughly be divided into three categories:

1. Housing need
2. Waiting lists
3. Financing prospects

These criteria may seem incongruous but are never-the-less realistic and practical.

Housing Need

In the case of a public sector development scheme, the applicants' current housing needs are an objective criterion which can and should be verified by a neutral agency as referred to above. The only limitation on "need" to be imposed may be the length of stay in present housing, because new allocations should not give rise to in-migration ie people should not be tempted to move into a sub-standard dwelling just to become eligible for a new dwelling. A stay of at least a couple of years in the same dwelling will serve as an effective disincentive to apply.

Some municipalities use a point-system to facilitate the selection procedure. Local conditions will dictate the factors to be included and the weight given to each. An example is listed below as a guideline. Points could be from 1 – 10 for all factors, where each factor is weighted (from 1 – 5) according to its importance. One reaches the final score by multiplying the "Points" with the "Weights". Household income is not included in the list because it is not a criterion in the initial selection. The rationale for this is that if a very poor family is in desperate need of improved shelter, then financing will be used as a mechanism to bridge the gap - within limits, of course. (See under "appropriate finance").

The number of points (1 – 10) for each factor is then multiplied by the weight to give the total number of points to facilitate a reasonably fair selection.

It is important that details of the units for allocation are advertised in order for prospective allottees to decide whether to apply or not, eg the scheme could be further away from employment, not attractive compared with present housing, clearly not affordable, etc.

As alluded to above, a situation could arise where (part of) a squatter settlement is to be removed and the local authorities are responsible for re-housing. In that case the selection process will be somewhat different, though the point system remains a good method for allocating different types of units.

Waiting Lists

A typical selection method, which unfortunately has turned out to be weak at best and abused at worst, is the waiting list. The reason is that needs and income may have changed for the families signed up years ago. Some sign up 'just in case' and waiting lists invite corruption. This is not to say that there should not be one, because needy families like to sign up for

	Points	**Weight**	**Total**
Family size	5	3	15
Number of children	2	3	6
Length of stay in town	10	2	20
Living space in sq m	8	4	32
Present density	9	3	27
Wall material	5	2	10
Roof material	5	2	10
Service availability	3	3	9
Distance to CBD	6	1	6

CBD = Central Business District

better housing. It can also be of marginal help in the selection process where two applicants are equal on points. A waiting list can also serve as a guideline for which type of units is in greatest demand and should therefore be provided in new schemes. However, it should always be made clear that to be on a waiting list does not assure one an allocation according to one's number on the list.

One more argument for waiting lists is that it is "politically correct" to have one. Unfortunately, and particularly in housing, it is necessary to be realistic also with regard to what is politically feasible. When it comes to social services in general, certain projects have a higher profile than others in terms of visibility and vote generation.

Financing prospects

Crucial to any selection of allottees is their "rent propensity" ie what they are willing to pay for a new dwelling. Orthodox terminology uses the term "affordability", but "willingness-to-pay" is a more appropriate term because it corresponds to rent propensity in the economist's jargon. The difference in usage between affordability and rent propensity can be ascribed to who determines them. Affordability is typically determined by financiers who relate present income to what they believe a potential borrower can afford. This can be more but also less than what the borrower can or is willing to pay. The recent sub-prime scandal in the US mortgage market is testimony to the latter. Rent propensity is determined by the borrower and reflects not only present rent but also potential rent if future income is realised eg generated by the dwelling to be acquired.

When selecting allottees for a new housing scheme, which presumably is built with a particular target group in mind, it is imperative that their income prospects are thoroughly analysed. As the previous article pointed out: in short, the poorer the family, the bigger the house! In other words, that if a family's present income is too low to qualify for a dwelling in orthodox terms, then they need to have the possibility to generate future income from the house itself. Initial sub-letting or permanent small scale business(es) could be such options. Fixed interest rate loans and elements of self-help in-puts in terms of labour could be other facilitating factors.

Allocation Procedures

Once the target group has been defined and the projects tailored to their needs, the selection process can get under way. Incidentally, it is wise to have short-listed about 10% more applicants than can be accommodated, because of "no-shows". In any case, the selected applicants should be revisited to confirm their family data, to ascertain their continued interest and to provide information about take-over formalities and moving practicalities.

It is assumed that documentation and finance arrangements are in place by the start of the process, so that allottees have only to sign the relevant papers if they are still prepared to take up the offer. A crucial element in this process is the communication between the "seller", be it a public or private entity on the one hand, and the allottee on the other. This can be done collectively at a meeting or individually in the home or at the seller's / agent's office. To use the meeting format where all allottees are invited saves time and has the advantage for the developer of being able to solicit feedback.

In cases of employer-sponsored housing where it is assumed that all employees are eligible for a dwelling, the selection formalities as outlined above can be simplified. Furthermore, the allocation procedures should focus on the type of unit each employee is entitled to.

As pointed out earlier, and contrary to orthodox allocation methods, the lowest paid staff-member should not necessarily have the smallest nor the cheapest house because the lowest paid workers can afford a dwelling only if it has extra rooms to let. The first article describes how a major corporation in Kenya successfully used this approach.

Just as important is the observation that in private as well as in public sponsored schemes the allocation documents should include the least number of restrictive clauses with respect to such matters as: owner-occupancy, sale or letting. The inclination by the developer to prevent the allottes from exploiting the benefits flowing from the privilege of having obtained a dwelling is understandable, to some extent even socially justified. But implementing restrictions of that kind will require an inordinate policing effort which is not economically feasible. The same goes for a clause which would exclude employees who already own a house, or, particularly in the public sector, if a spouse is already allocated a house by the same public entity. To enforce such restrictions will lead to invasion of privacy or endless litigation. It is not at the allocation stage of the housing process social equity considerations should be introduced, but earlier, namely at the selection stage.

Appropriate Finance

Whereas typical approaches to housing finance concentrate on present income and present house cost, appropriate housing finance focuses on future income and present costs. For low-income groups this is what can make or break their housing prospects. In addition, if the applicants for a loan are also asked to make a down-payment which they do not have, it will likely force them to borrow that amount at an even higher interest rate and on a shorter term, increasing the likelihood of default. Moreover, if potential borrowers are lured into accepting increasing interest rates not in line with future income prospects, default is almost assured. Witness the sub-prime mortgage scandal.

The term "appropriate finance" implies that repayment of a loan fits the borrower's income profile, or more precisely, his/her rent propensity over time. That also goes for the initial deposit and any security requirements apart from the dwelling itself. Poor borrowers are, contrary to conventional wisdom, not only quite aware of their willingness-to-pay (for what they need) but also prepared to go to great lengths to avoid default, because it is their 'chance of a lifetime' to be a house owner which will be the biggest and best investment they may ever make. That is precisely what has made micro-finance schemes so successful.

Appropriate finance also implies that the financier must be able to make small (but not riskier) loans profitable. Short of public subsidies, which are not advocated, it means charging more for small loans than for large ones. This is not politically correct, but it can be done by calling it something other than interest, eg commitment fee, service charge, etc. The point is that there must be an incentive for lenders to offer small loans to the needy whose present rent propensity according to research in slum areas is likely to be 45% - 50%. If they get a better dwelling on more appropriate financing terms, their rent propensity in absolute terms is likely to be even higher,

Land and construction cost in urban areas of poor countries are such that a low-income family (defined as a family living on less than $5 a day) cannot afford to buy a decent housing unit with services. They must rent or self-build a shelter or, alternatively, live in an over-crowded dwelling with other families. In fact, densities of structures and people reflect the typical situation that makes housing so attractive in economic terms. The demand for space relative to supply is such that the yearly rent per square meter returns the cost of this same space within three years or less. Put differently: such houses have a return on capital of 33%. However, the problem is that those who live there do not have the funds to invest.

This is where housing finance comes in as a mechanism to bridge the gap between present investment and future income from which to repay any loan taken. Not only has a low-income family thus become an investor, but it has acquired an asset which most likely appreciates in value over time; certainly the house produces an income which increases with inflation whether sub-let or owner-occupied (saved rent). To create such an opportunity can, therefore, greatly reduce poverty for the otherwise poor investor. It also creates income on the macro economic level due to the considerable accelerator effect of housing construction in general and low-income housing construction in particular.

Summary

Two premises underlie the arguments for promoting housing for the poor. (1) The demand for habitable space at the lower end of income groups exceeds supply to such an extent that rental income per square meter of space returns the cost of building that space within a given period of time, eg 3 years. (2) By making housing available to the poorest of families their income will be enhanced more so than by any other realistic undertaking, thus reducing overall poverty. Moreover, construction of low-income housing by way of its accelerator effect benefits many more low-income earners and thereby the whole economy.

Since a housing investment undoubtedly is the best and biggest a poor family will ever make, and since it is less risky for the institutions making the loans, it is crucial that the selection and allocation procedures favour those most in need of improved housing. Considering both the borrower's and the lender's interests, it is imperative that finance is made available on terms which are compatible with the borrower's rent propensity over time and at the same time is profitable for the lender. Practical improvements to current approaches regarding both of these conditions are needed and guidelines for selection of beneficiaries are recommended to optimise poverty reduction through the housing allocation process.

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For further information please contact
the conference organiser:

Tiffany Hurst
Scatterlings Conference and Events
Tel: +27 11 463 5085
Fax: +27 11 463 3265
tiffany@soafrica.com
www.soafrica.com
or view the conference website: www.IUHF2008.com

for further information on Sun City please go to:
www.suninternational.com