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THE HOUSING FINANCE SYSTEM IN KENYA

Volume I

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The East and Southern Africa Regional Housing
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PREFACE

In December 1983, AID authorized a $20 million Housing Guaranty (HG) Program in Kenya to finance housing constructed by private developers with the long term mortgage financing to be provided through the housing finance institutions. The project was intended to expand the private sector's capacity to design, construct, finance and service low cost housing.

At the time of initial project design in June 1983, the AID Regional Housing and Urban Development Office for East and Southern Africa (RHUDO) which is located in Nairobi, Kenya, took the first steps to foster the idea of a secondary mortgage market in Kenya. A seminar was conducted in Nairobi to introduce the concept to a representative group of Kenyan business and government officials connected with housing. At this time also in Kenya there was a growing movement to create new specialized housing finance institutions which, up until 1980, had numbered just three; one government-owned, one 50% government-owned and a private mutually-owned building society.

The HG project has been slow to get off the ground, not because the need was not there or the developers and housing finance institutions were not prepared to participate, but due to procedural problems in working out the mechanisms of the loan. In the meantime the number of specialized housing finance institutions has grown rapidly along with other banking institutions and as of the time of the field work of this study totalled four limited liability institutions and 32 registered building societies although most of the latter were not yet operational.

The RHUDO has also moved ahead with its assistance to the housing finance sector. It sponsored a six week training trip for mid-level managers from housing finance institutions, insurance companies and the Central Bank to the U.S. in June 1985. The training was conducted and coordinated by the

Institute of Financial Education and USL International, affiliates of the US League of Savings Institutions. This was followed by a three week trip by senior executives in November 1985. In both cases emphasis was given to the role of a secondary mortgage market within a housing finance system. In December 1985 the RHUDO and the USAID Mission in Kenya sponsored a workshop on the possibility of a secondary mortgage market in Kenya.

It was also decided to carry out an overall review of the housing finance sector in Kenya. This report represents that effort. The scope of work is included as Annex A and, among other things, calls for a review of secondary mortgage market possibilities. One aspect of the scope, the role of the informal sector, was eliminated and was to be done as a separate study.

The report is based on field work which took place during the period March 11-28, 1986. The study was carried out by a joint team from USL International and the Urban Institute. Team members were Donald Gardner, Samuel Peck and Thomas Malev of USL International and Robert Buckley and Harold Katsura of the Urban Institute. Assisting the team as a special member was Isaac Mugambi, Senior Lending Officer at the Housing Finance Company of Kenya.

A Steering Committee provided guidance to the team through periodic meetings during the course of the study. Members of the Steering Committee were: Gibson Maina, Chairman, from the Ministry of Works, Housing and Physical Planning; Kihara Waithaka, Chief Finance Manager of the Housing Finance Company of Kenya; Ms. Mou Charles, Ministry of Planning and National Development; Joseph Njuguma, Financial Controller of the National Housing Corporation and Steven Giddings of the AID Regional Housing and Urban Development Office.

The report contains six chapters in addition to the Executive Summary.

Chapter One places the housing sector in Kenya within a macroeconomic context. It shows the declining share of GDP and fixed capital stock in residential housing and contrasts these figures with the opposite trends that would more normally be associated with the changes in urbanization, population and income that occurred. It suggests that financial policy has been constraining the supply of credit to this sector. It concludes with an estimate of housing needs.

Chapter Two provides a brief overview of government programs in housing and how they are financed. Chapter Three then describes the overall financial sector as a framework for housing finance and outlines the dramatic changes in financial innovation in Kenya, identifies some of the problems with this evolution, and indicates the important beneficial reforms and trends that are now taking place. It concludes with a review of government financial policy throughout the economy and its impact on housing finance.

The Fourth Chapter focusses on the institutional participants in the housing finance sector. It details their growth, their regulatory problems, their resource mobilization and their lending activities and their liquidity needs .

Chapter Five considers how the elements of the previous chapters - housing needs, financial policy generally, and the current housing finance system - interact to affect resource mobilization. It also discusses some of the broader macroeconomic problems with the current system.

Chapter Six concludes with recommendations.

It should be noted that the report contains two major elements which, however, are interwoven. One is the macroeconomic context for housing in Kenya and the overall financial trends and policies that are part of this. The other is the housing finance system, where it fits into the financial structure, how it is regulated, and the institutions which make it up.

Both elements provide the underlying rationale for the recommendations of the report particularly with regard to mobilizing resources for housing at market rates of interest. However, the treatment of the macroeconomic issues is, almost by definition, more academic in nature and some readers may wish to rely on the Executive Summary for these aspects and concentrate on the housing finance system and institutions in the body of the report.

EXECUTIVE SUMMARY

This study describes and evaluates the structure of the Kenyan housing finance system to determine the adequacy of this system to provide for the mortgage credit needs of one of the world's most rapidly urbanizing economies. When this urbanization trend is combined with the extraordinarily high rate of population growth that has occurred in Kenya over the past 15 years, it is clear that the demand for housing and, consequently, mortgage credit, will be very high for at least the rest of this century.

Since 1980, the number of institutions comprising Kenya's financial sector has increased dramatically. Most of this increase has occurred in non-bank financial institutions (NBFIs), deposit-taking limited liability institutions which can charge higher interest rates than commercial banks and engage in some types of lending that banks cannot do, and building societies, mutually-owned institutions that also take deposits and make mortgage loans.

There are now almost 50 NBFIs and 32 registered building societies, not all of them operating as yet, along with 24 commercial banks. In addition to the building societies, four of the NBFIs are specialized housing finance institutions empowered to make long term mortgage loans. One is a subsidiary of a government-owned commercial bank and another is 50% owned by government. Insurance companies complete the picture of financial institutions that lend for housing, the two largest being government-owned.

Because of the proliferation of institutions and some questionable practices (one NBFI failed in 1984) the Central Bank is stepping up its supervision activities and a new Banking Act Amendment has been passed which includes, among other things, provision for deposit insurance, heretofore lacking in Kenya. Regulation and supervision of the building societies which is carried out primarily by the Registrar of Building Societies has been minimal up until recently. The Central Bank has been given new responsibilities in this area, however.

Mortgage lending by financial institutions, government and non-government, has tended to concentrate in the larger cities and reach higher income families. As a consequence, government has stepped in with programs for lower income families through the National Housing Corporation and local authorities, both rental housing and tenant purchase schemes. The programs range from completed housing to core units to sites and services. These institutions, thus, also play a role in housing finance. Significant subsidies are involved, both explicit through below-market interest rates and implicitly through poor cost recovery. The financing for these programs has come from the World Bank, AID's Housing Guaranty Program and government allocation. The repayment requirements of the external loans, coupled with poor cost recovery, makes the programs' selfsustainability appear questionable as now structured.

Therefore, while the social issues posed by rapidly growing housing needs are undoubtedly important, we think that an even more important question is the development of a financial system that can equitably and efficiently mobilize domestic resources. In our view, development of an effectively-functioning housing finance system can play an even more important role by contributing to the development of the overall financial system than it does in the fulfillment of social housing needs. Moreover, we believe that it is only through the development of a vigorous, competitive housing finance system that Kenya's enormous housing needs can be addressed.

Non-replicable subsidies for this sector cannot be expected to begin to satisfy the needs in this area. A viable and flexible cost-recovery system is essential to any improvement in Kenya's housing situation. Previous World Bank and USAID-assisted projects have demonstrated the physical possibilities of building low-income housing. The logical next step is to demonstrate the financial self-sufficiency that must underlie the provision of this durable fixed capital asset.

Our perspective is that housing, even for low and moderate income households, should be viewed as an important part of the fixed capital stock rather than as just a social need. This view suggests that improving the efficiency with which households finance one of the most desired forms of wealth-holding has potentially important effects on the economy:

-- It is probably the most direct means of increasing the share of savings in financial assets. Despite the proliferation of sophisticated financial intermediaries in Kenya, a recent World Bank study indicates that the share of savings in financial assets was virtually unchanged from 1970-82. Providing mortgage credit at market rates would be an important way to pay depositors in housing finance institutions a safe, positive return on their financial assets. Thus, housing finance would serve as an important nexus between the informal and formal financial sectors.

-- By allowing households access to credit at market rates of interest for housing, the system could increase savings by bidding resources away from a sector of the economy that is dissaving, i.e. the Government, and allowing that credit to be used to purchase an asset that will maintain its real value. Recent research suggests that this also would have a substantial positive effect on the supply of savings.

-- It could help eliminate the regressive effects of the current financial system. In 1984, inflation-adjusted interest rates in Kenya became positive for the first time in many years. However, many long term savers, such as National Social Security Fund participants, still receive a zero or negative rate of return. A repressed financial system that sets low interest rates implicity taxes the savings of the poor who do not have collateral and subsidizes borrowers. Financing housing at market interest rates could be an important way to provide long-term savers positive returns on their savings. Importantly, this return would be subject to very little business risk and would thereby help diversify the portfolios of long term institutional investors.

-- It could help lengthen the maturity of risk-taking of the financial system. One of the most important rationales for the current administered interest rate system in Kenya is the vulnerability of a small open economy to international financial events. Unfortunately, this system does not eliminate the risk, it just eliminates the financial system's willingness to bear it. The result is less long term credit with adverse consequences for investment and capital formation. Appropriately-structured adjustable rate mortgages could help broaden the supply of long-term credit, particularly to those households who are also the important entrepreneurs of the informal sector.

-- It could complement the development of the equity market. The March 1986 GOK Sessional paper indicates that a joint IFC-Central Bank of Kenya study will call for tax and regulatory improvements to encourage the development of Kenya's dormant equity markets. However, the discussion overlooks a central impediment to this development: to the extent that businesses do not have to compete with households (who are rationed out of the market) for credit, their borrowing costs of debt are lower. Why in such circumstances should firms issue equity when debt is implicitly subsidized?

-- Finally, the World Bank research suggests that current housing conditions in Kenya, rather than the low income of families, are the cause of disease and health problems. Improving these conditions, therefore, provides broader benefits to the entire society.

In summary, in our view, simple improvements in Kenya's housing finance system, such as through the creation of a liquidity facility and providing greater household access to market rate debt, could be expected to generate much larger benefits to the Kenyan economy as well as help address a pressing social need. We also believe that the timing for these kinds of changes is particularly opportune. The government's presence in the credit markets is contracting, the macroeconomic constraint is improving, and the government has already enacted significant policy changes - positive real interest rates and deficit reductions - and is considering others which a secondary mortgage market-like facility could complement.

A summary of the report's specific recommendations are as follows:

Recommendation No. 1 The Government of Kenya should create a strengthened regulatory/supervisory framework for specialized housing finance institutions (SHFIs), including both the limited liability companies and the building societies, to deal with the rapid increase in the number of such institutions since 1980 and to regulate their lending activities which are taking on more speculative tones. For the industry to expand and to operate effectively it must, among other things, engender a strong measure of confidence which should be enhanced by stronger regulation/supervision. The location and scope of this function should be the subject of a separate study.

Recommendation No. 2 Concomitant with the above, the GOK should take steps to create a liquidity facility for SHFIs. In order to carry out their function, SHFIs must lend for long term mortgages. Since all of their resources are raised through deposits or very short term (3 year maximum) housing bonds and since there is as yet no type of secondary mortgage market functioning, the SHFIs are always facing a potential liquidity crisis. For the more conservative this means keeping a high (in some cases 50%) percentage of assets in a very liquid form. For the not so conservative the risks are greater. To permit these institutions to have a higher percentage of assets in mortgage loans the Central Bank should establish a facility to enable SHFIs to borrow to tide them over short term emergencies.

Recommendation No. 3 The development of a trade association for the SHFIs should be encouraged. In addition to representing a growing and complicated industry, it can foster the exchange of information, set up training for its members, sponsor research and advertising and promote activities such as the development of a secondary mortgage market that will benefit the industry. The beginning steps to formulate such a trade association have already been taken.

Recommendation No. 4 Government along with the private sector should take the initial steps to develop secondary financing facilities for housing. An initial step should be the placing of long term deposits at market rates by the NSSF and the Post Office Savings Bank, perhaps supplemented by Kenya Reinsurance and Kenya National Assurance (all of them government institutions) in approved (by government) SHFIs. This could provide a measure of long term stability and indicate the confidence of government in these institutions.

A second step would be to encourage, utilizing the trade association contacts suggested above, the sale or trading of mortgages to or among institutions looking for long term investments and those wishing to generate more resources. That is, through informal contacts, a housing finance institution could arrange to sell a small block or mortgages to, say, an insurance company with the understanding that if any mortgage defaulted the originating institution would buy it back. This kind of activity could help to develop trust and publicize the market. If such informal selling and trading worked well, it could then provide the impetus to issue more formal securities. The process could evolve slowly of its own initiative but could be accelerated through the informal contacts among the emerging trade association members.

As part of this process the industry needs to look at other factors which will enhance the sale of mortgages or mortgage-backed securities such as establishing the legality of the sale of mortgages, standardizing mortgage documents and ascertaining the desirability of mortgage default insurance.

Recommendation No. 5 There is a need for the government to identify and clarify the appropriate financial relationship between public and private housing finance. While this study focussed primarily on the financial institutions that provide housing finance, the National Housing Corporation and local authorities also carry out lending operations in connection with their programs, usually at some level of subsidy, and, in some cases, programs which the private sector should be able to carry out. Nor do these programs appear to be self-sustaining in terms of generating local resources to carry them out. This entire relationship and the appropriate role for government programs and institutions needs to be examined.

I. HOUSING AND THE ECONOMY

A. Introduction

In the first section of this chapter we briefly consider the recent macroeconomic context that affects and is affected by the housing sector in Kenya. We put particular emphasis on placing possible changes in the housing finance sector within the context of the broader changes in the financial system that the GOK has either recently enacted or is now considering.

In the second section we consider the declining role of housing in the economy, focusing on its recent historical share of GDP, and in fixed capital formation. These declining trends are contrasted with the trends that would be implied by fulfillment of the non-financial aspects of the demand for housing associated with the reduction in per capita income and the increasing rates of urbanization and population growth. We conclude that an effectively functioning financial system (which was not under a significant amount of "stress" related to international economic events) would have allocated a much larger share of resources to the housing sector than has been allocated in the recent years.

Furthermore, as we discuss in a later chapter, it is clear that the financial policies that most affected the housing sector are inconsistent with the Government of Kenya's (GOK's) announced objectives to mobilize resources for equitable development.[1] In other words, while the financial policies that rationed the supply of funds away from the household sector were understandable in the context of the financial structure that characterized

1. See the Introduction to <u>The Development Plan 1984-1988</u>, Republic of Kenya, Government Printer, Nairobi, 1983.

Kenya in the early 1980s and the macroeconomic constraints on the economy at that time, this is no longer the case. The structure of the financial system and GOK policy have evolved significantly since that time. No longer does the financial system serve as a device that regressively subsidizes borrowers, and no longer is the GOK such a dominant borrower of funds.[1] Improving households' unsubsidized access to the financial system -- as through the mortgage market -- can be expected to have significant beneficial effects on both macroeconomic performance and urban development.

In the third section we demonstrate the conformity of the GOK's macroeconomic goals and social goals with respect to improving the housing situation of one of the world's most rapidly growing and urbanizing economies. To do this we first discuss the "housing needs" estimates that would be implied by fulfilling Kenya's needs in both an unconstrained and a constrained context. The unconstrained estimate is not meant to be a realistic forecast or target. It is presented only to give a sense of the dimension to the problem. It presents estimates of the amount of housing production and the share of GDP that would be needed to: (1) upgrade substandard units, (2) replace completely deficient units, (3) provide a new 2-room core unit for each additional net household, and (4) eliminate over-crowding. Such an objective could be achieved only by allocating enormous amounts of resources to housing, perhaps more than double the share of GDP that would be so allocated in the absence of such a goal, and we are

1. This is not true, however, of direct government housing programs, as we point out later, which continue to provide a high level of subsidy which is not focussed on low income families.

not prescribing such a goal as being desirable in any way.[1] As we said earlier, these estimates are intended to suggest the dimension of the housing problem that is posed by such rapid demographic changes. These numbers are stark and the estimates of the needs model used in the Nathan study provide vivid summary statistics.

The constrained estimate, on the other hand, indicates the share of GDP that would be allocated to the housing sector if the financial system did not constrain resource flows. In other words, it presents an approximation of the extent to which increasing the flow of resources to the housing sector is consistent with Kenya's macroeconomic goals of mobilizing resources more efficiently and equitably. It indicates that a significant increase in the share of resources going to housing, on the order of 30 to 40 percent, is consistent with and, in fact, helpful to the fulfillment of Kenya's larger macroeconomic goals. However, given the scale of housing needs in Kenya, even this large increase in resource flows is unlikely to improve housing conditions significantly. Indeed, most of the increase is necessary simply to avert further deterioration in housing conditions.

B. Macroeconomic Context

In recent years Kenya has experienced a decline in real per capita income growth. It has gone from being one of Africa's, and indeed one of the

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1. For example, in the Robert R. Nathan and Associates (Rourk and Roscoe) study of Kenya housing needs (1984) it was estimated that fulfilling needs would require an allocation of approximately 11.9 percent of GDP to housing by the year 1988. This figure is three times larger than the average share achieved over the past ten years. Our updated estimate continues to place the required share of GDP at 10 to 11 percent through the remainder of the century.

developing world's, highest growth rate economies to negative per capita rates in most recent years, and generally deteriorating economic performances in most years since the 1974-1975 oil crisis. Like most other relatively small, open-economies, it has also experienced a sharp increase in the level and volatility of inflation, reaching a peak of 22 percent in 1982, a continuation and even an acceleration of the world's highest population growth rate, 3.9 percent, and one of the world's highest urbanization rates, 7.9 percent.[1]

Government macroeconomic policy and regulation have also changed drastically in recent years. In response to the unstable conditions affecting Kenya's major export goods (coffee, tea, and tourism), and a sharp decline in the exchange rate (going from KShs. 7.97 to US $1.00 in 1977 to KShs. 15.9 to US $1.00 in March 1986) government presence and control of economic activity increased in the early 1980s. It has receded somewhat more recently as external economic conditions have improved. However, the GOK's role in the credit markets and its expenditures as a share of GDP are still significantly higher than they were ten years ago.[2]

This shifting economic environment creates further difficulties for an economy that has a low (about US $420) per capita income and is overwhelmingly rural (83%) and agriculturally-based (1/3 of GDP and over 80 percent of the employment). It is also a system that appears to have one of

1. This is over the intercensal period 1969-1979.
2. Economic Surveys of 1981 and 1985, Central Bureau of Statistics, Nairobi, Kenya.

the least egalitarian distributions of income in the world[1] and one that has not increased its participation in the world economy nor diversified its pattern of trade.[2] Finally, it is an economy that appears to be strongly affected by non-pecuniary economic transactions. As a number of our interviewees suggested, a monetary economy is relatively new to many Kenyans.

The housing sector can play an important role in the overall development of the economy. For example, housing purchases may be motivated by the demand for housing services, as is traditionally assumed to be the case. However, they may also be motivated by, among other things, a demand for:

1. A stable source of rental income. Hence housing demand can be an implicit demand for a stable source of income or something like unemployment insurance.[3] This kind of demand can be expected to be important in an economy with such a high unemployment rate.

2. A source of inflation-hedged wealth to draw down in old age. In this respect its demand is affected by the real return to pension funds and long-term savings vehicles.

3. A means to provide urban housing services to, say, rural kin in return for the kin's future or present services. One recent study suggested that as much as 21 percent of urban wages may be remitted to rural areas.[4] In this sense, the demand for housing is implicitly like the demand for a personal services contract or perhaps medical or "old age" care insurance.

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1. World Development Report, The World Bank, 1984, Table 28, p. 228. The figures are for 1976.

2. Its exports as a share of GDP in 1978-80 was the same as the level achieved in 1950-52, Reynolds, Economic Growth in the Third World 1950-1980, Yale University Press, 1985, p. 410; also its three major exports accounted for a larger share in the latter period.

3. Households in Kenya, World Bank, Michael Bamberger, Director, 1983.

4. Kenya Economic Development and Urbanization World Bank 1983.

4. A demand for an asset that can serve as collateral for borrowing for other purposes. For example, a significant share of corporate debt is issued against the immovable assets of the directors' personal property rather than the corporation. Similarly, as long as land has a structure on it, farmers or small businessmen can take out a mortgage against the property with a building society for other investment purposes. Without such an asset they are often unable to borrow. Hence, ownership of housing can provide one of the few means for small businesses to access formal financial markets.

While these observations may be obvious to an observer of the Kenyan economy, they nevertheless suggest that, when the good in question is as durable as residential housing can be, the structure of the general financial environment may be an important housing policy. In fact, in recent years we believe that it is only a slight exaggeration to say that the most important single housing policy has been financial policy.

Housing is clearly important to the savings decisions of households in an economy in which informal transactions play an important part of economic activity. However, in an economy in which interest rates and credit allocations are centrally-controlled by the government it is even more important. When negative real interest rates characterize the return on most forms of financial assets, as was the case for most financial assets in Kenya throughout 1978-1983[1], the ownership of real physical assets determines whether a household's financial position improves or deteriorates. In effect, in such financial systems savers either subsidize borrowers (such as governments with big deficits and wealthy borrowers who already have collateral and, hence, access to credit) or they withdraw from the formal financial sector. In such a case it is not surprising to see the domestic

1. Various <u>Economic Surveys</u>, Chapter on Money and Interest rates.

savings rate fall.[1] Nor would it be surprising if the informal savings sector boomed. The formal financing system, in such a context, becomes part of the tax system. Borrowers are subsidized and accordingly access to borrowing is limited.

In its fifth five-year plan the GOK recognized the undesirable effects of using Kenya's relatively well-developed financial system as a means to subsidize GOK borrowing[2]. The theme of the plan is "mobilization of domestic reserves for equitable development." Concrete examples of policies that have been or are being implemented that are consistent with this theme are:

- the establishment and maintenance of positive real interest rates since 1984;
- the significant reduction in the GOK's presence in the credit markets;
- the development of a new regulatory structure for depository institutions that will, when finalized, include both a deposit insurance program to increase confidence, and increased attention to the fiduciary responsibility of formal financial intermediaries:

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1. Measures from various issues of Economic Surveys, Table 2.6 suggest this occurred. It fell by 11 percent from 25.1 percent between 1977-1980 to 22.4 percent between 1981-1984. It is measured as the complement of total consumption divided by total resources available for Domestic Investment and Consumption. With the establishment of positive real interest rates in 1984, savings increased. We are not suggesting a clear cause and effect relationship here or for that matter even that a particular trend occurred. Savings data are notoriously difficult to sort out. We are simply suggesting that if financial intermediation can be done with positive real returns it would not be surprising if it increased significantly.

2. It is important that a distinction be drawn between government efforts to monetize the deficit, which is almost certainly one of the most efficient tax mechanisms available in an economy with a significant amount of informal and/or non-monetized economic activity and selective credit policies that the government pursues (e.g. requiring National Social Security Fund and Post Office Savings Bank investment largely in government securities at low rates) to reduce the cost of such deficit monetization. Such policies are not nearly as efficient a revenue source. Furthermore, as we discuss below, they can have significant adverse effects on the efficiency of the financial system.

- the establishment of a Commissioner of Insurance and new regulations to govern the insurance business;

- the preparation of a policy paper to govern the investment strategy of the National Social Security Fund (NSSF) that will, when approved, result in an amendment to the NSSF Act.

- a joint study by the Central Bank of Kenya and the IFC that will be released by the GOK as a discussion paper on the desirability of:

  1) increasing the efficiency of GOK debt-management policy by moving to a less administratively-set interest rate environment; and

  2) improving the functioning of Kenya's dormant equity markets.

These changes suggest that the GOK is moving fairly aggressively _to begin to establish_ a financial system that attempts to intermediate between borrowers and savers so that resources and risks are allocated efficiently. However, it is important to stress that the movement to positive real rates, greater fiduciary responsibility, and less government presence in the credit markets is just a beginning. In fact, at present there is not a true primary market for any debt instruments in Kenya, much less a secondary market for particular types of debt. Rates may now be positive, but the GOK still controls them. In addition, much needs to be done to curb business reliance on debt rather than equity to finance investment projects before the financial and capital markets price business risks anywhere near effectively.[1] Finally, a great deal of managerial skill and/or good luck on international

1. There has only been one new equity issue in the past ten years although during our visit it was announced that Barclays Bank would offer a new equity issue of KShs. 50 million. The "much" that needs to be done includes: improving the investment climate, e.g. price controls, tax changes, and promulgating SEC-type regulations for the stock exchange.

economic events will be needed in order for the deposit insurance program to become financially sound rather than another subsidy to borrowing.[1]

Although Kenya has a fairly sophisticated process of financial intermediation for its level of development, it has not used this system to price and allocate risks. With the stable interest and inflation rate environment of its first ten years of independence, the cost of this lack of pricing policy was small, and interest rates were changed only one time in the 1967-77 period. As in many other countries, however, the fifth five-year development plan recognizes that these costs are no longer insignificant. The frequency with which both the levels and differentials for interest rates has been adjusted since 1980 has created both a very different financial system than the one that operated in the early 1980s,[2] as well as the perceived need to change the rules by which interest rates are set. A clear choice has been made to move towards market rates that are set by institutions that are fiducially sound. However, to emphasize again, while the choice has been made, the policies to implement this choice are only now being put into place.

In our view, the establishment of a secondary mortgage market-like facility in Kenya should be seen as an important part of this evolution

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1. At present there are 32 building societies registered to operate. This is 31 more than the number that served Kenya between 1972-1982, and only 5 less than the total of domestically-controlled firms on the Nairobi Stock Exchange. It is likely that this number will decline sharply, and at least some of the depositors will be eligible for deposit insurance protection. In addition, a number of large non-bank financial institutions that will be eligible for insurance coverage are currently technically insolvent. It will require close supervision and enforcement in order to make the insurance fund truly an insurer that can rely upon fees charged to institutions to cover payments made to depositors rather than a subsidizer of risks.

2. The share of liabilities held by non-bank financial insitutions grew from 22 percent of the share held at commercial banks in 1977 to almost 51 percent in 1984. Source <u>Economic Survey</u>, 1984, Annex 1, Table 5.5.

towards an efficient and equitable financial system. While we are not advocating in the short run a secondary mortgage market in the true definitional sense of the term, we believe a secondary market-like facility can accomplish many of the same ends provided by a true secondary market (see Section V E). It is not only an instrument that will help Kenya fulfill its housing needs, but, more importantly, it is a device that will allow credit to be allocated more efficiently and the financial system to serve the needs of both the relatively poor and the informal sector more efficiently. Moreover, not to focus on how such a facility would complement other GOK policies designed to improve the equity and efficiency of domestic resource mobilization is to unnecessarily cast the argument into a provincial as well as a misleading "housing priorities" versus more pressing structural adjustment priorities. Not only are fulfillment of these priorities <u>not</u> mutually exclusive, they can be mutually re-enforcing. In our view, this kind of misleading perspective was taken in a recent World Bank study, where it was argued:

> There have been various proposals to increase the supply of housing finance by long term investments through the National Social Security Fund (NSSF) or by additional tax advantages for savings depositors. These proposals largely ignore the opportunity cost of reallocating capital funds in Kenya's tightly controlled domestic finance market. Given the current economic constraints in the country and the priority needs of industries -- there is little prospect of a reallocation of capital funds to the housing market. (p. 14 Executive Summary)[1]

An implicit premise of this view is that any such supplying of credit to housing by NSSF or other institutions serving long term savers would lower

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1. <u>Kenya Economic Development and Urbanization Policy</u>, World Bank East Africa Project Dept. 1983.

the returns to the savers to benefit housing, which has a lower rate of return than industry.

However, participants in the National Social Security scheme have in recent years received a negative return on their savings in order to lower the cost of GOK borrowing. At present they receive a zero effective rate of return.[1] Hence, NSSF policy has encouraged government dissaving (by making its expenditures cheaper), and discouraging formal financial intermediation (by yielding a negative return to savings, and rationing households from credit for which they would pay market rates). A policy that permitted middle-income households to bid for funds with the GOK and businesses to purchase an asset (housing) that should appreciate in real terms, that is generally uncorrelated with business risk, and for which there is enormous demographic demand, would improve the efficiency and equitability of resource allocation. It could also provide a safe, positive, real rate of return to a social security system that, unless current policies are changed, will provide less effective purchasing power to participants than was contributed.

In the next section we attempt to demonstrate why we believe the financial sector has been a binding constraint not only on housing expenditures but on resource allocation generally. What we show is that non-financial factors., i.e. income change, population, etc., could not have explained the secular decline in the share of GDP going to residential capital. The elimination of the above factors points to financial policy as

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1. Beneficiaries of NSSF receive an 8 percent nominal return on their accumulated savings.

the reason and, as we show in a later chapter, we believe that the circumstantial evidence is compelling.

The theme of our argument is not that housing is a socially meritorious good of which more is needed, (although in the Kenyan circumstances a reasonable person might make this argument) but rather that the current financial system results in less resources allocated to housing than would a freely operating system. This misallocation in turn produces: greater fragmentation and higher transactions costs for financial intermediation, greater reliance of the business sector on debt rather than equity financing, lower overall economic growth due to the deadweight losses of regulatory "taxes" on saving, less incentive for government to reduce spending since its borrowing rate is subsidized, and greater pressure to increase relatively inefficient government spending to offset the regressive distributional effects of financial regulatory structure.

In addition, the creation of a secondary market-like facility would also be an efficient means to improve housing conditions. The importance of this contribution is difficult to overlook. Although Kenya's current and prospective population and urbanization rates are among the highest in the world, GOK explicit expenditures on housing are among the lowest. Unless current housing trends are reversed, it would appear virtually certain that Kenya's future housing needs will outstrip new housing production by a wide and increasing margin.

For example, the recent GOK Sessional Paper indicates that 100,000 urban housing units will be needed annually for the rest of the century. [1]

1. GOK Sessional Paper, Economic Management For Renewed Growth (released March 1986).

This is about fourteen times the annual rate of production by the formal sector over the past eight years.[1] Moreover, given the scale of the potential shortfall in housing production, further decline in the state of current housing conditions is likely, (which according to the GOK are deplorable: 35 percent of urban dwellers live in slums or squatter developments and only six percent of rural dwelling units are permanent (P.38 ES 1984). Such a deterioration in housing conditions could serve to seriously constrain economic growth and social development.[2]

C. Resource Allocation

In order to assess policies with respect to the housing sector we first review recent trends in fixed capital formation in dwellings as it relates to Gross Domestic Product (GDP) and fixed capital formation generally. The trends indicate a steady secular decline in housing's share of both GDP and gross fixed capital information.

This trend is then compared with the kind of trend that would be predicted by the behavior of traditional real, as opposed to financial, factors that should affect resource allocation to housing. All the relevant factors: the increase in the urbanization rate, the increase in the population rate, the possible contracting problems and competitive weaknesses of the mortgage market, and even the trends in real per capita income, imply that, if markets had functioned efficiently, little or no decline or even an increase should have occurred.

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1. See Economic Survey 1985 Table 3.8.
2. The World Bank Report, Kenya Economic Development and Urbanization Policy, presents evidence that current housing conditions, rather than income levels, produce disease and higher infant mortality.

The following table presents a number of growth rates that give some insight into housing's place in the Kenya economy between 1979-1984.

ANNUAL GROWTH RATES OVER 1979-1984

1.	Per Capita GDP Income in Real Prices	0.0
2.	Inflation	12.0
3.	Population	3.9
4.	Urban Population	7.9
5.	Total Fixed Capital Formation in Current Prices	9.0
6.	Fixed Capital Formation in Housing in Current Prices	6.0
7.	Urban Housing Fixed Capital Formation in Current Prices	-1.5

Data are from Various Economic Surveys.

Income

The first line indicates that real, inflation-adjusted income growth has been close to nil over the time period. This kind of income constancy produces a greater reliance on the existing housing stock because housing is a durable good and, by postponing its construction, one is, in effect, foregoing mostly future consumption rather than current consumption. When income is not rising, it is often desirable to seek ways to reduce current consumption as little as possible and reducing housing construction is one way to do this. This type of effect should lead to housing making up less of GNP.

On the other hand, however, this greater reliance on the existing stock may bid up rents so that more is spent on housing. If this is so more of current income will go to the housing sector, increasing the share of GDP allocated to housing production.

Statistical studies could be used to estimate how much changes in per capita income should change resource allocation to housing. While the quantitative estimates from these partial equilibrium perspectives should be taken with some caution, the qualitative relationship is clear: minimal change in real income should have a minimal effect on the share of resources going to housing.

Hence, before taking demographic and urbanization figures into account one would expect a housing share of GNP that is comparable to that observed in 1979 and somewhat larger than the average of the last two years for which we have data (1983 and 1984). Instead, we witnessed a decline of 1.3 percent of GDP, almost four times as large.

Urbanization

Comparisons of lines (5) and (6) with line (1), i.e. Gross Fixed Capital Formation as a share of GDP, and Fixed Capital Formation in Housing as a share of GDP, indicates that capital formation in general suffered as a result of the lack of growth in real per capita income.[1] It also indicates that housing capital -- including both the modern and traditional sectors -- formation declined even more sharply. And, although there is no disaggregated data, our interviews gave the strong impression that the drop in resources going to lower to moderate-income households was even sharper than the overall trend. The conjecture was that low real-interest rate mortgages and rapidly appreciating property values made housing an increasingly attractive investment to the limited number who had the collateral to obtain access to credit.

As a share of GDP, housing went from 4.7 percent in 1979 to 3.4 percent in both 1983 and 1984. The downward trend was never reversed. As a

1. This, of course, is an extremely short trend and as such should be regarded with caution.

share of gross fixed capital stock, it went from 17.2% in 1979 to 15.0% in 1984, with 1982 representing the only year that housing's share increased over the previous year.

Comparisons of lines (4), Urban Population Growth, and (7) Urban Housing Fixed Capital Formation in Nominal Prices, also presents an interesting insight into resource allocation to housing. The 7.9 percent growth in urban population in 1979 translated into approximately 29,000 additional urban households; in 1984, it implied more than 37,000 new households.[1] Each of these new households induced additions to the urban housing stock, of about K.Shs. 1830 in 1979, about K.Shs. 1310 in 1984.[2] However, remember that prices had approximately doubled during this time period, so that the inflation-adjusted value of the latter figure is halved. Consequently, in inflation-adjusted terms each new urban household in 1984 spent or received about one-third of the amount that a similar household had spent on additions and improvements to the existing housing stock six years earlier.

Even if only one half of these additional urban households is housed in the very conservatively priced KShs. 30,000 unit that the new Sessional Paper aims at as an appropriately-priced unit for lower income families, then the housing share of GDP must increase by .25 of GDP.[3] In short, it is

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1. See tables 3.1 and 3.9 of the 1985 Economic Survey, Kenya.
2. These figures are derived by dividing the share of the amount of urban housing fixed capital formation by the number of new urban households.
3. GOK Sessional Paper, Economic Management for Renewed Growth. According to the Ministry of Works, Housing and Physical Planning's Kenya Low Income Housing Report, KShs. 30,000 will purchase a unit that includes a single rental room of 12.8 sq. meters and shared facilities (House Type R-6).

difficult to imagine how current and recent urbanization and demographic trends could possibly result in less resources going to housing capital formation.

Population

It is true that the dependency ratio of the share of population under 15 and over 60 relative to the working population between those ages will increase slightly in coming years, and that this should reduce the number of households for a given increase in population. In addition, the share of the population in those years that form households most frequently, age 20-29, will also decline slightly through the 1980s.[1] Nevertheless, Kenya's demographic die has been cast; increasing population growth rates (from 3.3 in 1974 to 3.9 in 1978) will call for a greater share of GDP allocated to housing, perhaps as much as .25 percent more of GDP.

Adding this figure to our other real factors indicates a housing share of about 4.1-4.2 percent of GDP, with significant prospective upward pressure from all three factors. This is a figure that is approximately ten percent higher than what was achieved over the 1975-1984 period, and similar to the level achieved during 1979-1984. However, it is also a figure that is more than 20 percent higher than the results achieved in the last two years, i.e. 1983 and 1984.

Housing Affordability

A final factor that affects the share of GDP allocated to housing is its relative cost or affordability. We consider three possible problem

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1. See the Economic Survey 1979, Chapter 3.

areas: mortgage contracting problems, lack of competitive pricing in either the housing finance or housing input markets, and the level of standards set for the housing units that are produced.

Mortgage contracting can pose an affordability problem whenever contract terms are based upon nominal rates that are lower than the inflation rate, particularly when the inflation rate is relatively high. With either fixed-rate or variable-rate mortgages, high inflation rates cause real monthly expenses to be tilted towards the earlier years of the loan even though inflation has no effect on real overall costs. In effect, under high inflation, lenders want to be compensated in the near term for the more rapid erosion of the real value of future payments caused by the higher inflation.

Consequently, it seems very likely that higher rates of inflation have made housing less affordable in Kenya. One recent study suggests that this effect would have significantly reduced housing's allocation due to the kinds of inflation experienced in Kenya during the early 1980s.[1]

Lack of competitive pricing in housing input markets can also make housing less affordable simply because of the higher prices that can be charged for inputs. For example, in Kenya, the current ceiling on mortgage interest rates is 19 percent. Most new building societies and housing finance institutions keep rates at this ceiling. However, with a roughly 9 to 10 percent inflation rate this implies a very high real borrowing cost of about 10 percent.

In addition, the Housing Finance Company of Kenya, the East African Building Society and Savings and Loan Kenya, old line institutions, are

1. Robert Buckley and Ranjana Madhusudhan, "Financial Aspects of Housing's Role in the Economy: An International Analysis" Maxwell School Working Paper, Syracuse University, 1984.

simultaneously charging an effective mortgage rate of about 16 percent. This is still a relatively high real rate, but significantly lower than their competitors' rate. The simultaneous existence of such a large interest rate differential, 3 percent, suggests that the mortgage market is not very competitive, and/or households do not sufficiently understand the borrowing terms offered to them so that they can compare these terms with alternatives available to them. If this is so, housing is both unnecessarily expensive and resources are misallocated from households to lenders.

The sessional paper indicates that if population growth can be held to 3.7 percent per year, average incomes by the year 2000 would be about 14 percent higher than the 1980 figure (p. 7). In other words, income growth would be slightly more than enough to restore the 20 percent cut in real income that has occurred since 1978. If we follow our earlier logic, this should result in an increase in GDP going to housing of about .4 - .5 percent over the 4.1 percent level that occurred in recent years.

This "optimistic" or hopeful population growth rate would represent a tempering of demographic demands over those of recent years. However, any such slowing is unlikely to exert much downward pressure on housing demand. When combined with the urbanization rates, there should be additional resources going to housing. The effects of urbanization rates on the demand for housing depends fundamentally on the degree of success of the secondary cities approach that underlies government planning. Success would help to minimize the pressure for increased resources but it is hard to imagine it declining. As the 1985 Economic Survey described it:

> Considering that the total urban housing stock in 1979 accommodated nearly 550,000 households, the output of new urban dwelling units required over the next five years represents 55 percent of the entire housing stock existing in 1979 while the output required between 1990 and 2000 amounts to twice the 1979 total. (p. 29)

We conclude that at least .25 percent more of GDP will go to the housing sector even if the program continues to diffuse urbanization rates.

Finally, as we discuss in a later chapter, a financially-deeper, more effectively functioning financial system increases household ability to adjust their portfolios to the vagaries of macroevents, particularly in small open economies such as Kenya. Household attempts to insulate themselves from such shocks will result in both more savings, and more of that savings in housing. The issue is, "will households be allowed to so structure their savings?" At present most of them are not.

In sum, we think that a reasonable range of effective housing demand is likely to be on the order of 4.3 to 4.7 percent of GDP. This is a figure that is consistent with the optimistic forecast of the recent Sessional Paper (p. 49). It is also, however, 30 to 40 percent higher than the figure achieved in the past two years, and less than half the share needed to fulfill all of Kenya's housing needs. However, before explaining our estimates of these needs, it is important to emphasize that, while we think that housing's share of GDP would increase if markets worked effectively, we are nevertheless agnostic as to what the appropriate or optimal level should be. Our point is not that we or anyone else knows what this optimum is. Rather, as we discuss in Chapter V, our point is that more competitive debt markets should be permitted to determine this level.

D. <u>Housing Needs Estimates</u>

In order to get a better sense of the magnitude of Kenya's housing problems, a housing needs assessment conducted in early 1984 by Phillip Rourk and Andrew Roscoe of Robert R. Nathan and Associates (Rourk and Roscoe, 1984) was updated.[1] Some of the key results of this update are presented below.

Despite the GOK's recent successes in reducing minimum housing standards in urban areas, the financial burdens posed by Kenya's housing needs are tremendous. Under current standards, annual expenditures roughly equivalent to 10 to 11 percent of GDP would be required throughout the remainder of the century to adequately house Kenya's burgeoning population. By the end of the century, required housing production in urban areas alone is likely to exceed 100,000 units per year; in rural areas a staggering annual production rate of 290,000 units may be required. Even as early as 1988, required annual production of units will reach nearly 60,000 in urban areas and about 220,000 in rural areas.

Even with lower standards in effect, the cost of a core unit remains prohibitive for most Kenyan households. Over the planning period, roughly 40 percent of metropolitan households, and 80 percent of households residing in other urban and rural areas will be unable to afford such dwellings without varying degrees of assistance. Given expected levels of future income -- even assuming that most households devote an unusually large 25 percent of their earnings to housing expenses -- the difference between the total investment that households can afford to make and the investment requirement needed to achieve the objectives of the housing plan reaches nearly 2.6 billion (1983 KShs.) in 1988.

To a large extent, Kenya's housing needs are driven by new households formed out of its growing population. New households account for

1. A summary of the procedures used to update the Rourk and Roscoe study, an explanation of the model used in the study, and the results are contained in Annexes C, D, and E.

approximately half of the total housing production requirements over the planning period. Even if the rate of population growth were to immediately decline, there would only be a limited reduction in housing investment requirements. This occurs because the population that is expected to form the new households over the next two decades or so is already living.

The large, unconstrained needs estimates presented above correspond poorly to the more realistic levels of anticipated housing investment discussed earlier (4.3 to 4.7 percent of GDP). This, of course, is an indication of how severe Kenyan's housing problem is. It also suggests that continued efforts toward developing a more modest and incremental approach towards satisfying Kenya's housing needs are necessary merely to avoid deterioration in the housing situation of Kenya's population.

II. GOVERNMENTAL FRAMEWORK FOR HOUSING

A. Introduction

Housing is financed and supplied through a variety of channels that include three different government organizations: The Ministry of Works, Housing and Physical Planning (MWHPP), the National Housing Corporation (NHC) and local authorities like the city of Nairobi. The MWHPP is charged with developing and administering government policy and programs in housing. All government programs include some level of subsidy.

From the financial sector, funds to finance housing include the partially government-owned Housing Finance Company of Kenya, the government-owned Savings and Loan Kenya and two government-owned insurance companies. Indirectly, funds for housing flow from the National Social Security Fund.

In our analysis and interviews we focussed primarily on financial sector activities with a view to increasing the effectiveness and level of financial flows to housing on a market-oriented basis including the possibility of secondary financing facilities which might eventually lead to a true market. As a consequence, most of our discussion emphasizes mortgage lenders and the possible sources of additional financing and we only touch on the complicated interactions and processes of government programs. Nevertheless, a number of features of the public sector warrant mention in the larger context in which our study must fit. In what follows we briefly discuss some aspects of the public sector delivery system and the subsidy it entails. The GOK's financial policy and its effect on the private sector is discussed at the conclusion of Chapter III, The Financial Sector. Finally, the public sector's housing finance activities are discussed in Chapter IV on Housing Finance. Our discussion of the public sector is not by any means complete. We emphasize only those features that seem to be important as they relate to the functioning of the overall housing finance sector and private lenders within that sector.

As stated above, the Ministry of Works, Housing and Physical Planning has overall responsibility for government housing policy and implementation of government programs. It does not, however, directly carry out the programs. That is done by the National Housing Corporation and the various local authorities. Brief descriptions of the programs of these institutions follow:

B. The National Housing Corporation

The NHC in its present corporate form was established in 1967. Although it reports to its board of directors, it is also subject to the supervision of the MWHPP. Its primary role has been to develop and finance housing projects but it now also provides technical assistance to those local authorities who need it and, in some cases, directly implements local authority projects.

The NHC's current housing programs fall into what it loosely defines as "middle class" projects and "low cost" projects. In middle class projects the cost of the houses ranges from KShs. 250,000 to KShs. 400,000. NHC finances the construction by borrowing commercially at 14%. The cost of the construction financing is included in the price of the house. The long term financing of the mortgages comes from the Housing Finance Company of Kenya (HFCK).

NHC has an informal arrangement with HFCK to provide the long term financing for its projects. This is not required by law or some government decree; it is really a complementary relationship. There is a consultative committee set up for each project.

Although it is NHC's intent to cover its costs on these projects, it is not always able to price its projects at cost in secondary cities.

In some cases NHC has had to reduce the prices in order to sell the houses. Although it might take a loss on a project in a secondary town, NHC hasn't tried up to now to make up for this by charging more on, say, a Nairobi project. In other words, NHC has not engaged in cross-subsidizing. NHC is, however, including a small profit margin on a new Nairobi project.

For its low cost projects the financing comes from several sources; the government through the MOWPP or through external funding such as the AID Housing Guaranty Program (HGP) or from World Bank loans.

NHC has three types of low cost projects:

LOW COST RENTAL - NHC borrows from the government at 6% for 40 years and on-loans to local authorities for the same term at 6 1/2%. The local authorities handle the rentals. In the big municipalities with the capability to handle construction it is a straight loan. For smaller towns, NHC will act as developer using contractors and turn the project over to the local authority.

SITES AND SERVICES - NHC gets money on the same terms as above from the GOK. It on-lends to the local authority for 20 years at 6 1/2%. The local authority lends to the purchaser for 20 years at 8%. Construction of the sites and related services is on same basis as above. The beneficiary is responsible for constructing the housing unit.

TENANT PURCHASE - This type of project is financed on the same basis as sites and services projects but the project is composed of completed houses. The purchaser does not get title until the house is paid-off.

Where special funding is involved, i.e. AID HGP or World Bank, the terms that relate to the financing source are applied. For instance, in the case of a recent HGP which is being utilized for housing in small towns, the GOK terms to the NHC are 11% for 27 years plus a grace period of 3 years. NHC lends to the local authorities for 11 1/4% for the same term. Local authorities on-lend to purchasers of serviced sites (and/or core houses) at 12%.

The above applies only to the cost of the super-structure and on-site infrastructure. For off-site infrastructure and community facilities the HG funding comes through the Ministry of Local Government (The Local Government Loans Authority) to the local authority.

The Government's "Development Estimates for 1985-1986" indicate NHC would get a total of KShs. 8.5 million. It's not clear, however, whether this is a grant to cover operations or whether this includes the loan fund from the GOK.

NHC faces very serious defaults on the loans it has made. It was indicated that over 80% of the local authority obligations to NHC were not fulfilled and about 60% of individual loans were not repaid.

In the previous chapter we discussed the secular decline in the share of resources going to the housing sector. While the causes of this decline are multi-faceted and affected both the private and public sector, the single biggest source of the reduction comes from the lower activity levels of the NHC. For example, between 1979 and 1983 formal housing units completed per year (inclusive of sites and services) declined by slightly more than 5500 units from 9567 to 4024. (See Table II-1.) During the same period NHC's activity fell by almost 5200 units from 6474 units in 1979 to 1285 units in 1983. NHC completion of units did pick up to about 4500 in 1984.

As can be seen from Table II-1, NHC accounted for two-thirds of the formal housing units completed between 1979-84, and the local authorities

Table II-1

RECORDED COMPLETION OF DWELLINGS BY PUBLIC AND PRIVATE SECTORS COMPARED WITH THE FORMATION OF NEW URBAN HOUSEHOLDS, 1979-1984

Table 3.8

	1979	1980	1981	1982	1983	1984°	Total	%
National Housing Corporation Houses ..	4,085	3,527	2,755	2,928	687	2,393	16,380	37·2
[illegible] and Service	2,389	2,454	2,719	2,550	598	2,099	12,809	29·1
nistry of Works and Housing°°	156	482	471	49	968	154	2,230	5·2
Other Public Sector ..	221	481	206	443	790	155	2,290	5·2
Private Sector	2,716	2,065	1,918	2,083	981	451	10,214	23·2
TOTAL.. ..	9,567	9,009	8,069	8,033	4,024	5,257	43,979	100·0
Estimated number of new urban households ..	29,800	32,100	34,700	37,400	40,400	43,600	218,000	
Recorded new units as % of new households ..	32·1	28·0	23·3	21·5	10·0	12·1	20·2	

°Provisional.
°°Data for the fiscal year brought forward to the calendar year.

Source: Economic Survey, 1985, p. 38

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accounted for an additional 10 percent. Hence, it is clear that the public sector has played a major role in the provision of housing services. As indicated, a significant portion of this role was funded by the World Bank, USAID and other international agencies. These projects helped cause the share of GDP going to the housing sector to increase to the relatively high levels that were observed in early 1980s. A major goal of these projects was to investigate as well as demonstrate how large sites and service schemes and core housing could accommodate lower income households. The physical aspects of this demonstration are considered successful. However, the financial and loan recovery aspects were not emphasized as pointed out. While the NHC often served as loan dispursal agent, for instance, it did not truly serve as a financial intermediary.

NHC funds have often become a form of GOK grant to local authorities, with the GOK repaying the international lenders. Our interviews indicated that on almost all the projects NHC funded with local authorities the authorities use the project rents for other local expenses and do not remit payments to NHC. NHC, in effect, is misperceived as a financial intermediary. Although it provides technical assistance on the development of housing projects, its central role appears to have been to serve as something of a local revenue sharing device. The result is that while a great deal of housing has been constructed and planning related technical expertise centralized in NHC, the institution through which these services have been provided is de-capitalized. It has not used its domestic borrowing authority and it receives little in the way of loan repayment.

The level and targeting of housing subsidies appears to be ineffective. While the housing subsidies used take a number of different forms, it is not clear that the resources are effectively targeted. For example, NHC has made 8 1/2 percent homeownership loans available when nominal mortgage interest rates have been 19 percent and the inflation rate over 20 percent. While it is difficult to say precisely what the market interest rate was, it is reasonable to argue that during the early 1980s it exceeded 20 percent and at present is 19 percent. These figures imply subsidy levels of 60 percent or more. In addition, loan recovery has been poor, increasing the effective subsidy to 70 percent or more.

Besides the high level of subsidy per loan, many of the loans have been absolutely large. Effective targeting to lower priced units, more on the order of the Nairobi Housing Development Department programs combined with lower per unit subsidies, say 15 to 20 percent, could increase the target audience by a multiple. It is not hard to construct a targeting scheme that would subsidize five to ten times as many units as has been done by NHC in the past. However, it is important to stress once again that the above discussion is illustrative. Empirical documentation on who the beneficiaries are and a better analytical rather than accounting measure of the amount of subsidies would be a prerequisite exercise to any attempt to improve the targetting of subsidies.

C. Nairobi Housing Development Department

Neither the time or the scope of the study permitted a detailed look at local authority housing programs. A brief look at Nairobi's housing programs was done even though recognizing that Nairobi is at a level far exceeding other local authorities. It does represent the pattern of local authority housing programs, however, even though smaller authorities may not have separate housing departments. What is interesting is the scope of activities of the Nairobi Housing Development Department. Within the past eight years or so it has financed or has underway over 24,000 low cost units including sites and services. The HFCK, by comparison, has financed housing for "only" some

15,000 families, including NHC-developed housing, in its 20 years of existence.

The Nairobi Housing Development Department, which was set up in the mid 70's with the help of the World Bank, is responsible for the development and administration of low cost housing developments in Nairobi. There is a Department of Social Services and Housing which is responsible for administering the City's rental housing although at present there is no new rental housing being built. All new projects are tenant purchase. (Annex F provides more details on Nairobi's housing programs.)

III. THE FINANCIAL SECTOR

A. The Regulatory and Supervisory Framework

The Central Bank of Kenya (CBK) is the basic regulatory/supervisory body for banking and other deposit-taking financial institutions in Kenya. Its activities are governed by the Central Bank of Kenya Act and the Banking Act. For the most part this means the commercial banks and so-called non-bank financial institutions (NBFI's) described in more detail below. More recently (1985) the CBK has taken on supervisory responsibilities for the building societies.

As set forth in the Central Bank Act, the main responsibilities of the CBK are "to regulate the issue of notes and coins, to assist in the development and maintenance of a sound monetary, credit and banking system in Kenya conducive to the orderly and balanced development of the country and to the external stability of the currency and to serve as banking and financial advisor to the Government".

To this end the CBK administers a set of policy instruments which include interest rate guidelines on minimum deposit rates and maximum lending rates, setting the discount rates, setting reserve requirements, administering selective credit controls and setting foreign exchange restrictions.

Issuance of actual licenses under the Banking Act comes from the Ministry of Finance with the advice of the CBK. The MOF shares with the CBK the functions of monitoring the financial sector and in establishing monetary and economic goals and policies.

The Registrar of Building Societies (RBS) is under the Attorney General's Office and is responsible for administering the Building Societies Act. It operates with a very small staff; a Senior Estate Controller and two inspectors.

The insurance companies are governed by an Insurance Companies Act which is administered by the Registrar of Insurance located in the Attorney-General's Office. Regulation has been minimal and the Act does not specify composition of the investment portfolio of insurance companies.

A new Insurance Act was gazetted in 1985 which, however, will not go into affect until July 1, 1986 or January 1, 1987 at the latest. It establishes the position of Commissioner of Insurance who will report to the Minister of Finance. Among other things the Act specifies the composition of insurance company assets within broad categories. The new specification, however, does not differ significantly from the current portfolio structure.

B. The Institutions

1. Overview

Kenya has a broad and well developed array of financial institutions. In addition to the Central Bank, there are 24 commercial banks and almost 50 non-bank financial institutions (NBFI's), both types of institutions being deposit-taking institutions licensed under the Banking Act, 32 (registered) building societies licensed under the Building Societies Act, a Post Office Savings Bank, a Cooperative Bank (apex bank for the cooperative movement) and a large number of savings and credit societies, some 42 insurance companies, several development finance institutions, the National Social Security Fund and other private pension and provident funds and one equity finance/venture capital company. Kenya also has a stock exchange which has operated for many years although with a very thin market.

Several key financial institutions, e.g. two commercial banks, two housing finance institutions, the National Assurance Company, the Kenya Reinsurance Company, the Post Office Savings Bank and the National Social

Security Fund are wholly or partly owned by government. However, most financial institutions represent a vigorous private sector.

The commerical banks are important mobilizers of financial instruments although their relative importance has declined in recent years. As of December 1984 their total assets were KShs. 24.8 billion, compared to KShs. 12.5 billion in assets of NBFIs. Insurance companies had about KShs. 10 billion in assets at the end of 1985. The commercial banks are also the most important source of funds for the private sector. As of December 1983, their total advances outstanding to the private sector were almost KShs. 16 billion, compared to a figure approximately half that for NBFIs.

Since commercial banks and NBFIs concentrate on short-term deposits, the financial system is oriented as a whole towards the provision of short-term finance. This tendency became more exaggerated in the early 1980s as the administered interest-rate ceiling increased the riskiness of long-term lending. Finally, an ancillary consequence of the development and growth of the NBFIs is that commercial banks' liabilities have become even shorter term as the NBFIs have placed increased competitive pressure on deposits with longer maturities, bidding them away from commercial banks.

As the relative share of the commercial banks in the financial system has declined in recent years, deposit-taking NBFIs have become the fastest growing section.[1] Comparing the deposits in NBFIs with time and savings deposits in commercial banks, deposits in NBFIs have risen from 42

1. See any recent Economic Survey for a documentation of this trend. In particular see page 65 of the 1985 survey for a comparison of rates of growth.

percent of such deposits in commercial banks at the end of 1976 to 65 percent at the end of 1984. There has also been rapid growth in the number of such institutions. Moreover, as restrictions on NBFIs have grown, building societies increased from the one institution that had served Kenya throughout most of independence to 32 at the end of 1984 (although only 15 are in operation).

The impetus behind this growth was clearly a favorable differential in interest rates that NBFIs could pay on deposits as well as lower reserve requirements. The former relates to the fact that commercial banks are limited to 14% on loans while NBFIs and building societies can charge 19%. NBFIs have also been able, until recent changes by the Central Bank, to charge effective rates of interest that exceed the stated maximum.[1] The NBFIs and building societies appear to be the next major source of private-sector finance, principally through mortgages, hire purchase, secured installment loans and trade credit. NBFI lending is also mainly short-term, with their hire purchase and installment loans having average maturities of three years.

Building Societies tend to lend for 15 year mortgages with variable rates. The discretion to vary the rate appears to be completely the lenders up to the 19% maximum. However, the Registrar of Building Societies can determine the "reasonableness" of most building society practices and could probably overrule any changes thought to be too drastic or unfair. Because of the diversity of financial services they offer, the NBFIs have not

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1. They do this through charging on the original principal rather than the unamortized segment of their loans.

been as well regulated as the commercial banks, and some of them have weak financial structures. This problem was recently addressed by the new Banking Act of 1985 which is discussed subsequently. However, its provisions remain to be implemented.

Four development banks are currently the primary source of long-term debt finance for productive investment. Two of them, the Industrial Development Bank and the Development Finance Company of Kenya, specialize in financing medium and large-scale industry by mobilizing foreign exchange loans from external sources for onlending to investors. In the past these two banks also supplied long-term local currency capital, both equity and debt, but their activities in this area have declined as they have been unable to raise long-term local currency. The total loan and equity portfolios of these development finance institutions as of December 1983 was KShs. 2.4 billion, which was only 10% of the total private-sector loans of commercial banks and NBFIs at that time.

The pension funds are also important mobilizers of financial savings in Kenya. At the end of 1984, the total estimated portfolios of such institutions accounted for about KShs. 15 billion.[1] This compares with approximately KShs. 24.8 billion in assets for the commercial banks and KShs. 12.5 billion for the NBFIs as of the same date. The largest of these contractual savings institutions is the National Social Security Fund (NSSF), which held KShs. 8.1 billion (66%) of these investments. NSSF had invested KShs. 5.5 billion of this in government stock and is currently investing

1. See Central Bank of Kenya reports.

all of its new collections in GOK paper awaiting the development of a new portfolio strategy. The private insurance and pension funds had about 40% of their investments in real estate.

Finally, interest rates, which are controlled by the Central Bank and currently range from 11% to 16.5% per annum for deposits, became positive in real terms in 1984, and therefore are no longer a direct disincentive to the holding of financial assets in the form of deposits. Their relative levels, however, are still affected by GOK decisions. In fact, some deposits (e.g. with the Post Office Savings Bank) as well as housing bonds are tax free. On the lending side, as mentioned above, commercial banks are limited to a maximum of 14% on their loans; other financial institutions can charge up to 19%.

In sum, the financial system, at least as regards deposit mobilization and lending, appears to be fairly, if imperfectly, competitive within the rules dictated by the Central Bank and Ministry of Finance. Although government mandates that banks and NBFIs lend to agriculture an amount equivalent to 17% of their deposit liabilities, and directs that NBFIs hold treasury bills to the extent of 50% of their liquid assets, there is less government intervention in credit allocation than is the case in many developing countries.

We now turn to a more detailed discussion of the intstitutions that make up the finance system.

2. <u>Commercial Banks</u>

Of the 24 commercial banks, four dominate the system; the Kenya Commercial Bank, Barclays Bank of Kenya, Standard Bank and the National Bank of Kenya. Two of the banks, Kenya Commercial Bank and the National Bank of Kenya, are owned by the government while a fifth bank, Grindlays Bank

International is 40% owned by the government. Most of the remaining banks in the system are foreign controlled but, more recently, several banks have opened which are financed by local investors. In June 1983, the four major banks held about 65% of the total deposits held by the commercial banks but this was a declining figure. Barclays Bank alone by the end of 1985, however, had 30% of the total savings account business of all deposit taking institutions. In terms of loan volume, the four largest banks had slightly over 60% in June 1983.

Since the major proportion of commercial bank deposits are short term (averaging between 3-6 months), loans are also for the most part short term. Three years is the maximum loan that commercial banks can make but loans seldom exceed two years. The banks have traditionally concentrated on import-export financing, domestic trade and business loans, provision of letters of credit and foreign exchange transactions. Only commercial banks can issue overdraft facilities. There has been almost no equity financing.

No more than 24% of a bank's loans can be in real estate. Presumably this is in the form of construction loans although it's not clear whether residential mortgage loans to employees count in this figure.

Some of the banks have trust companies as subsidiaries (or departments) responsible for investing the assets of private pension and provident funds and of individuals and/or their estates. Such trust companies invest in equities, lease hires, real estate, mortgages and more liquid assets in terms of time deposits. Although no overall figures were available on trust company assets, Barclay's Trust Company was reported to manage "several hundred million" in assets.

The old line commercial banks have tended to be very conservative in their lending. It's not uncommon for a bank to get 200 %

collateral for loans, even though they're short term, and this means something tangible, e.g. cash, property, stocks, bank guaranties etc. What we're talking about here are personal loans and small business loans so you can see how difficult it is to get a loan.

3. Non-Bank Financial Institutions

The Banking Act defines a financial institution as "a company, other than a bank, which in Kenya accepts deposits of money from the public repayable on demand, or after a fixed period or after notice and employs these deposits in whole or in part by lending or any other means for the account and at the risk of the person accepting the deposits, and any other company carrying on financial business which the Minister may by notice in the Gazette, declare to be a financial institution for the purpose of the Act". Such companies in Kenya are registered under the Companies Act and licensed under the Banking Act and are known as non-bank financial institutions (NBFIs).

The growth in the number of NBFIs has been remarkable; 16 in 1980, 23 in 1981, 32 at the end of 1982 to something around 40 in 1984 and now to almost 50. The first such institution was established in 1955. This growth in the number of NBFIs is reflected in the statistics cited in Section III B 1 above and in Table III 1.

Why the rapid growth? The NBFI's activities have included financing hire purchase, housing mortgages and, to some extent, merchant banking. More recently these activities have expanded to include construction or bridging loans and bills discounting. The Banking Act has restricted the activities of commercial banks in hire purchase and real estate. Interest rate regulations permit NBFIs to charge 19% on loans while restricting commercial banks to 14%. This, in turn, has enabled the NBFIs to pay higher deposit rates and the result has been a rapid growth in both numbers of NBFIs

TABLE III.1

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NON-BANK FINANCIAL INSTITUTIONS DEPOSITS AND CREDIT 1979-84
(KShs millions)

Quarter Ended	DEPOSITS: Demand	Time	Savings	Total	LOANS AND ADVANCES TO PRIVATE ENTERPRISES: Agri-culture	Manu-facturing	Building and Construction	Housing	Trade: Exports	Imports	Domestic	Enterprises Including Partnerships	Personal	Total
June '79	613.7	2,705.8	327.2	3,647.2	110.5	342.6	211.3	701.9	33.9	107.0	252.1	381.7	450.0	[illegible]
June '80	[illegible]	[illegible]	415.7	4,367.8	143.9	348.6	378.1	916.4	22.2	86.7	378.6	491.5	321.2	[illegible]
June '81	294.6	4,003.1	636.0	4,934.0	197.6	464.5	524.8	1,550.0	12.4	102.6	590.1	613.5	327.1	[illegible]
June '82	264.3	5,141.2	716.8	6,122.3	678.0	719.6	634.3	1,834.1	41.9	173.5	572.5	948.1	[illegible]	[illegible]
June '83	340.4	6,515.4	786.5	7,642.3	899.1	820.0	627.0	2,135.6	89.6	98.9	864.0	1,278.0	[illegible]	[illegible]
Mar '84	692.4	7,797.7	1,001.7	9,491.0	1,051.8	1,035.6	713.0	2,362.4	97.4	103.6	1,213.6	1,428.7	325.5	[illegible]

Source: Central Bank of Kenya.

Note (1) include "finance companies" as defined in this report as well as IDB and HFCK; do not include insurance companies, pension funds.

and in total deposits. NBFIs can also buy property and develop it on their own which a commercial bank can't do.

In fact, in June 1983, 12 of the 34 NBFIs in existence at that time were affiliated with commercial banks although since that time the percentage has dropped. More recently this tendency has picked up again but the reverse is also occuring; that is, some NBFIs have started commercial banks. Commercial banks can open checking accounts and engage in foreign exchange transactions which NBFIs cannot.

Of interest to this study are those NBFIs which concentrate exclusively on housing finance in some form. First, and most important, is the Housing Finance Company of Kenya (HFCK) owned equally by the government and the British Commonwealth Development Corporation, which was incorporated in 1965. HFCK converted to a financial institution under the Bank Act of 1978. The others are Savings and Loan Kenya, another well established institution which is now owned by the Kenya Commercial Bank, Kenya Savings and Mortgages owned by the Jimba Credit Group and Home Savings and Mortgages, the latter two being created since 1982. These institutions receive certain regulatory relief by virtue of investing exclusively in housing finance. Their activities are discussed in detail in Section IV A 2 on housing finance institutions.

The rapid growth in the number of financial institutions (this includes most recently the building societies) and the increased competition for deposits and lending activities began to cause some concern as to the financial viability of some of the institutions. The eventual collapse of one of the NBFIs, Rural-Urban Credit Finance Company, the first and so far only collapse of a financial institution in Kenya, and the shaky conditions of several others ultimately led to the passage of the Banking (amendment) Bill of 1985.[1] (It must still be gazetted before it becomes law and certain provisions may eventually be changed.)

4. Building Societies

Building Societies operate similarly to the British mutual societies or mutual savings and loan associations in the US and are registered under the Building Societies Act by the Registrar of Building Societies. Thus, they are not owned by sharehclders but, in effect, by share account holders and their capitalization is their net worth or excess of assets over liabilities. Any surplus, after taxes, goes to increase the net worth or reserves of the institution. There is currently no minimum requirement for maintaining a level of net worth.

Building societies collect deposits and make loans for housing and land, both long term residential mortgages and short term construction loans or land purchase loans. Loan terms are not limited to a specific number of years such as the commercial banks or NBFI's.

From 1972 until 1984 the only licensed building societies were the East African Building Society (started in 1959) and Pioneer Building Society which had been in business since 1982. Over the years preceeding 1972 there had been a scattering of other building societies created but they had gone out of business. Restriction of lending activities to housing did not attract new institutions.

1. Since the field work for this study was completed, several more institutions have failed.

The period since 1984 has seen a large number of building society licenses issued and there are now a total of 32 building societies which have been licensed. Of these, seven are fully operational, i.e. taking in deposits and originating loans. Another eight are partly operational, i.e. they have opened branches and are taking in deposits. The remaining 17 have not yet begun operations. As part of the trend toward financial conglomerates, five of the seven fully operational building societies are controlled by financial institutions governed by the Banking Act.

A detailed treatment of the building societies is contained in Section IV.

5. <u>Insurance Companies</u>

There are currently forty two insurance companies in Kenya, life and/or casualty, up from 23 in 1982. The total assets of the insurance business are about KShs. 10 billion with annual premiums in the KShs. 2-3 billion range.

The new Insurance Act which includes the establishment of a Commissioner of Insurance will come into effect shortly. It specifies the composition of insurance company assets as follows:

TYPE OF INVESTMENT	% OF ASSETS TO BE INVESTED LONG TERM INSURERS (LIFE)	 SHORT TERM INSURERS (CASUALTY)
- Government securities, Statutory Bodies and Local Authorities	90%	50%
- Mortgages on property in Kenya; debentures secured by such mortgages; debentures/stock of companies on the Kenya stock exchange*; Loans on life insurance policies; deposits in financial institutions licensed under the Banking Act		
- Of which not less than 25% for life companies and 20% for casualty companies should be in Government securities, statutory bodies and local authorities		
- Investments in whatever the insurer sees fit, with the Commissioner of Insurance empowered to veto investments he considers unsuitable**	10%	50%
	100%	100%

* Limits as to how much can be invested in any one company are specified in the Act.

** A further constraint is that the insurer cannot invest its assets in a private company other than a bank or financial institution licensed under the Banking Act.

Insurers are given two years to comply with these investment specifications. Extensions of time can be granted by the Minister of Finance.

There is some feeling in the industry that the new Act gives too much regulatory discretion to the Commissioner of Insurance. In addition, it is felt that the Act's specifications as to investment of assets will significantly constrain investment income. This conclusion is based on the Act's requirements that a certain percentage of assets be invested in government securities as well as other instruments that yield less than the returns generated from current investment portfolios.

The new Act also reconstitutes the Kenya Reinsurance Corporation (KRC) which is wholly-owned by the government. The principal activity of KRC is the transaction of all classes of the reinsurance business. By law KRC must reinsure 25% of the insurance business in Kenya equally from all companies. KRC began operations in 1970 and started off by taking 5% of the insurance and gradually worked up to the present 25%.

Fifty percent of the 25% is reinsured again in international markets and KRC in turn reinsures international business. KRC's total assets are now about KShs. 1.1 billion and its inflow of premiums is about KShs. 700 million p.a. plus investment income.

Twenty percent of its investments go into short-term deposits (30 - 90 days) at an average rate of interest of 15%. Thirty percent of its investments are in government T-bills and stock. The remaining 50% is invested in real property, either as commercial property which is rented out, as residential estates which it is developing and will then sell or as long-term mortgages on residential property. (See Section IV A 3a for more details on housing finance). It will thus have no difficulty complying with the new Act as to investments.

The other big insurers in Kenya are Kenya National Assurance (government-owned) whose asset structure is similar to KRC; American Life Insurance (ALICO) which is somewhat smaller but very active; and Kenindia, an Indian-owned company.

No recent figures for KNA were made available but at the end of 1984 KNA had total assets of its life insurance activities of almost KShs. 1 billion. Of this about KShs. 75 million each was invested in government securities and equity shares , respectively, another KShs. 276 million in commercial property investments, KShs. 176 million in mortgages for residential properties including KShs. 25 million to local authorities for rental properties and KShs. 47 million for policy loans. More details of KNA's investments in residential housing also are contained in Section IV A 3 a.

In general, insurance companies have been conservative in their investments, reportedly holding perhaps 35 - 40% in cash and short term government securities and much of the remainder in real estate. One company indicated it also made some business and consumer loans. Again, more details on housing finance are contained in Section IV A 3 a.

6. Pension and Provident Funds

a. The National Social Security Fund

The NSSF is under the Ministry of Labour. NSSF coverage started in 1966 and currently applies to some 1.4 million wage earners in 35,000 organizations. Private sector employees account for more than half of those covered. Employees and employers each pay 5% of wages and NSSF is now bringing in about KShs. 3-4 million per day. Since its inception it has collected over KShs. 12 billion.

Beneficiaries receive a lump sum payment at retirement. Beneficiary accounts currently receive interest at 8%. This rate was set in 1985 when it was increased from 5% which it had been since 1978. From 1975-78 it was 4% and from 1967-75 it was 2 1/2 per cent.

NSSF does not have any actuaries on its staff at present nor does it make any projections as to pay-out and there is concern over eventual problems. The World Bank has recently seconded an actuary to work with the Civil Service Retirement System.

NSSF is governed by two committees; a Management Committee and an Investment Committee. The Investment Committee approves all investments. It was reconstituted in October 1985 and includes the Director, the Permanent Secretary of the Ministry of Finance, the Director of the Federation of Kenyan Employees and a representative of the Workers' Union.

Prior to 1980 NSSF followed a conservative investment practice that involved approximately 75% of its funds going to government T Bills and other stock and 25% going into other investments; about half into parastatals and about half into financial institution deposits and equities.

During the 1980-85 period, clearly a free-wheeling period in the financial sector, NSSF reversed its investment policies and put 75% of its investments into non-bank financial institutions and into equities. The collapse of a major non-bank financial institution, Rural-Urban Credit Finance Company in 1984 which had NSSF deposits, and the shakey condition of several other NBFIs, caused a major controversy over the allocation of NSSF funds. It also caused the reconstitution of the Investment Committee mentioned above and the appointment of a new Director. Reportedly some KShs. 500 million was on deposit in small NBFIs which is being withdrawn gradually.

Since October 1985 all new funds have been placed in government securities awaiting the development and passage of an amendment to the NSSF Act. It is intended that this amendment will be tabled in Parliament before July.

The amendment will likely include a plan identifying the types of investments that NSSF can make. It is also intended to give NSSF parastatal status and establish a board of trustees to run the organization. Among other things it is intended that parastatal status will enable NSSF to increase the number and quality of its inspectors to insure compliance with the Act.

It was indicated that the marginal return for new NSSF investments (currently government T-Bills) was 15% with an average portfolio return of between 11-12%. NSSF holds a substantial amount of longer term government stock that will yield only 5% through the year 2010. As reported above, it has called in its deposits from the non-bank financial institutions but some are having to make incremental payments. It still has some deposits in government-owned institutions such as Housing Finance Company of Kenya and Savings and Loan Kenya, possibly some on a long term basis.

b. Other Pension and Provident Funds

A number of companies have pension funds and there are also private provident funds. The funds are often managed by the trust departments of commercial banks. Little information was obtained during this study. A subsidiary of the periodical, Finance, recently published a study of "Provident Funds in Kenya".

7. The Post Office Savings Bank

The POSB comes under the Ministry of Posts and Telecommunications and is supervised by the Ministry of Finance. It has a seven person board of directors of which two are from the MOF. The chairman is from outside government.

The POSB takes in savings and invests in government paper and in short term deposits at commercial banks and non-bank financial institutions. The POSB has a head office in Nairobi but savings are collected and withdrawals handled by the Government Post Office at its branches throughout Kenya. Thus, the POSB blankets Kenya in a way that no other financial institution does (other than the National Social Security Fund); it has 1.3 million savings accounts and almost everybody has saved there at one time or another. It is the only place that people in many rural areas can save.

The POSB has generated plans to open its own branches and to make short term loans, i.e. to operate like a commercial bank. It has no date set for doing this, however, and our understanding is that the Central Bank has discouraged the idea. The plans do not, at this point, include the possibility of long term lending such as mortgage lending.

Most of the POSB's deposits come from ordinary savings accounts; about KShs. 700 million out of total deposits of about KShs. 850 million. The remaining KShs. 150 million is split about evenly between fixed deposits, a save-as-you-earn contractual savings plan and bearer bonds (premium bonds) guaranteed by the government.

Ordinary savings accounts are passbook accounts. They pay 11% which is the minimum set by government. The minimum amount to open an account is KShs. 20 but no interest is paid unless one has an account of at least KShs. 100. As mentioned, there are 1.3 million savings accounts handled by the post office at its branches and and POSB pays a fee for these services.

Fixed deposits are from a minimum of KShs. 10,000 to a maximum of KShs. 500,000. The interest rate ranges from 11.5% for 3 month deposits to 13% for 24 month deposits and is tax-exempt.

The Save-As-You-Earn Contractual Savings Scheme is for a 24 month period. Payments are set at a minimum of KShs. 60 per month. The interest rate is 8.25% p.a. with a 10% bonus at the completion of the period bringing the effective rate to 9.075%. The interest is tax free and there is a penalty for early withdrawal.

The premium bonds are really lottery bonds that have no expiration date with drawings and prizes every month. The bonds are sold in units of KShs. 10 and KShs. 20 and the principal amount is guaranteed by the government. Currently there is about KShs. 50 million in premium bonds outstanding. Brochures for the scheme indicate KShs. 120,000 in prizes each month with the top prize being KShs. 50,000. With this amount of prizes and KShs. 50 million outstanding, it would indicate the POSB is paying an equivalent interest rate of only about 2.9% p.a., obviously a good deal for the POSB.

As stated, the POSB invests in both government T-bills and stock and in short term deposits at commercial banks and NBFI's. It is earning 14% on current investments but it still has about KShs. 300 million of old government issues paying as low as 6%. The POSB has also invested in a new building costing about KShs. 90 million which will be its headquarters. It will rent out about 2/3 of the building. However, it would have to get government approval to invest more of its funds in commercial real estate.

8. Cooperatives and Credit Unions

a. The Cooperative Bank of Kenya

The Coop Bank is owned by some 1200 credit and savings societies and cooperatives that maintain accounts at the Bank. Its activities are governed by the Cooperative Societies Act and supervision is carried out by the Central Bank and the Ministry of Finance in conjunction with the Ministry of Cooperatives.

At the end of 1985 it had approximately KShs. 800 million on deposit, mostly short term, from the cooperatives and savings societies that make up its ownership and another KShs. 410 million in loan resources from international donor/aid agencies. The Coop Bank also began to accept savings, investment and fixed account deposits from individual savers in 1982 and such accounts now total about KShs. 20 million despite the fact such savers cannot borrow.

Savings accounts pay between 11-12% and fixed deposit accounts pay up to 12 1/2% for periods up to one year.

Loans are made only to member credit and savings societies and cooperatives. The terms on loans utilizing its own deposits are made at 14% for periods of 12 to 36 months. With funds from international agencies the terms are based on individual agreements between the Ministry of Finance and the agency.

The Coop Bank is not allowed to engage in long term lending by the Cooperative Societies Act. However, the Coop Bank recently established a subsidiary that has applied for a non-bank financial institution license under the Banking Act that would provide long term lending to credit societies and cooperatives.

b. <u>Cooperatives</u>

Some of the larger cooperatives, e.g. marketing cooperatives, producer cooperatives, also conduct a financial operation. There are thirteen of them which are called "banking sections" and they are actually part of the cooperative.

They are exempt from the Banking Act but conduct banking business, i.e. take in deposits and make loans, under the Cooperative Societies Act. The Central Bank has no control except through its supervision of the Cooperative Bank. One of these banking sections was closed recently because of some irregularities.

No data was obtained on the scope of these banking sections' activities.

c. Savings and Credit Societies

There are a number of savings and credit societies in Kenya, many of them employee based, but little in the way of overall statistics. There is a Kenya Union of Savings Cooperatives (KUSCO). Typically individuals open share accounts and receive "dividends". Loans are often made at 6% and share account dividends pay 4%. As explained by one advocate: One joins to get low cost loans and your "deposits" are risk free, there are no defaults or delinquencies. Members are eligible to get a loan six months after joining of up to three times their share capital.

Obviously this won't work if that is the reason everyone joins and some sort of lottery system would have to apply. However, this appears to be the appeal.

One savings and credit society which released its figures in the newspapers showed total share capital and deposits of KShs. 57.6 million with 9,478 members, thus indicating KShs. 6075 per member in deposits.

C. Governmental Financial Policy and the Housing Sector

Financial policy in Kenya has been characterized by significant changes in the number of financial intermediaries, the allocation of financial liabilities among types of institutions, the scale of the GOK's presence in the credit markets and in the confidence and efficiency of the system in allocating resources among alternative investments.[1] The series of innovations and regulatory changes is a complex story. However, it is only a slight exaggeration to say that the catalyst for change was the increasing volatility of international capital markets.

When this increase in the volatility of international interest rates and economic growth of developed economies is combined with the inherent volatility in Kenya's export earnings sources it is clear that a financial system that (1) relies almost exclusively on primary placement debt markets to finance investment, and (2) has an interest rate structure that is administratively set; and (3) is used as one of the government's chief means of financing government expenditures, will undergo significant stress and change.

Changes in the prices of coffee, tea and oil as well as real interest rates have had significant effects on overall economy activity inducing similar changes in the level of government borrowings and expenditures in an effort to stabilize the economy.

Between 1979-80 and 1981-82 the deficit increased from 5.6 percent of GDP to 12.9 percent. Government borrowing to finance these increased expenditures similarly increased, going from 2.5 percent of GDP to 6.8 percent.

With this pressure to tap the credit markets, the GOK increased the reserve requirements on commercial banks (CBs), thereby forcing them to hold more GOK paper, and reducing the profitability of banking. It also provided an incentive for CBs to move into the non-bank financial institution (NBFIs) financial structure. In Kenya's administratively-set interest rate environment, NBFIs have been allowed to charge higher interest rates in return for a prohibition on their participation in foreign exchange transactions and checking account market. NBFIS also had lower government reserve requirements.

1. We have attached several tables as Annex I on the relative size, investment and support for GOK borrowings.

In short, the fundamental changes in the financial structure in Kenya have been rooted in the changed international economic environment which called for an increased GOK role to stabilize the economy. The GOK did this through increased pressure on the commercial banking system to support GOK borrowings which induced the banks to shift the form of the financial intermediation to a less pressured ownership form, i.e. to NBFIs. The climax to this change has not yet occurred. However, to this point it has culminated in a Banking (Amendment) Bill of 1985 which attempts to (1) level the playing field between CBs and NBFIs; and (2) restore confidence in the financial system after the demise of the large Rural-Urban Credit Finance Company in 1984.

Basically the amendment calls for: (1) an increase in the minimum paid-up capital for banks from KShs. 10 million to KShs. 15 million and a similar 50% increase for locally incorporated NBFIs for paid-up capital to KShs. 7.5 million; (2) adequate provision for bad debts before projects are declared bad; (3) restricted trading in the share capital of financial institutions by prohibiting, for example, an NBFI from owning shares in a commercial bank; (4) limiting loan to value ratios on fixed capital to no more than 25% of an institutions's liabilities; (5) prohibiting financial institutions from acquiring immovable property; and (6) introducing a Deposit Protection Fund in which each bank or NBFI will be required to contribute KShs. 100,000 and not more than 0.4% of its average deposit liabilities over the year before the notice to pay is issued.

In addition to the Banking Amendment, however, are more fundamentally optimistic financial factors. First of all, the macroeconomic environment has improved substantially. Oil prices have fallen and all Kenya's choice export earning industries have improved prospects. This reduces the need for the GOK to place the financial system under pressure through subsidized deficit monetization, and there is every evidence that advantage is being taken of these fortuitous circumstances. For example, the deficit was reduced to 9.3 percent in 1984 from 12.9 percent only 2 years earlier. Government borrowing fell by 2.2 percent of GDP to 4.6 percent. In addition, real interest rates became positive on most financial assets for the first time in six years, suggesting that the GOK is relying less on the financial system to subsidize its borrowings.

Finally, three inter-related policy proposals are currently being developed by the GOK that may substantially rationalize the government's ability to stabilize the economy. The studies are:

1. Tax Reform - Our interviews as well as newspaper accounts indicate that the GOK is currently undertaking a study of how to reform the tax system so that government revenues respond more elastically to changes in income.

2. Debt Market Reform - The Sessional Paper indicates that an IFC-Central Bank paper on moving to a market for risk-free government securities will be released for disscussion. If action follows this discussion, it represents a fundamental change in the structure of financial policy. In addition, the GOK is currently undertaking an analysis of the appropriate investment strategy for the National Social Security System (NSSF). Appropriate change in this policy also represents the acceptance of a different principle of financial intermediation. Instead of administratively setting an interest rate that the GOK believes borrowers can afford, policy change here <u>could</u> suggest that interest rates should be determined by the assurance that participants will necessarily receive a positive rate of return on their NSSF contributions.

NSSF beneficiaries now receive a zero real rate of return on their contributions after having received a negative rate for many years.[1] At present Kenya's young population has accepted this form of taxation. However, as the population ages, it is unlikely that the current system will satisfy. Moreover, the only way it can be truly adjusted is to move to market rate financial instruments for investments.

3. Equity Market Reform - The Sessional Paper also indicates that the joint IFC-Central Bank of Kenya paper will discuss the need to revive Kenya's dormant equity market. The paper suggests a number of tax and regulatory changes that can help foster the development of this market. Such changes would of course be conducive to the development of this essential means of allocating business risk throughout the economy. However, perhaps equally important to the development of a functioning equity market is the competitiveness of the credit markets. As long as credit is relatively cheap, why would a firm issue equity?

In most developed financial systems, government, households and businesses bid against each other in borrowing. In Kenya, household access to credit has been limited until very recently by the fact that the interest rate was such that anyone who could issue debt was subsidized. Obviously, households with relatively high transaction cost collateral are at a

1. The accumulations in the Fund receive an 8% nominal interest rate payment.

disadvantage with respect to corporations in such a competition.[1]

Clearly one does not want to subsidize larger housing units for already well-housed households at the expense of plant and equipment. However, neither does one want to subsidize corporate debt issuance so that no equity capital is demanded by firms as is the current situation in Kenya. Moreover, it is important to remember that housing not only provides consumption services to households, but it can also be an effective means to save in a way that is relatively insulated from changes in macroeconomic circumstances. In an open, volatile economy such as Kenya the demand for this kind of asset as a savings vehicle should be large.

In the next chapter we discuss the current means of supplying funds for this source of finance.

D. Summary of the Development of Financial Intermediation

The preceding review of financial institutions in Kenya indicates that the breadth of this important sector of the economy has made enormous gains, particularly in making the possibility of financial assets available throughout the economy. The Post Office Savings Bank and the National Social Security Fund extend the system of financial intermediation throughout the economy so that the overwhelming majority of Kenyan households now have access to formal financial intermediation if they choose to participate. In this respect, Kenyan financial policy is to be commended. As a recent World Bank study noted:

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1. Although housing is one of the most efficient forms of collateral from a credit risk point of view (it is fixed in place and subject to less business risk than most other forms of specific fixed capital), it has a relatively high transaction cost because of the size of the debt relative to the underwriting and processing costs per loan.

Institutionally, the financial sector contains a number of financial institutions of various types, with some of the more advanced forms, such as insurance companies having an importance not usually associated with countries at Kenya's income level. Annex 3, p. 99. James Hanson and Craig Neal Interest Rate Policies in Selected Developing Countries 1970-82 World Bank Working Paper #753, 1985.

By many standards of traditional development finance policy it is also to be commended: it has moved the surplus, and supposedly inelastically supplied, savings of households at low cost to borrowers who are presumed to be lead sectors of the economy. The GOK has established development finance institutions and parastatals to target these funds to strategic sectors. Unfortunately for Kenya, however, the strategy itself is severely flawed and only in retrospect are the costs of pursuit of this approach becoming manifest:

1. Many parastatals and the development finance institutions are in significant financial distress if not technically insolvent;

2. The equity markets are dormant and corporate lending is heavily collateralized with the result that risk capital goes to those projects that have been successful in the past (and hence have some value) rather than to those that may have ex ante value as well as riskiness;

3. Despite the growth of financial intermediaries, the share of savings in financial assets is virtually unchanged between 1970 and 1982,[1] and while anecdotal, the impression is that the informal financial sector has grown, increasing the fragmentation of financial intermediation. Hence, while the scale of financial intermediation has increased, it is not clear that the depth has;

4. The lack of a true secondary market for debt instruments seriously impedes the ability of the GOK to withdraw from its support for parastatals. Hence, its ability to move towards privatization is constrained; and

5. The developing system of financial intermediation has not developed a means of providing long-term financing for investment. In fact, it seems likely that the financial changes and evolutions of recent years have resulted in a shorter overall maturity of financial assets. In other words, the financial system has shed rather than helped share and allocate the most important risk that the economy now faces: interest rate risk.

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1. It went from 29 percent in 1970 to less than 33 percent in 1982. See Hanson and Neal Table 2, Annex 3, p. 104.

In Section V we discuss the macroeconomic costs of these imperfections in the current financial system. We also discuss the government policies that are the main causes of these costs, and how a secondary mortgage market-like facility would help reduce these costs.

IV. HOUSING FINANCE

A. Institutions

1. Government

Both the National Housing Corporation and the City of Nairobi carry out the functions of a financial institution in implementing their programs described earlier in Chapter II. That is, they provide long term loans to finance the housing units (or in some cases, serviced sites) that they develop. In the case of the NHC most of its financing is in the form of loans to local authorities who in turn on-lend or rent. Also, in the case of the NHC, its "middle class" housing projects are sold directly to individuals with the long term financing provided by the Housing Finance Company of Kenya.

The other big municipalities such as Mombasa and Kisumu have programs similar to Nairobi with variations as the local government units get smaller. However, all of the local government units apparently have programs of both rental projects and projects where they on-lend to purchasers.

As we understand it, long-term financing for most of these programs comes from the GOK, in some cases utilizing external funds. There are two exceptions. One is the "middle class" housing of NHC mentioned above. The other is the City of Nairobi which borrowed directly from US lenders under the AID HGP with the guaranty of the GOK.

None of the government entities however, raise their resources from other than GOK, or GOK guaranteed, sources. As discussed in the earlier section, the lending terms of most of the government programs (the Nairobi City Council projects at Umoja are exceptions) are considerably below market with a significant subsidy element. When poor collections are also taken into account, both individual loans and NHC loans to local authorities, the subsidy element is increased. If and as GOK resources are reduced, the impact will be significant.

NHC's programs to local authorities would be reduced although it's "middle class" program could continue. As the City of Nairobi's current projects are completed, it does not have a financing source for new programs. The Nairobi Housing Development Department has plans to create a Housing Development Fund but has not yet ascertained where the funds will come from.

Thus, from a housing finance perspective, government programs at both the central government level (NHC) and the local level (municipalities and local authorities) rely almost entirely on GOK funds, are generally subsidized and have poor cost recovery records. To put these programs on some sort of self-sustaining financial basis, the programs need to target their beneficiaries better (NHC), improve their collections and look for long term sources of money that can be loaned at rates closer to market.

2. Specialized Housing Finance Institutions

a. Introduction

Specialized housing finance institutions fall into two categories: those which are limited liability companies registered under the Companies Act and licensed under the Banking Act and mutually-owned building societies which are registered under the Building Societies Act. The former come under the direct supervision of the Central Bank and the latter under the Registrar of Building Societies although the Central Bank recently has been given some supervisory authority over the building societies as well.

The limited liability companies come under the definition of a non-bank financial institution and include four institutions: the Housing Finance Company of Kenya (HFCK), 50% owned by the GOK and 50% by the Commonwealth Development Corporation (CDC), a British Government agency; Savings and Loan Kenya, wholly-owned by the Commercial Bank of Kenya, a GOK-owned commercial bank; and two privately-owned institutions. There are currently (March 86) 32 licensed building societies of which 15 are operational to some degree.

Of these institutions, three have been in business for more than twenty years; HFCK, Savings and Loan Kenya and East African Building Society and they dominate the business. HFCK has assets of close to KShs. 1.5 billion, Savings and Loan KShs. 840 million and EABS about K.Shs. one billion.

The rest of the institutions have come into being since 1980 and, of these, the other two limited liability companies, Home Savings and Mortgages and Kenya Savings and Mortgages have assets of around KShs. 250 million and KShs. 100 million, respectively. Of five active building societies that were interviewed assets ranged from KShs. 10 million to KShs. 50 million or so (with no published reports). These figures can be contrasted with the commercial banks which had KShs. 21.1 billion in total bills, loans and advances as of the end of 1984 and the total loans and advances of all NBFI's which were at KShs. 8.4 billion as of the end of December 1984.

Thus, it can be seen that the old line institutions still dominate the housing finance business but, as described in following sections, the new institutions are bringing some aggressive competition to bear. Despite the competition, however, it appears that formal housing finance institutions are not reaching much below middle income families with their financing. Although no statistics were available, the types of projects that are being financed and which are described in the following sections are fairly indicative. Details on the limited liability companies can be found in Annex J and on building societies in Annexes N, O and P.

b. Summary of Activities

1. Resource Mobilization

Both types of housing finance institutions raise their resources primarily through deposits. Although there are variations, these deposits fall into roughly the following categories.

The first are share (in the case of building societies) or savings accounts. These include the small accounts and the money can be drawn on demand. Interest rates on such accounts are currently around 12%.

The second category is composed of investment shares or accounts. These usually have some minimum, say, units of KShs. 500 and require some notice of withdrawal such as one month. Such accounts pay a slightly higher rate of interest, now around 13%.

The third type of deposit is for some fixed term, usually up to a year. Investors are more typically institutions. Here again the interest rate is slightly higher in response to the fixed term and currently might be typically around 14%. However, the rates on these deposits are negotiable and depending on the size of the deposit and its terms the rate can be as high as 15%.[1]

Finally, the housing finance institutions are raising resources through the issuance of housing bonds, the interest on which is tax free. These bonds are really like certificates of deposit and their tax free status makes the interest rates slightly lower. Currently, interest rates

1. As we understand it, the National Social Security Fund can place deposits with the Housing Finance Company of Kenya for long term periods at a rate 2% below the HFCK lending rate.

range from 11% for six month maturities up to 12% for 24 and 36 month maturities.

Since the primary purpose of the housing finance institutions is to lend for long term residential mortgages, it is in their interest to obtain funds on as long a term basis as they can. Consequently, there are a number of advertisements for savings appearing in local papers, particularly for the housing bonds which are for the longest period and at a slightly advantageous interest rate to the institutions.

Some of the newer building societies are aggressively marketing variations on the above schemes or offering slightly more favorable rates. One is paying 12 1/2% on regular savings and, in addition, has special types of accounts, e.g. "preferential investor," that pay 12 3/4%. Others are offering "save-as-you-earn" accounts where employers are authorized to deposit a specific amount each month from an employee's pay. Still others offer special savings accounts for children. Clearly the competition is spawning a variety of savings schemes.

What does not exist, however, is any access by the housing finance institutions to the long term funds that would more adequately support their long term lending. With the exception of the long term deposits of the NSSF available to HFCK, the housing finance institutions get their money for three years or less. Nor do they have access to borrowing facilities to tide them over a liquidity crunch or a market to sell mortgages, participations in mortgages or securities backed by mortgages.

2. Investment and Lending Activities

The short term nature of the resources utilized by the housing finance institutions, described above, has significantly affected their lending activities. First, because they have no source of liquidity or a market in which to sell mortgages or mortgage-backed securities, there is a tendency on the part of the more conservative institutions to keep a larger percentage of their funds in short term, liquid investments than they might otherwise do.

Second, they are lending or investing in activities other than long term residential mortgages which they feel to be more profitable and of a shorter term nature although, in some cases, tied-in to the eventual provision of long term mortgage financing. The most prominent of these is development. In fact, there is some evidence that some of the building societies see this as their main vehicle of profit and the long term mortgage financing provides one means to enhance the sale of new houses.

Several institutions have set up subsidiaries or engage in this activity as part of their operations. In some cases th building society is one part of a group of financial/development companies designed to raise deposits and to provide the mortgage financing. Typically, the development of a housing project is financed through deposit resources and this is converted to long term mortgages when the project is sold. The risk, of course, is that costs will overrun estimates or that inadquate market analysis has been done and the project won't sell.

A number of projects underway have houses in the KShs. 350,000 - 400,000 range. Even at 16% and 20 years to repay and 10% down which are the most generous of the terms offered (see below), payments by the borrower could run in the neighborhood of KShs. 5,000 per month, very high according to income figures. Yet this is the range that most people in the business continue to talk about.

The following is an example of how housing prices are outstripping the ability of "middle income" families to afford the houses they want. For example, if middle income is defined as falling in the range of KShs. 3000 - 7000 per month, a family at the upper end of this range would make KShs. 84,000 per year. A typical lender might lend up to three times a borrower's income or, in the example cited, KShs. 252,000.

Even assuming a down payment greater than 10%, say, KShs. 48,000, you are talking about a house costing "only" KShs. 300,000. According to knowledgeable people, middle income families earning KShs. 7000 per month feel that a KShs. 300,000 house is not acceptable. Developers, including those associated with housing finance lenders, thus are tending to build more expensive housing. Many of the potential borrowers who apply do not, therefore, qualify for the type of houses they want to buy.

As a result of their development activities, some of the housing finance institutions are not originating any mortgages due to the requirements to finance the property development. Depositors are being told that mortgages will be available in about a year and that they will be given first priority on the residential properties being developed. The outcome of this stragegy is yet to be determined since some depositors will clearly not be able to afford the houses being developed and others may not prefer that location. The result could be a withdrawal of funds.

One building society has purchased land which it is subdividing and selling off in individual plots. It is requiring 1/3 down payment with the balance to be paid over a period of twelve months. Other housing finance institutions are making short term loans, e.g. agriculture equipment, with land and real property as collateral.

Qualifications for residential mortgages and the loan terms vary to a considerable extent among the different institutions. There is no standard application form nor mortgage document in the industry as far as could be determined. Down payments range from 10% to as much as 30% with the maximum loan for building societies being KShs. 750,000 unless approval is obtained from the Registrar of Building Societies.

Most of the building societies and housing finance institutions are currently charging 19% for residential mortgage loans, the maximum permitted by the Central Bank. The old line institutions, however, are considerably under this figure. Savings and Loan Kenya, quotes a figure of 16% as does the East African Building Society. In the case of the latter, because of the method of calculating payments, the effective rate is 16.8%.

HFCK quotes a lending rate of 13 1/2%. However, it calculates monthly payments on an annual declining balance basis as opposed to a monthly declining balance basis so that the effective rate is actually around 16%. As mentioned above the Central Bank controls the interest rate chargeable on loans. It also sets the basis on which payments are calculated.

Toward the end of 1985 it decreed that all mortgage loan payments should be calculated on the monthly declining balance basis. As the lender with the largest portfolio to adjust, HFCK has delayed its implementation along with one other building society. By continuing to quote a rate of 13 1/2% this is clearly misleading to borrowers. There were also indications picked up informally that some mortgage loans are discounted in certain cases by some institutions to yield more than the 19% maximum.

There is one additional very important point relative to interest rates on mortgages in Kenya. That is, all mortgages in Kenya are "adjustable rate mortgages" (ARMs). The rate can be adjusted upward (or downward) by the lender subject to the maximum set by the Central Bank. Such an adjustment would presumably be related to the lender's cost of funds. When an adjustment is made, the whole portfolio moves. Thus, all mortgages in a lender's portfolio are returning the same rate at a given point in time.

Repayment periods range from 10 to 25 years with 15 years being the most usual. Fees and settlement costs include valuation costs, legal costs such as a title search and stamp duty of 1/2% on the loan. In the case of East African Building Society, for example, these costs amount to KShs. 4,000 for the first KShs. 100,000 of the loan and go up to KShs. 12,412 for a KShs. 750,000 loan. In addition, the borrower must pay 3% stamp duty on the sales price of the house (the seller pays amother 3%), casualty insurance costs and must pay his own legal costs. Mortgage life insurance is also often a requirement. Thus, it can be seen that settlement costs are quite substantial and represent a very high cost, percentage wise, for smaller loans which could impact lower income borrowers to a greater degree.

Generally, mortgage loans will not be approved for anyone over 55 years of age or who does not have regular employment. Many of the institutions also require that the borrower be a saver at the institution for some prescribed period of time and/or to have some minimum amount on deposit.

Up until recently there has been no type of mortgage default insurance available in Kenya. However, Home Savings and Mortgages has worked out a plan with the Kenya Commercial Insurance Company to underwrite private mortgage default insurance. This could prove to be a key factor in establishing any type of secondary mortgage financing facility. No details were obtained as to premiums and exact coverage but this initiative is clearly of considerable importance.

Table IV-1 is a summary of the terms offered by a representative group of housing institutions.

TABLE IV-1

MORTGAGE TERMS USED BY A SAMPLE OF INSTITUTIONS THAT ORIGINATE MORTGAGES

Particulars	Housing* Finance Company of Kenya	East African Building Society	Savings* and Loan Kenya Limited	Pioneer Building Society	Kenya* Savings and Mortgages	Home* Savings and Mortgages	Equity Building Society
LOAN (Ksh)							
Maximum	600,000	750,000	Not fixed	750,000	800,000	500,000	750,000
Minimum	22,000	150,000	Not fixed	100,000	50,000	Not fixed	25,000
As % of value	90%	70%	90%	80-90%	80%	80%	80%
INTEREST							
Rate	13.5%	15%-16%	16%	15%	19%	19%	19%
Period	10-25 Years	15-20 Years	25 Years	10-25 Years	15-20 Years	15 Years	15 Years
Calculated on reducing balance	Annual	Annual	Monthly	Annual	Monthly	Monthly	Monthly
FEES							
Application per Ksh 100,000 (Ksh)	410	1,000 Con. Fees Nil for Survey		1,000	Nil	Nil	Nil
INSURANCE							
Coverage Restricted or Free	Free	Res.	Free	Res.	Res.	Res.	Res.
SECURITY							
Lease Balance	30 yrs	45 yrs	-	30 yrs	20 yrs	45 yrs	Being considered
Mortgage Second	Yes	Yes	Yes	Yes	No	Yes	No
Rencing	Yes	Yes	Yes	Yes	Yes	Yes	Yes
APPROVAL TIME							
Min	4 weeks	2 weeks	2 weeks	1 week	3-4 wks	3-4 weeks	1 week
Max	6 weeks	8 weeks	6 weeks	4 weeks	6 weeks	6 weeks	3 weeks

* Limited liability companies licensed under the Banking Act
The remainder are building societies

Source: local newspaper article

c. Building Societies

1. Scope of the Business

Because of the rapid proliferation of building societies since 1984 and their potential major impact in housing finance, even though only one is of significant size at the time of this report, the following section describes their activities in some detail.

Prior to 1984, there was were only two operational societies, East African Building Society (started in 1959) and Pioneer Building Society (started in 1980). Starting in late 1983, an upsurge in licensed building societies took place. The present count is summarized below:

	NUMBER OF BUILDING SOCIETIES
- Licensed	32
- Licensed and fully operational (taking in deposits, originating loans)	7
- Licensed and partly operational (opening branches, taking in deposits)	8
- Licensed but not operational	17

The underlying reasons for this expansion in the number of licensed building societies go back to the 1977-78 coffee boom when many new financial organizations were formed, both commercial banks and particularly non-bank financial institutions. Because of rapid growth in both deposits and lending, financial institutions licensed under the Banking Act began to diversify their activities and services and groups of related companies were formed and operated under the same management. By 1984 the number of financial institutions of this type had reached almost 50. At this point the Central Bank found that there was a sufficient volume and variety of financial institutions and, therefore, stopped issuing licenses. However, as part of this diversification, several financial institutions formed building societies which applied for and received their licenses to operate as building societies through the Registrar of Building Societies, by definition, not the Central Bank.

This, then, led to the other major factor accounting for the building society upsurge. That is, with no further licenses being granted under the Banking Act, the only option for groups interested in starting financial institutions was to obtain a license to operate a building society.

In our range of interviews other reasons were advanced for the proliferation of building societies in the past four years. One was that rural areas, particularly those where there are cash crops, were underserved by financial institutions, particularly the larger institutions specializing in housing finance such as HFCK, SLK and EABS. Further, that individuals in these areas have higher savings rates, are more stable savers and respond to personalized services. While it is true that some of the new building societies appear to have made a real move to establish rural branches, it is often due to the fact that the directors of these institutions have ties to the areas.

In our view, the primary reasons for the rapid creation of building societies in the early 1980s was the ease with which licenses could be obtained relative to licenses for commercial banks and NBFI's, i.e. qualifying for and receiving a license, up to recently, has been a quick, fairly automatic and inexpensive process, the minimal supervision by the RBS, the ability to charge the same high rates of interest that NBFIs can charge and the potential of generating deposits that could be used for development activities.

2. <u>Regulation and Supervision</u>

The building societies are governed by the Building Societies Act. The Act is administered by the Registrar of Building Societies (RBS) who comes under the Attorney General. (A summary of the Act is contained as Annex I.) Building societies are registered under the Act by the RBS but licensed by the MOF. The RBS supervises the building societies according to specifications set by the Act which is very general in requirements that must be met. Except for what building societies can and cannot do and setting the license application/renewal requirements, the RBS is given wide discretionary powers as to specific requirements.

Triggered by the collapse of one of the NBFI's in 1984, building societies have also been subject to the regulatory and supervisory powers of the Central Bank since 1985. In addition, by informal agreement between the Attorney General, the Central Bank and the MOF, no new building societies are to be registered by the RBS without consulting with the Central Bank and the MOF. As a result, no new building societies have been approved for about a year.

Several interpretations were put forward as to lending restrictions applied to building societies. One interpretation is that building societies can lend for any purpose as long as they get land and real property as security. The other interpretation is that building societies are <u>supposed</u> to lend for housing but that this is not enforced. From what interviews disclosed it appears that some building societies are definitely lending for purposes other than housing, either long term or for construction.

The only other allowable activity is residential property development and this is supposed to be done through a development subsidiary. As with NBFI's, building societies are not allowed to offer checking accounts or to engage in foreign exchange transactions.

The RBS conducts reviews of building societies when an organization or group applies for a license to open a new building society or a building society proposes to open a branch, when a license is renewed which is required annually and when a building society proposes to originate a loan that exceeds KShs. 750,000. A summary of procedures with regard to the above is contained in Annex M.

RBS's approach to the supervision of building societies is not to be forceful with its far-reaching authorities as far as pushing for specific operating standards or levels of financial performance because it considers most of these institutions to be young, inexperienced, and on a steep learning curve. Nevertheless, RBS feels that the management of many building societies frequently shows inadequate experience and skills or lack of proper training with the result, for instance, that there is also a lack of good long term planning or adequate cash flow projections, items that could quickly get a building society in trouble. However, with a small staff and the large number of new building societies it does not appear that more review will be done in the immediate future unless the Central Bank increases its activities relative to building societies.

In some respects this policy of being flexible or lenient toward building society operations makes some sense. The building societies are mutual self help organizations that, in the case of many of their borrowers, may be the first indebtedness that they incur. However, on the other hand, the building societies are left entirely to themselves to develop and improve their operations. No technical guidance is provided by RBS. RBS recognizes some of the building societies' shortcomings but approaches them with the idea that more experience and time alone, with minimal supervisory intervention, will lead to higher quality operations and financial condition.

In addition, given the nature of the evolving financial markets, new building societies are not necessarily financially naive mutual societies. In fact, in recent years it is far more likely that new building societies are being formed to avoid the kinds of regulatory oversight that applies to the rest of the financial system.

Up until recently the building societies have had no liquidity reserve requirements. However, the Central Bank has now set liquidity requirements for the building societies of 20%, split evenly between cash and current account balances at banks and in money market and government securities.

RBS' policies of discouraging large loans as well as not charging annual branch license fees for branches operating outside Nairobi, Mombasa, Nakuru and Kisumu, are aimed at encouraging building societies to open branches and to originate more small loans in the rural areas.

The building societies, for the most part, have avoided originating loans over KShs. 750,000. East Africa Building Society, the only building society that has done so to date, has never been vetoed as a result of this review.

In summary, the regulatory presence of RBS to date is one that building societies can for the most part ignore. In effect, there is little or no supervision.

3) Building Society Activities

As mentioned earlier, there is at least some ambiguity in the Building Societies Act as to what building societies should be making loans for. One interpretation is that as long as real estate is provided as collateral or security for a loan, the loan proceeds can be used for whatever purpose the borrower desires. In addition, while the Central Bank sets an interest rate cap that building societies can charge, there is no control as to term.

Consequently, some building societies are originating more short term loans for business or farming purposes (for which real estate functions as the security for the loan) than long term loans for housing. Several recent newspaper articles that reported extensive building society lending for non-housing related purposes.

The Act also does not specify what percent of deposits should be set aside for lending to depositors and for reserves. As a result, most building societies have formed subsidiary property development companies in which they invest their resources. It is unlikely that the depositors understand that this limits their access to long term financing.

A number of building society managements apparently feel that long term mortgage lending is not as profitable as property development ventures. The reason that they engage in retail housing finance at all is because being licensed under the Building Societies Act means that retail mortgage origination is supposed to be their main line of business. In addition, the desire to obtain a mortgage loan is often the basis for people saving at a particular building society or a building society as opposed to some other financial institution.

During the field work, the team conducted interviews with eight building societies or individuals associated with building societies, including East African Building Society, already identified as the oldest and by far the largest building society. (A summary of EABS is contained in Annex O.) The other institutions have been in business for only a very short period of time, or were just getting started. However, they are considered to be representative of the new institutions and their problems.

4) New Institutions

The recently formed building societies are all headquartered in Nairobi, have their head office there and often have several branches elsewhere, sometimes in rural areas. Offices of those institutions interviewed were often very modest with perhaps 3-5 employees serving the public.

Despite this modest appearance, many low to middle income depositors have been opening accounts at these institutions at a rapid pace because they seem to believe a building society represents their only access to long term housing loans with an institution whose personalized service they can relate to. Furthermore, many savers, in recognizing that deposit insurance does not exist, spread their risk by, in turn, spreading their savings around among many institutions.

Some financial institutions also deposit short term money in building societies, not only for the same spreading of risk reasons but also because the management of these financial institutions knows the management of a particular building society and is, therefore, interested in supporting it. Some parastatal institutions such as Kenya National Assurance Company Ltd. place large deposits in building societies as part of government's policy to foster their development.

Based on the building societies interviewed, we have developed a proforma picture of the typical new society that has emerged as to size and scope of operations. This proforma is contained in Annex E.

As far as deposits and retail mortgage origination, people such as teachers, small business owners and farmers often living in rural areas and earning KShs. 2000 - 4000 per month (i.e. low to middle income) are the targets of some of these new building societies. They are found to be reliable, steady savers and punctual at making mortgage payments - not one foreclosure was reported by the building societies interviewed.

Most of the new building societies are in the midst of ongoing retail market development campaigns in areas where they have branches in operation that are aggressive and expensive. They involve distributing leaflets translated into the local languages, making presentations at "barsas" (the equivalent of a town meeting), door-to-door canvassing and conducting seminars in the evening. The new building societies have tried to adopt special features and methods which they feel will give them a competitive edge with depositors including such things as faster loan processing, savings incentive schemes, mortgage repayments which are responsive to needs, e.g. a farmer whose income may vary throughout the year. A more detailed treatment of these efforts is contained in Annex G.

The new building societies are just completing their first full year of operation (March 1985) and have not yet produced official financial statements. From estimates made by their managements in the interviews we conducted, none earned a profit in their first year. High administration and marketing costs resulting from the opening of branches and training of personnel, major property development costs and a small depositor base supporting these expansion activities were among the primary causes for the losses that were estimated.

There is a feeling, however, among the building societies that they can become profitable this year and they cite the following developments which they expect to occur:

- Major depositor base expansion (as much as double last year) as a result of the extensive marketing activities and continued branch network growth;
- The completion of the first generation of property development projects, i.e. sale of housing units, including the provision of financing.
- A more supportive government policy in the form of parastatals such as Kenya National Assurance Company placing greater amounts of funds into fixed deposit type accounts of these building societies.

d. Summary of Problems and Conclusions

The primary problems facing specialized housing finance institutions are similar for both building societies and limited liability companies although problems vary in degree according to the newness of the institution. The problems fall generally into six categories: financing; affordability; scope of activities; management and operations; public trust and regulation/supervision.

Financing

Financing problems in the housing finance industry can be looked at from two standpoints: that of the institutions which relate to the availability of funds to meet demand and that of the potential borrower from an affordability standpoint. The latter is dealt with in the section below but it impacts on availability of funds.

That is, as we understand it, HFCK, for example, is in a fairly liquid state because many loan applicants cannot afford the houses they want or that are on the market. Nor was it reported that Savings and Loan Kenya or East African Building Society were short of funds to meet their demand. This would presumably not be so if more affordable houses came on the market.

But the same situation apparently does not obtain at the newer housing finance institutions where loan demand reportedly exceeds the amount of funds _available_ for lending taking into account what these institutions feel they must maintain in the way of liquidity (see earlier sections which indicated that some institutions keep as high as 50% of their funds in cash or short term instruments).

For instance, a building society or other housing finance institution less than two years old would probably have an average weighted maturity of deposits of 180 days. Savings (share) accounts would probably account for less than 20% of its liabilities. These, however, are the stable deposits. If 80% of the deposits are only 6 months on average, it is difficult for the institution to prudently lend long unless it has access to a re-financing facility or can sell its mortgages. This is why building societies and housing finance institutions tend to keep a high liquidity. At the moment there is no where to turn to borrow to meet liquidity needs nor any institution currently in the market to buy mortgages.

Availability of funds has also constrained the pace at which new markets are developed and branches opened. To open a branch requires KShs. 3 - 5 million of additional deposits.

If Kenya's housing needs are to be met an adequate level of financing needs to be available for the housing finance institutions outside of direct government funded programs.

Affordability

As has been pointed out in an earlier section, and noted above, effective demand for housing appears to be constrained both in the price of houses being developed by builders for the market and in the types of houses that "middle income" people would like relative to their incomes. This has apparently resulted in the example cited with the HFCK where non-eligibility of applicants has been a problem.

Although partly a result of high land costs and building standards, part of the problem is due to the higher profit margin that developers feel they can get on more expensive houses. But this market is drying-up. Housing finance institutions, through their development subsidiaries, could actually get at this problem but seem to be building to the same high levels.

The problem is beyond the scope of this study. However, if developers re-examine their market possibilities and if middle income people adjust their desires to more realistic levels, then the demand for housing finance would probably dramatically increase as demonstrated in the up-date of housing needs.

Housing Finance Institutions' Non-Mortgage Activities

The housing finance institutions appear to be turning increasingly to the development of housing projects as the way to profits. With minimal regulation in effect, a number of these ventures present some risk to the institutions. If the projects do not go as planned, the institutions run the risk of financial failure. With no deposit insurance yet in place, depositors could lose their money with all the ramifications for the business that this implies.

In addition, because of the lack of long term liabilities mentioned above, some of the new institutions are engaging in short term lending, with real estate as collateral, for purposes other than housing.

The problems arising out of these activities are two fold: (1) the risk associated with the development projects; and (2) the use of resources for other than long term mortgages by definition reduces the availability of funds for mortgages. This is particularly troublesome if one assumes that many of the depositors in housing finance institutions are expecting to be able to borrow for a house. In effect, the availability of mortgage finance has been the strategy used to build a depositor base.

Management and Operations

It would appear that there is an inadequate supply of trained personnel and experienced management to staff the new institutions being created, the expansion in branches and the increase in numbers of savings accounts and lending activities underway. This has caused a slowing down in the development of the institutions since training is both time consuming and expensive. There has also been some transferring of staff to new institutions bidding for employees. The result at best can be ineffectual operations, e.g. slow processing of loan applications, delays in withdrawals etc., but at worst can be bad management decisions involving such things as investments in badly conceived development ventures.

Operating costs are high, particularly the start-up costs of new institutions. For instance, many of the new institutions have started expensive marketing efforts aimed at increasing their depositor base which have involved such labor intensive efforts as door-to-door solicitation of both individuals and employers who might be interested in promoting save-as-you-earn accounts to their employees. Too many accounts with balances of, say, KShs. 100-400, however, can be expensive to service so marketing efforts also need to be directed at larger accounts.

Public Trust

With an increasing number of building societies conducting such full-scale marketing campaigns and opening branches in competition with commercial banks and the large number of NBFIs, some indecision and confusion among potential depositors as well as borrowers has been found. In addition, the collapse of Rural Urban Credit Finance Company in 1984 reduced public confidence in financial institutions - this event occurring in a country without deposit insurance. There is some concern that the public is withholding substantial assets from financial institutions, even in towns in which branches have opened.

Regulation and Supervision

Overlying all of the above is the lack of a strong regulatory and supervisory framework to govern an area of the financial sector that is rapidly expanding and whose strength and health are essential if Kenya's housing problems are to be adequately addressed. In addition any inadequacies among the housing finance institutions would clearly impact on the overall financial sector.

The Registrar of Building Societies appears to be inadequately staffed to handle the regulation/supervision of the growing number of building societies and does not even deal with the NBFI's operating as specialized housing finance institutions. The Central Bank at the moment is preoccupied with implementing the new banking legislation, setting up a deposit insurance fund (which will include the building societies) and the regulation/supervision of commercial banks and the almost 50 NBFIs. Although it now has the authority to play a role in supervision of the building societies, it is not yet equipped either staffing-wise or experience to actually play this role.

In summary, what the housing finance institutions, particularly the new ones, are doing in response to the problems which they face are to:

- Move as quickly as possible, through the property development subsidiary required by law, into the entire cycle of property development with the objective of improving profits.
- Continue the expensive, wide-scale marketing efforts in progress for at least another year or two. The objective is to expand the depositor base and size of depositor accounts as well as to open branches as quickly as the size of trained personnel and management will permit.
- Solicit support from the government's National Social Security Fund, parastatals such as Kenya National Assurance Company Ltd., and other financial institutions in the form of deposits.

Another strategy that the housing finance institutions are pursuing is to become a more cohesive, organized trade group. At present, they operate autonomously although they have considerable communication with one another on an informal basis. They realized that they can be more influential and effective as a group than as separate institutions pursuing individual goals. Thus, they have taken the first steps to form a trade association.

Our recommendations concerning the housing finance institutions are contained in Chapter VI.

3. Others

a. Insurance Companies

Insurance Companies provide housing finance in several ways although time limitations precluded much examination of individual companies and industry statistics were not available. Examples described below are based on the two big government companies and one private company.

Essentially, insurance company financing of residential housing takes the form of long term mortgage financing, often with a preference given to policyholders and, with some companies, probably restricted to this category, construction financing of residential developments and staff loans. As with some of the building societies, some loans to individuals are made for purposes other than housing but a mortgage is obtained as collateral.

Kenya Reinsurance Corporation (KRC) with about KShs. 1.1 billion in assets and a premium flow of about KShs. 700 million annually has something on the order of 50% of its assets in real estate, either as commercial property which is leased, as residential estates which it is developing and will then sell or in long term mortgages on residential property some of which arise out of its development activities. About 60% of the real estate investment is in commercial property and 40% in residential housing.

KRC's major development scheme now underway is of some interest since it represents KRC's current approach to housing investments.

The housing development is an estate of 700 units just outside of Nairobi. KRC will also provide the long term financing to the buyers. Total cost of the project will be on the order of KShs. 400 million and the units will sell for about KShs. 300,000. The project also includes schools, shops, etc. which will be rented out.

For the residential units the terms of the long-term financing are 13% for owner-occupied units and 14% for investor-owned units, 20 years to repay. Loan repayments are computed on a monthly declining balance basis. The borrower also has to buy life and fire insurance from KRC.

Interestingly, an official of KRC said KRC would like for some investor to take over (buy) its mortgage loans so that KRC would not have its money tied up and could, in turn, develop more projects. This appears somewhat inappropriate for an insurance company which by definition has long term funds to invest. It appears KRC wants to become a developer in a big way, not an investor, and it has some additional housing programs in the works with tenant purchase schemes planned for four secondary cities. Finally, KRC makes mortgage loans to staff at a 5% interest rate of which K.Shs. 10 million is outstanding.

The Kenya National Assurance Company makes mortgage loans to its policy holders. Mortgages are only granted to first time house buyers and the house purchased must be occupied by the owner. Non-policy holders are required to purchase a life insurance policy with KNA as a condition for receiving the mortgage.

KNA has about 450 mortgages outstanding at an average of KShs. 500,000/mortgage. The maximum loan is KShs. 1,000,000. Terms for individual borrowers are 13% for 15 years with a 10% down payment if it is a new house and 20% if an existing house. KNA will lend up to 3 times gross income of the male in the household plus 2/3 of his wife's income.

KNA also makes construction loans for housing rental projects at 15%, 3 years to repay. About 75% of its housing finance is for individual mortgage loans and 25% is for loans to developers building rental units.

Although not a stated policy, KNA tries to avoid originating individual mortgages in rural areas because of difficulties in the event of a foreclosure due to the Rural Land Act.

Finally, KNA makes loans to local governments @ 12 1/2% and 20 years to repay for housing estate development. The local authorities build houses for rental or sale with on-lending terms the same as KNA charges. From a trustee perspective, local government is seen to be less likely to default than an individual, particularly with the added complications of the Rural Land Act.

One private insurer writing both life and casualty with its headquarters in Nairobi, branches in Mombasa and Kisumu and an agent network throughout the country was interviewed. (10th largest in terms of premium income.) This company only has about fifty mortgages outstanding. Included in these fifty mortgages are general purpose loans in which the property is used as collateral. These mortgages are originated exclusively for insurance clients as a mechanism to promote insurance underwriting. The terms are 17% for investor-owned houses and 14% for owner-occupied houses; 7 years to repay; a maximum LTVR of 70% and KShs. 5 million per borrower; a committment fee of 1% and a requirement that the borrower purchase life and property insurance.

The company acknowledged that these terms are inferior to what the government-owned insurance companies are offering and to housing finance institutions in terms of the short repayment period. However, it is not interested in originating mortgages at the rates these other institutions offer (except for insurance promotion purposes) when 15 1/2%, six month term deposits, involving far less risk, are available.

Thus, many borrowers who apply for such mortgages are those who do not qualify for mortgages with regular housing finance institutions, such as, non-citizens, investors in commerical or residential properties (non-owner occupied), and properties in which there is title for the entire property but not for the individual units.

One other thing appears clear. People interested in obtaining mortgage finance, particularly at terms offered by the government-owned companies, will often take out a life insurance policy just to become eligible for a mortgage loan.

b. Cooperatives and Credit Unions

As stated in the earlier section, the Cooperative Bank with some KShs. 1.2 billion in deposits and loans from international aid agencies, is precluded by legislation from engaging in long term lending. Thus, although there are now more than 100 housing cooperatives in Kenya, they are only able to borrow short term from the Cooperative Bank. The Cooperative Bank has applied for a license to operate an NBFI which could extend long term loans to credit and savings societies and to coops including housing coops. It is not clear what the current status of this new NBFI application is.

There are a large number of credit societies but little in the way of statistics and what percentage of portfolios are for different types of loans. It is assumed that a high percentage of loans made by the credit societies are used for home improvement purposes as is generally true in most countries. These societies do not lend, however, for long term mortgages as far as is known.

c. Commercial Banks

Commercial banks are not involved directly in long term mortgage financing because they are precluded from making loans for longer than three years. They are indirectly involved, however in several ways.

First, as the parent company or key member of a financial group of companies which involves a housing finance institution. For instance, the Kenya Commercial Bank owns Kenya Savings and Loan Kenya, described above, the Pan African group of companies of which the Pan African Bank is the keystone also includes a building society and the newly established Trade Bank has also set up the Nairobi Building Society.

Second, all of the banks extend mortgage loans to their employees. One of the larger banks makes mortgage financing available to all of its employees at 6% with 25 years to repay. With 340 employees this can be a substantial amount. Some of the banks charge as low as 3-3 1/2% and all make this benefit available to stay competitive in the employee market.

Third, a number of the big banks have trust company subsidiaries as described in Section III B 2 above. Mortgage lending is one of the categories in which these companies invest but, although no extensive survey was done, the impression is that the investments are in commercial properties. In one case the collateral required was twice that of the loan which is consistent with other commercial bank lending policies. Residential mortgage lending by this particular trust was considered too risky.

Finally, the commercial banks do some construction financing of residential housing developments with the long term financing provided by one of the housing finance institutions but this is mixed. One large bank said that it just doesn't get involved in construction lending any more after several bad experiences. Foreclosing is such a problem in Kenya and residential development so risky that it has eliminated such loans from its lending activity.

For those firms that do get involved in construction lending for residential development, the developer must produce a commitment for the long term financing from a substantial and reputable institution. This could be interpreted as one of the big three, i.e. HFCK, Savings and Loan Kenya, EABS. The lender will also look at the financial capacity of the developer and the feasibility of the project as well as require a performance bond.

Since commercial banks have been the principal source of construction finance in the past, their apparent reluctance to play a larger role or even to actually cut back on this type of lending has undoubtedly been one of the factors that have led new housing finance institutions to provide their own up-front project financing in connection with development subsidiaries. Or, to put it another way, that investors with development interests have sought to create building societies for the purposes of financing development.

In total, as of 6-30-85, out of KShs. 20.3 billion in bills, loans and advances outstanding by the commercial banks only slightly over KShs. 1 billion or about 5% was in loans for building and construction. Since this includes commercial property lending as well, residential lending would appear to be quite small in the total picture.

V. RESOURCE MOBILIZATION FOR HOUSING FINANCE

A. Introduction

In earlier chapters we indicated that in our view the housing sector received less financing than would be the case if markets functioned fairly effectively. We have argued that the household sector has largely been rationed out of the credit market to the advantage of government and other borrowers. In this section we present evidence that this has occurred. We then identify the "imperfections" in the financial system that cause such behavior. Finally, we point out the larger costs to the economic system of the continued pursuit of such a macroeconomic strategy. In our concluding section on recommendations we discuss how a policy to improve household access to credit -- importantly at market rates of interest -- could both reduce the costs to the economy of current financial regulatory policy, as well as improve housing conditions.

B. Savings, Investment, and Credit Flows

Table V.2 presents data on investment, consumption and savings over two time periods 1972-1978 and 1978-1984. For the first period only the changes over the entire period are presented; for the second period Table V.3 presents year-by-year changes. The unusual caveats that apply to the intrepretation of data that is subject to cyclical variations and difficult measurement problems should be taken even more seriously in interpreting data for Kenya. Consistent integration and measurement of traditional and informal sectors of the economy as well as a volatile macroeconomic environment that causes outcomes to vary from plans compound the usual problems.

In the earlier period available resources increased at 5 percent per year annual rate, a rate that implies a 1.1 percent per annum increase in per capita income. The typical Kenyan household, however, did not use this

TABLE V.2

RESOURCE USAGE

	1972-1978	1978-84
*Annual Rate of Change in Resources Available in Real Terms	+5.0	+1.0
Percentage Change in Investment as a Share of GDP Over the Period	+1.9	-4.1
Percentage Change in Consumption over Period		
Public	+4.7	+.7
Private	-6.6	+3.4
Percentage Change in Gross Domestic Saving Rate Over Period	-5.4	+1.2

TABLE V.3

	1978	1979	1980	1981	1982	1983	1984	Ave. Period
Avail. Resources 1982=100	99.3	93.2	100.8	103.1	100	95.5	100.3	98.9
Investment as a Share of GDP	25.4	19.5	18.8	26.0	21.6	20.8	21.3	21.9
Consumption/GDP								
Public	17.8	19.0	19.4	17.5	18.2	18.9	18.5	18.4
Private	56.8	61.5	61.8	56.5	60.2	60.3	60.2	59.0
Gross Domestic Saving as a Share of GDP	15.3	13.1	10.4	16.7	13.5	16.9	16.5	14.6

*This measure takes GDP at market prices and adjusts for foreign exchange effects. It is presented in Table 2.6 of various issues of the Economic Survey.

increase in purchasing power for consumption. Over the period the share of private consumption declined by almost exactly as much as the accumulated increase in purchasing power. The increase was used largely to finance an increase in government consumption (about 70 percent of it), and for increases in investment. However, after the change in investment in stocks is accounted for, related perhaps to the coffee boom, even the share of investment in fixed capital declined. The sharp decline in gross domestic saving seems to be more related to cyclical trends than indicative of a reduction in the savings rate.

In short, over the 1972-78 time period, the typical Kenyan household was able to maintain a constant level of real consumption expenditures. Increases in earnings over the period were allocated to increases in government consumption, largely to a defense build-up and education expenditures, and to changes in inventories, probably to export commodities. In addition, and perhaps more importantly, over this time period the role of parastatals in affecting investment decisions increased by more that 500 percent[1] and governmemt grew at a rate that exceeded wage employment growth by 50 percent.

In the more recent period, the growth of government presence in economic activity increased further. However, in the same period the macroeconomic constraint was more severe. Instead of being able to hold household consumption levels at a constant level, population growth far outstripped the growth in resources available.

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1. Kenya Growth and Structural Change, World Bank, p. 43. This figure is with respect to the volume of net outflows from central government to parastatals between 1972 and 1978.

All of this reduction in income growth was not accounted for by a reduction in consumption. The increasing share of private consumption, and as we will show later, debt issued, permitted households to offset some of the reduced growth in income by drawing down on both their accumulated wealth and deferring future investments. A larger share of the reduction in purchasing power was reflected in reductions in private consumption. Unfortunately, most of the non-consumption cut-back took the form of reduced investment. In addition, the reduced level of government expenditures on economic services, rather than transfers, i.e., towards government involvement in resource allocation rather than distribution.

Table V.4 shows that this steadily increasing government presence in the economy took a sharp jump in fiscal year 1980-81. In that year total government expenditures as a share of GDP increased from 31.5 percent to 43.4 percent. And while the government presence has declined since then, back to the levels achieved in 1978-1980 in the next fiscal year, due to increased development expenditures, the government share increased once again going from 32.2 percent to 36.4 percent.

The table also indicates that although Kenyan tax rates and other revenue sources produce a relatively high and expanding level of income, that expenditures expanded even more rapidly in the early 1980s and particularly capital expenditures.[1] The level of government borrowing and the amount of domestic credit available also expanded sharply with a deficit that increased

1. However, it should be noted that the World Bank Report Kenya Growth and Structural Change was very critical of the inelasticity of Kenya's tax structure. In addition, all our discussions of tax issues with government officials in Kenya were avoided on the grounds that a major tax reform initiative was under discussion within GOK.

TABLE V.4

CENTRAL GOVERNMENT FINANCES

	71/72	78/79	79/80	80/81	81/82	82/83	83/84	84/85	Ave. 78-85
(1) Current Revenue	15.2	23.6	25.1	31.3	29.1	28.1	26.0	24.0	26.7
(2) Current Expenditure	15.7	21.9	22.5	30.6	31.5	32.9	28.3	25.8	27.6
(3) Surplus	-0.5	1.5	2.7	0.7	-2.4	-4.8	-2.3	-1.8	-.9
External Grants	0.8	0.6	0.8	0.8	0.8	0.8	0.3	2.6	1.9
(4) Available for Investment	0.3	2.3	3.5	1.5	-1.6	-4.0	-2.0	0.8	0.1
Capital Expenditures	3.8	10.2	9.0	12.8	11.3	7.6	7.3	10.4	9.8
Development	(2.3)	(6.8)	(7.0)	(9.2)	(8.3)	(6.3)	(6.4)	(9.4)	
Equity and Loans	(1.5)	(3.5)	(2.0)	(3.6)	(3.0)	(1.3)	(0.9)	(1.0)	
(5) Deficit as a Share of GDP	3.5	6.3	5.6	11.3	12.9	11.6	9.3	9.6	9.7
(6) Total Govt. Expend. as a Share of GDP	19.5	32.1	31.5	43.4	43.3	40.6	32.2	36.4	
(7) Domestic Credit as a Share of GDP			30.4	29.6	32.0	37.1	32.4	32.3	32.0
(8) Govt. Mang. Dev. Expense as % of GDP		.03	.32	.42	.33	.21	.08	.16	

Sources: The first three years are from World Bank Report, Kenya Growth and Structural Change Vol. 1, 1983. The other data are from various Economic Surveys. It should be noted that the early data from the World Bank Report do not exactly coincide with later Economic Survey Reports. We were unable to correct The Bank Report due to the unavailability of sufficient Economic Surveys. Consequently, the magnitudes of the changes should be examined with some caution.

by more than 7 percent of GDP within two years even though government revenues also grew by 4 percent of GDP.

Since fiscal year 1982-83 the pattern of government involvemont in the economy has been reversed. Current expenditures and taxes have been cut, both by 17 percent from their peaks. The deficit has contracted by 25 percent, and government capital expenditures fell by more than 40 percent before increasing again in 1984.. Overall government expenditures as a share of GDP fell by more than 26 percent, or 11 percent of GDP before rising again slightly in the last fiscal year. This represents very significant cutbacks in GOK economic activity.

The data point out the declining share of government expenditures on housing capital as a share of GDP. These expenditures were never large, peaking at slightly less than half a percent of GDP in fiscal 1980-81, and have generally followed the secular decline in housing's overall share of GDP. However, the relative smallness of this figure indicates that the activity of the National Housing Corporation even though heavily subsidized was not included in the government's budget. Even if the funds came from international donors, any subsidy involved with their usage should have been reflected in government expenditures.

Finally, the data indicate the significant role the government plays in the nation's private financial markets. Every year during the period more than 2.0 percent of GDP was invested by the government in loans and equity participations. Unfortunately, the weakened financial status of these development bankers -- The Industrial and Commercial Development Corporation, The Industrial Development Bank, and The Development Finance Company of Kenya -- suggests that the investments of these intermediaries have not been profitable. While there may be justification for the government to undertake unprofitable investments, treating them simply as expenditures can obscure the subsidy involved. The effects of these subsidies on resource allocation, and the extent to which they are not, in fact, a form of financial intermediation are important issues that can easily be obscured in a capital budget.

In Table V.5 we show the effect that government credit market regulations and interventions can have on credit flows. A quick review suggests that these flows have a limited effect on investment decisions. Examining the relationship between increases in credit to a sector and increases in the share of investment by the sector shows that in 12 out of the 18 observations increases in the share of credit to a sector resulted in a decrease in the share of fixed capital formation in that sector.[1] This inverse rather than positive relationship became more pronounced after 1981 in the agricultural sector.

The data also shows the increased use of debt financing throughout the economy. The average loan-to-value ratio for a shilling invested in fixed capital almost tripled between 1978 and 1984 going from 23 percent to almost

1. For example, between 1978 and 1979, the share of fixed capital in agriculture increased from 15.7 to 16.5 but agriculture's share of credit fell from 4.9 to 4.6 percent. This represents one observation.

TABLE V.5

CREDIT AND FIXED CAPITAL FORMATION AS A SHARE OF TOTAL PRIVATE LENDING AND CAPITAL FORMATION

Agriculture	Share of Fixed Capital Investment	Share of Private Credit	Implied Loan-to-Value Ratio	2/1
1978	15.7	4.9	.073	.31
1979	16.5	4.6	.077	.28
1980	18.8	3.9	.078	.21
1981	09.2	5.9	.232	.64
1982	9.6	11.6	.609	1.21
1983	7.8	12.7	.904	1.62
1984	8.6	11.3	.816	1.31
Manufacturing				
1978	13.0	16.3	.186	1.25
1979	12.4	16.5	.205	1.33
1980	13.0	15.1	.321	1.16
1981	11.9	12.	.352	1.02
1982	12.2	9.9	.623	.81
1983	12.6	15.4	.454	1.22
1984	12.9	11.8	.671	.91
Housing				
1978	14.0	30.0	.50	2.14
1979	17.6	28.2	.43	1.60
1980	17.1	34.2	.74	2.0
1981	16.7	32.8	.70	1.96
1982	19.0	30.7	.81	1.62
1983	16.0	29.2	1.01	1.83
1984	15.4	25.2	1.01	1.63
Fixed Capital Totals				
1978	10280	2405	.234	
1979	10800	2935	.272	
1980	11120	4136	.372	
1981	14500	5209	.359	
1982	13360	6710	.502	
1983	14420	7978	.553	
1984	16720	10324	.617	

Source: Various versions of the Economic Survey and the Central Bank Report. Again the data should be interpreted with some caution because of the limited number of observations. In addition, it is not all inclusive. For example, it does not appear that building society or parastatal loans are counted in the credit figures which are for private financial institutions.

62 percent.[1] The agriculture sector in particular benefited with its relative share increasing more that four-fold and its average loan to value ratio increasing by a factor of eleven. Despite this increase in financial intermediation, however, as we noted earlier, the total level of real fixed capital investment declined over this time period.

The debt/capital relationship for the manufacturing sector appears to oscillate cyclically around a constant level of slightly more than 1.0.[2] The housing sector level of intermediation also oscillates. However, it appears that the subsequent peaks are each lower than the preceding one. The 1984 figure is almost 25 percent lower than the 1978 level. In the next section we discuss the mechanisms that the government has used to channel credit towards the agriculture sector, away from the housing sector and towards satisfying its own borrowing needs.

C. Regulations Governing Credit Flows

The GOK affects credit flows in three central ways: captive lenders, primarily the NSSF and the POSB; directed credit allocations, e.g.

1. The use of loan to value ratio is, of course, an exaggeration. Particularly in Kenya, existing capital assets are used to finance inventory adjustments as well as capital expenditures. In addition, as we noted, the debt could have been issued to draw down on savings to maintain consumption in the face of declining income. This is particularly true for the housing sector which has the highest debt to capital ratio. It is often the case that residential housing represents the largest single form of tangible wealth in an economy. As a result, the increase in housing in any year relative to the existing stock is relatively small, tending to increase the indebtedness that is collateralized by this asset. Finally, as indicated in the table the figures refer only to private financial institutions.

2. While this ratio is clearly an exaggeration, it is nevertheless worth remembering that there has been only one new equity issue during the entire time period.

agricultural loans must equal 17 percent of deposits; and through the manipulation of the level and composition of reserve requirements for CBs and NBFIs.

The chief so-called captive lenders are the NSSF and the POSB. The former held slightly less than half its KShs. 12.5 billion portfolio in GOK stock and Treasury bills, the latter held its entire KShs. 700 million (latest data 1982) in GOK paper. As of May 1984 the NSSF held 28 percent of the outstanding nominal value of government securities and 43 percent of outstanding government stock. Between the two institutions in 1984, they also held 20 percent of outstanding Treasury bills.[1]

The problem is not so much that the "captives" hold government debt, it is the rate they pay for it. While these institutions represent the major captives, other public bodies, including the Central Bank, also hold government debt at sometimes subsidized rates. These subsidized rates in turn result in regulatory taxes being placed on the beneficiaries of the investors. For example, the rate at which NSSF participants accumulated interest has been negative in every year until most recently when their return was increased to 8 percent, just matching the rate of inflation.

The NSSF was one of the chief vehicles used to fund the increase in public debt in the early 1980s. Basically it is usable only because of its relatively nascent state and the age profile of its participants. At present its annual inflows greatly exceed payments and it has used this excess to fund government operations.

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1. These data are from Central Bank of Kenya Economics and Financial Reviews.

Commercial banks have traditionally had both liquid asset reserve requirements and minimum statutory requirements that have been varied as a means to control monetary policy.[1] The NBFIs and the BSs are now also subject to liquidity requirements. In the former case the legal requirement is 24 percent, at least 50 percent of which must be in government securities, and in the latter case the requirement is 20 percent, again with 50 percent of this reserve taking the form of government securities.

Finally, commercial banks and NBFIs are directed to invest a certain proportion of their deposits in the agricultural sector, 17 percent in the case of CBs, and 10 percent in the case of NBFIs. Our interviews suggest that these allocations have very little to do with encouraging agricultural investment. They tend to serve to collateralize the rural assets that many Kenyans hold. The data in Table 5.3 support this view. The increase in credit to the sector has not been correlated with an increase in fixed capital formation in the sector.

D. The Macroeconomic Costs of Financial Regulations

We consider three costs associated with the current financial regulatory structure. These costs can be termed collateral or ancillary costs that are associated with the side effects of the policies. The costs are: excess burden costs associated with the regulatory taxes on both the return and indeed the savings of households; the costs of portfolio maturity imbalance associated with the structure of financial intermediaries; and the

1. A table in the appendix lists both the commercial Bank liquidity ratios and interest rates over the 1979-83 period.

costs of the misallocation of business risk associated with a greater reliance on debt rather than equity.

Excess Burden Costs

In order for regulatory reductions in the return to saving to produce deadweight losses for the economy, the supply of savings cannot be perfectly interest rate inelastic. If it is, there is no excess burden. Determining whether savings does respond to changes in return is not an easy empirical or theoretical matter. The measurement problems are enormous and theory provides little to no restrictions that can help infer even the direction of savers' response. However, recent work by Summers[1] shows that taxes that transfer capital income from those economic agents that save at higher rates to those who save at lower rates will unambiguously reduce the level of saving, and by potentially large amounts.

This is precisely what has occurred in Kenya throughout most of the 1980s. Not only did the negative real interest rates reduce the return to saving, it also taxed the saving itself. If we suppose that the real return was just 2 percent, the negative return of approximately 4-5 percent that obtained in the early 1980s was equivalent to a tax of 300 percent on the return to saving. This is a very large tax that regressively appropriates the savings of those households who do not own real assets and transfers them to those who do.

It is also a tax that transfers savings from high saving households to the government of Kenya which was dissaving. If one follows Summers'

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1. Lawrence Summers, "Tax Policy and Saving", National Bureau of Economic Research Working Paper, 1982.

work, it is clear that this kind of policy should have reduced savings channeled through the formal financial system if not the overall supply of savings. Even the former type of reduction increases the transaction costs of resource mobilization.

In addition, it would have created excess burden or deadweight losses for the economy that represent a loss to society of income. The empirical difficulties involved with measuring the size of this loss made the measurement of this kind of loss to the economy subject to enormous measurement error. Nevertheless, it is important to remember that even under conservative assumptions, these losses are likely to be very large. One could take illustrative estimates of the size of this loss for various assumptions about the elasticity of supply of savings. However, for any nonzero elasticity the losses that correspond to the roughly 300 percent tax rate on the 17 percent of GDP saved must be very large.

The most direct way of reducing these losses to the economy would come from freeing the captive investors in government securities. This is not to suggest that they should not hold government securities; rather simply that they should not hold them at below-market interest rates.

b. Portfolio Maturity Imbalance Costs

A small open economy like Kenya will always be subject to the vagaries of movements in international interest rates. The risks associated with such interest rate movements are in fact probably one of the reasons that the government has been reluctant to move to a market determined rate of interest. Sudden, sharp increases in interest rate can create financial havoc.

The kinds of problems that can be caused by large unanticipated interest rate movements can present particular problems for households. For example, a noted British macroeconomist, David Laidler (1972), has suggested that the use of uncapped adjustable rate mortgages,[1] the sort that are identical to those used in Kenya, were a primary cause of Britain's inability in the 1960s and early 1970s to deal with inflation. The government, he argues, avoided tightening monetary policy because the required increases in interest rates would have raised mortgage rates by too much too quickly for political tastes. The result was increased inflation.

Financial regulations that induce a shortening of the maturities of financial assets, as has occurred in Kenya, and a mismatching of the maturities of the assets and liabilities of financial institutions create risks that can be avoided by more flexible and diversified investment strategies that permit better hedging.

It is clear that the revolution in the financial services industry has increased in this kind of risk in Kenya. Exactly in what ways and by how much is a very complex issue that is well beyond the scope of this paper. What we would like to focus on is one way in which a secondary market-like instrument can improve the allocation of this risk by shifting it to those with a comparative advantage in such risk-bearing.

If households were given access to variable rate mortgages that had caps on how much interest rates could increase within a year, this risk

1. A capped adjustable rate mortgage is one that permits a limited adjustment per time period. In the US, for example, the most frequently used cap permits increases of up to 200 basis points per year and 500 basis points over the loan life. This notion is much like a deductible insurance contract, the household takes an appreciable part of the risk, but in digestible bites, and the institution takes on catastrophic risk. The institution earns a return on its portion of the risk and also on making the household risk burden digestible. Laidler's work is in the American Economic Review.

would be shifted to the investor. If, however, the rates could increase gradually over the life of the loan, and the investor could charge a slightly higher initial rate, the investor would be accommodated as long as the investor's liabilities were longer term. This is exactly the kind of liability held by the NSSF. Its financing of such capped mortgages would reduce household exposure to sudden macro shocks, but still give a long term, rate mortgage rate of return to investors.

Corporate Financing Policy and Financial Regulations

The data on income growth presented in Chapter I indicates that Kenya's income growth is one of the world's most volatile. In order to undertake an investment in such an economy an investor would have to be assured of a higher than normal rate of return to compensate for the higher risk exposure.

In the US, the higher interest rates associated with debt instruments used by higher risk firms encourages these firms to rely to a greater extent on equity financing rather than debt financing. In fact, in the US the average firm has a 1:2 debt to equity ratio, and for those firms considered higher risk the ratio is lower. In Kenya, on the other hand, the equity markets are virtually unused, the implied loan to value ratio for gross fixed capital formation is very high and the development finance parastatals are technically insolvent.

The misallocation of risks and investment resources in this kind of financial regime have to be large. Indeed, a central focus of the IFC-Central Bank study, discussed in the most recent Sessional Paper, is how to stimulate the development of the equity market in Kenya. The discussion in the Sessional Paper suggests that both tax and the regulatory environment of the Nairobi Stock Exchange are important components of a thriving equity market. Equally important, however, as well as seemingly overlooked by the IFC-CB study, is the opportunity cost of debt. As long as households are denied access to bid for debt at a market rate of interest -- as through a mortgage market -- not only are their portfolios imbalanced, but so too are businesses encouraged to use debt rather than equity to finance investments. An efficient, competitive housing finance system could help "push" businesses towards the equity market that the IFC-CB study suggests they should be "pulled" towards by tax and regulatory measures.

To sum up, the GOK is withdrawing from the credit markets as the macroeconomic constraint improves. An important next step is identifying not who it is who should take its place, but how can bidders for these funds be provided the most efficient, equitable playing field on which to bid for these funds.

In a small, open, newly monetizing economy that is urbanizing and growing at incredible rates, housing is much more than just a consumption good with a very high capital output ratio. It is perhaps the central means by which households can insulate their savings from macroeconomic adjustments. It is also one of the most efficient means by which they can collateralize the future earnings of the human capital that the GOK has invested so much in. The macroeconomic gains from improving household access to a competitve credit market are difficult to exaggerate.

E. A Secondary Mortgage Market's Role in Financial Policy

The definition of a secondary financial market is a market on which financial assets can be sold from one investor to another one. If such markets are operative, the liquidity costs of holding various financial assets declines. As a result, lenders and particularly deposit-based ones need to hold less of their portfolio in liquid assets to meet unanticipated demands or changes in credit flows. However, perhaps the most important secondary market is the stock market. In this market investors can, with very low transaction costs, move funds to those sectors of the economy that are thought to be the most productive. They can also divide their funds into risk classes that afford much greater diversification possibilities. Finally, the existence of this market allows funds to move geographically to those areas of the country that most need them. For example, from a capital-rich area like Nairobi to secondary towns that have less capital. This type of function increases in importance with the increase in the geographical area and the costs of moving funds from one part of that area to another.

Inasmuch as Kenya does not have a true secondary mortgage market for risk-free government securities; the fundamental secondary market, the stock market, is dormant; and the country is relatively-small geographically, an obvious question arises: Are there any advantages of creating a secondary mortgage market-like facility in Kenya?

An affirmative answer does not come from the "need" to lower mortgage costs, although that would be an important beneficial by-product. An affirmative answer can be based on the need to increase the return to savers with the objective of increasing the share of savings in financial assets. In Kenya's urbanizing and already financially-deep, open-economy, appropriately structured mortgage contracts (that adjust for the high core rate of inflation) can be expected to be safe investments that are relatively uncorrelated with business risk, and afford a positive return on savings. To the extent that already existing components of the formal financial sector, e.g. building societies, and the POSB, can rely upon such safe assets with which to pay higher returns to savers, the outreach of the formal financial sector will increase.[1] To the extent that NSSF pays a positive return to savers, the taxation of the return to savings declines and transfer of these savings to consumption (i.e. government expenditure) is reduced.

The development of a secondary mortgage market, in the sense of one intermediary selling a financial asset, a mortgage, to another intermediary is complicated by the lack of true secondary markets in any debt instruments. However, the principal achievemnt of a secondary market, increased asset liquidity, is still possible. If long term investors provided investments in mortgage lending institutions of comparable duration as the loans financed, much of the uncertainties that create the demand for liquidity by deposit-taking institutions would be eliminated. Alternatively, if a refinancing facility were available at market rates, liquidity needs could also be more easily satisfied. These instruments could be an important means by which the formal financial sector could attract household savings.[2]

If the GOK is to accept the basic principle in the forthcoming Central Bank-IFC Report, that market forces rather than administrative dictates should set interest rates, facilities that permit households to bid for credit should be an essential component of this strategy. A correctly-

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1. For example, the share of POSB in formal financial savings declined between 1970 and 1982. Craig and Hanson.

2. The example of financial intermediaries investing, i.e. depositing funds for a longer term in other financial intermediaries is a simple process that accomplishes much the same ends as purchasing mortgages. It is exactly this kind of transformation of small-denominated mortgage debt into larger security like debt that the Federal National Mortgage Association (FNMA) of the U.S. engaged in as its first secondary market activity. Over the longer term it has also packaged mortgages directly.

..structured secondary mortgage-like facility can not only help empower these demands (and thus help determine rates), it can also help avoid some of the most undesirable political impediments to moving to freely floating interest rates (wide sudden swings). Finally, such an instrument may be able to increase overall savings, and can almost certainly help to increase the supply of savings in financial assets.

VI. RECOMMENDATIONS

Our recommendations fall into two categories: those in which some actions can be taken immediately and those in which at least some of the actions will take some time to implement. It should also be noted that the thrust of our recommendations is aimed at the financial sector. Although government agencies do get involved in the housing finance function, i.e. the National Housing Corporation and local authorities, we had indicated earlier that our treatment of this in this paper was not comprehensive. Nevertheless, one of our recommendations does take the financing of government housing programs into account.

A. Recommendation No. 1

Create a Strengthened Regulatory/Supervisory Framework for Specialized Housing Finance Institutions

A recently released IFC-Central Bank study recommends a new capital market group to encourage, regulate and publicize the benefits of an equity market in Kenya. We believe a comparable regulatory/supervising/coordination body is essential for the credible development of a viable, strong housing finance system.

Prior to 1980 there were three specialized housing finance institutions in Kenya, two falling into the category of non-bank financial institutions and one a building society. Today there are four NBFIs specializing in housing finance and 32 building societies registered, most in the last couple of years.

It has already been pointed out that the Registrar of Building Societies, by nature of staff limitations if for no other reason, exercises minimal regulation/supervision of the building societies. The Central Bank, while recently being empowered to play a more active role in building society supervision, is currently preoccupied with implementation of the new Banking Act amendment and creation of a deposit insurance fund (which will also cover building societies).

At the same time, along with the creation of many new institutions and the problems that alone entails, you have minimal standards for the business with many of the institutions involved with risky development projects. For instance, the risks associated with financing housing development projects as opposed to mortgage financing are significantly larger. Failures by housing finance institutions on the development projects they are so actively pursuing, even if the new deposit insurance protected depositors, could de-stabilize the further development of a long term housing finance industry and would certainly impact badly on the new deposit insurance fund.

The development and location of the appropriate regulatory structure is a major initiative that should be carefully thought out and integrated into the broader financial policy being developed by the Ministry of Finance and the Central Bank. For instance, should the Registrar of Building Societies be expanded and strengthened in its present form or should it be pulled out and the function expanded to include the housing finance institutions other than building societies and perhaps located in the Central Bank?

Such an issue is beyond the scope of this study although it would appear that having all housing finance institutions supervised and regulated by one body or department should be considered. We do not consider it feasible at this stage, however, that some separate agency be created to carry out this function.

B. Recommendation No. 2

Create a Liquidity Facility for Specialized Housing Finance Institutions

As pointed out in the study, long term housing finance lenders that raise a large part of their resources through deposits are faced with the inevitable problem arising out of such activities of "lending long while borrowing short". In Kenya, at present, the housing finance institutions raise their money either through individual deposits or some form of term deposits or housing bonds, mostly by other institutions, with a maximum term of three years.

Given the competition for savings and some current uneasiness in financial circles (there is no deposit insurance in place yet) the resource base of the housing finance institutions can be unstable (not so true of the three old line institutions but certainly of the others). The result is that the more prudent institutions keep a high liquidity, much more than the recently instituted 20%, but the less prudent operate with a thinner margin. In the former case the ability of the institution to make mortgage loans is obviously curtailed; in the latter the risk of problems can be great.

At the moment there is no place for these institutions to turn if they have any type of liquidity crunch resulting from a major loss of deposits. In fact, one of the reasons that some of the institutions now keep such a high liquidity is that the NSSF pulled back some substantial deposits two years ago when the NBFI, Rural Urban Credit, failed.

We believe that, pending the establishment of some sort of secondary financing facility or secondary mortgage market discussed below, the specialized housing finance institutions should have access to some sort of liquidity facility to see them through emergencies. Such a facility could be considered in conjunction with the strengthened regulatory framework recommended above.

C. Recommendation No. 3

Encourage the Development of a Trade Association

The development of the trade association should be encouraged and strengthened. The focus of many trade groups is to represent the views of its members before government on matters of interest to the group. While we wouldn't deny the need for such representation, we feel that there are other important aspects of the housing finance industry in which the trade association can play an important role.

One is to continue to push the idea of a secondary mortgage market in which its potential members have played the lead role so far. But it can go further than that in this regard. It can actually promote the trading of mortgages among its members on a trial basis as suggested below. It can foster the development of standardized mortgage instruments, perhaps in conjunction with the regulatory body recommended above, that would be necessary to the functioning of any market.

It can take the lead in creating common training facilities for employees of its members. And finally, it can commission studies or research into matters of interest to the industry. There are, of course, other things in which the trade association can get involved, not the least of which is the sharing of information that grows out of frequent contact, sponsoring advertising campaigns to instill public confidence, etc. The point here is that the trade association can play an important role at this time in the development of Kenya's rapidly developing housing finance industry.

D. Recommendation No. 4

Develop Secondary Mortgage Financing Facilities

1. Long Term Deposits

The National Social Security Fund (NSSF) and the Post Office Savings Bank (POSB) should break out of their captive market position as supporters of GOK debt instruments. They could make long-term deposits in approved mortgage lenders identified by the Central Bank-Ministry of Finance[1] at rates at a minimum of slightly above the rate on comparable maturity Treasury securities.

As discussed in the body of the report, this type of mechanism apparently already exists but is not currently in use. It would be desirable to determine why it has not been used since the demand for mortgage credit should be high and the current return on the NSSF portfolio is low. These funds should be on-lent for mortgages at a specific mark-up (effective yield rather than contract rate). If the demand for credit exceeds the supply from NSSF and POSB, approved lenders should be allowed to bid up the interest rate differential over Treasuries. Consideration should be given to limiting the size of these loans to, say KShs. 250,000 in order to provide maximum access to families on the lower side of the income scale or setting some percentage of the total that must be used for loans not exceeding a given level.

The portfolio strategy now being developed for NSSF needs to evaluate the usefulness of mortgage investments within a broader, diversified

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1. This function would presumably eventually be carried out by the regulatory supervisory body recommended above. HFCK, Savings and Loan Kenya and East African Building Society, for instance, would appear to meet any criteria that would be set up.

long-term investment strategy. Input into the current study is important. The premise, however, should not be that housing finance per se is desirable, but rather than interest rates should be determined by reference to a real positive return to the NSSF portfolio, rather than an affordable rate for borrowers.

2. <u>Encourage the Initial Development of a Secondary Mortgage Market</u>

The first issue that must be dealt with is return. The largest mortgage lenders are now lending in the 16% range and only the smaller, newer institutions are lending at the 19% maximum. Assuming that the buyer of mortgages would not want to do the servicing, you would have to allow something for servicing. What that would be in Kenya now isn't known although HFCK, Savings and Loan Kenya and EABS could undoubtedly come up with a figure.

Say that you allow 1 point to service. That could mean mortgages for the big lenders selling to yield around 15%, the smaller lenders at 18%. If, as was pointed out by one observer, you can currently get as high as 15 1/2% -- 16% in two year term deposits, why buy a mortgage with its potential problems? Thus, for the immediate present, the interest rate level has eliminated the mortgages of the large lenders and the smaller lenders would undoubtedly be perceived as the most risky.

However, it should be noted that Kenya Reinsurance and Kenya National Assurance Company, both government-owned, are currently lending for mortgages at 13%. Such institutions would appear to be likely candidates at some point for the purchase of mortgages, particularly in the case of Kenya Re which is also engaged in the housing development process, a risky venture for an insurance company which should be looking for long term investments.

The approach that would appear to make most sense as an initial approach would be to foster secondary market trading of mortgages among existing approved mortgage lenders, particularly between smaller branch offices of building societies in capital-short secondary cities and larger lenders in the capital-rich major cities as well as with insurance companies, trust companies and provident funds. This process could evolve slowly of its own initiative but could be accelerated through the informal contacts among the emerging trade association members. That is, through informal contacts a housing finance institution could arrange to sell a small block of mortgages to, say, an insurance company with the understanding that if any mortgage defaulted the originating institution would buy it back. This kind of activity could help to develop trust and technical assistance between the different institutions as well as publicize the market. If such informal selling and trading worked well, it could then provide the impetus to issue more formal securities. As the process developed, any impediments to the formal trading of mortgages or mortgage-backed securities could be worked out.

At some point these securities could eventually be traded on the developing capital market. The test would be the quality of the mortgages involved, the reputation of the institutions originating the mortgages and the perceived and actual strength of the industry as a whole. This is where the regulatory/supervisory function recommended above comes in.

3. <u>Mortgage Instruments</u>

Our interviews along with the affordability and risk distribution issues discussed earlier indicate that mortgage instrument design is a major issue. Market rate but affordable instruments, (e.g. graduated payment mortgages combined with variable rate mortgages with interest rate caps) can be designed with success strongly dependent upon the appropriateness of the instrument. Sophisticated financial instruments cannot solve all the affordability and risk problems associated with housing finance, but sophisticated concepts can be used in relatively simple forms to improve things considerably.

With regard to mortgage default insurance, we are not advocating the institution of such insurance by government as a necessary ingredient for the sale or trading of mortgages. However, as pointed out in the body of the report, Home Savings and Mortgages has worked out a type of private mortgage default insurance with one of the insurance companies. It would be worthwhile to look at the mechanics and experience of this endeavor and attempt to explore with possible secondary mortgage investors whether such a factor significantly increases the attractiveness of the mortgage as an investment.

E. Recommendation No. 5

There is a Need to Identify and Clarify the Appropriate Financial Relationship Between Public and Private Housing Finance

The National Housing Corporation's (NHC) relations with Local Authority (LA) Governments need clarification. We have been told that at present the remittances on NHC projects that are collected by LAs are usually not repaid to NHC. Instead they are used as a source of funding for LA expenses. The GOK has to use its own revenue to repay the loans to the World Bank and AID, while LAs use the proceeds of the investments to fund what must frequently be recurrent expenses rather than investments. Central government may want to provide grant assistance to local authorities. However, to use what is nominally a financial transaction to do so obscures the nature of intergovernmental relations. This is obviously a complex topic that goes well beyond the scope of this project. However, to the extent that it effectively decapitalizes a major participant in the housing market it is worth the attention of the housing sector.

Technical Issues

1. A study of the financial conditions and relationships of housing intermediaries and transfers to this sector and urban sectors would help make subsidy levels and their effects more explicit. When the public sector accounts for such a large and declining share of housing production, its relationship with potential private intermediaries should be clarified.

2. A study of the targeting of existing subsidies could probably improve expenditure efficiency. NHC, for example, lends at 8 1/2% and, for projects with external financing, e.g. Housing Guaranty loans, slightly above the rate on the international loans, e.g. 11 1/2%, regardless of what the domestic market rate of interest is. Currently, the former rate represents a subsidy of 10 1/2/19 = 55%. And, since loans recovery is poor, this can easily increase to a 75% cost reduction. It would be much more effective if smaller subsidies, say 20%, were allocated to those households who were thought to be closer to buying a unit. In addition, NHC's loans range from KShs. 250,000 to KShs. 400,000. It would seem that NHC should serve a lower income group. By providing smaller subsidies to less expensive units the number of units induced could be a multiple of current levels.

3. A comparison of interest subsidies with loan restructuring could show the costs of the former (as well as current approach) used to solve affordability problems. A good deal of GOK concern with housing affordability was reflected in the perceived need to lower mortgage interest rates relative to the rates on other financial transactions. Unfortuantely, the implicit subsidies associated with the more affordable, but lower return, mortgages requires lower returns to savers or increased government expenditure or both.

It also typically means that the supply of such low cost loans has to be severely rationed so that few households have access to any credit.

An alternative means of lowering initial mortgage expenses that does not require subsidization is to use graduated-payment-mortgages. Those loans call for an increase of a certain percent of the loan amount for a specified number of years, after which payments level out again. For example, at a 19% mortgage rate a loan that increased by 6%, (i.e. about half the inflation rate of the past seven years) for the first five years of the loan life and thereafter levels off, would produce a 20-25% reduction in initial monthly mortgage payments. In other words, it would make the initial payment on a 19% loan like the payment on a 14.5-15% loan, and do so without subsidy.

As long as the rate of graduation selected was significantly smaller than the inflation rate, even if wages did not keep pace with inflation, the increased payments would nevertheless require a small share of monthly income.

4. Integration of Housing Needs Model Estimates with Housing Reforms. In the first part of this study we attempted to identify the strengths and, importantly, the weaknesses of the housing needs model. When decision-makers focus strictly on the numbers produced by needs studies, there is always the danger that they will adopt policies which will be oriented towards production and subsidies. This kind of thinking can have adverse consequences. The analyst who proclaims the "need" to direct 11 percent of GDP to housing is likely to be met with a great deal of skepticism from those who would argue (correctly) that such a policy would be bad for the economy. Such proclamations can shift attention away from housing finance and building standard reforms to debates about the size of the government's housing budget.

It is a point worth repeating: the needs estimates do not dictate what share of GDP should go to housing or how much housing should be produced. The housing needs assessment methodology can yield figures which give an indication of the magnitude of Kenya's housing problems, and can provide a sound basis for comparing alternative housing strategies. Of particular interest is the fact that the methodology is currently being revised such that analysts will soon be able to examine the impact of graduated payment mortgages on affordability. The methodology remains a useful device that forces planners and policymakers to think about the relationships between their policies and a variety of key economic and social indicators.

THE HOUSING FINANCE SYSTEM
IN KENYA

Volume II

Prepared For:

The East and Southern Africa Regional Housing
and Urban Development Office
Agency for International Development

and

The Government of Kenya

Prepared By:

USL International Inc.

The Urban Institute

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KENYA HOUSING FINANCE STUDY

Scope of Work

SERVICES TO BE PROVIDED

A. Purpose of Study

The purpose of this study is to describe the structure and to analyze the recent trends of the housing finance system in Kenya and to assess the adequacy of the structure in meeting the housing needs, both mortgage and rental, of all Kenyans, with emphasis on those families of low and moderate income. The study will also address the possibilities for mobilizing an increasing flow of domestically generated resources to the shelter sector and the means by which this may be accomplished. The study will also review present Government policies and actions as they affect the flow of funds to the housing sector with a view to recommending changes and innovations in order to make the catalytic role of the Government more effective in mobilizing and channelling financial and other resources to housing. The possibilities for the establishment of a secondary mortgage market will be elaborated upon and if the findings indicate the feasibility of a secondary mortgage market in the near future, specific steps will be delineated which lead directly to its establishment.

The study will be used together with that recently completed in Zimbabwe as the basis for establishing a methodology for future financial studies on the housing situation in developing countries.

B. Scope of Work

The consultant team will:

1. Review all materials recently completed (e.g. within the past five years) dealing with mortgage and rental housing needs in Kenya, focusing on the needs of low and moderate income households. Available information and/or recent studies on Kenya's capital markets will also be reviewed.

2. Update estimates of effective housing demand with special emphasis on low cost housing (i.e. below KShs. 120,000 per unit), and estimate required levels of housing production and finance to meet the demand for the next 20 years.

3. Briefly describe the current structure of the financial sector in Kenya, identifying each type of financial institution by function and the relative size of each as measured by its percentage of total financial assets in the country. Institutions to be described shall include, but not be limited to, the Central Bank of Kenya, National Social Security Fund, the commercial banks, finance houses, merchant banks, the building societies, pension, insurance and provident funds, co-operative savings and credit societies, and other cooperative and agricultural credit institutions.

4. Discuss trends in the national government's borrowing requirements and expected demand for borrowing in the near term future. Comment on the effect government borrowing is expected to have on the financial system (e.g. on interest rates, liquidity, reserves).

5. Briefly discuss current trends in the financial sector, evaluating the strength of the system as a whole and identifying recent changes in the relative strength of each type of institution. Discussion shall include a description of the liquidity position of the various types of institutions.

6. Analyze the effect of governmental actions and policies in so far as effective operation of each type of institution is concerned (e.g. on interest rates, reserve requirements, etc). Discuss the role of the Ministries of Finance and Planning and National Development in establishing economic planning policy and the role of the Central Bank in regulating the financial sector.

7. Discuss in greater detail the primary housing finance market, describing the role of the (a) building societies and other private sector housing finance institutions and (b) governmental and local authority housing finance and production activities. Discussion shall included the type of housing finance and the target group served by particular types of institutions and the amounts of such housing financed.

8. Describe the vital role of the informal sector in both providing shelter finance and in producing housing. Although the study will focus on formal sector housing finance and production, it will also ascribe the role of the informal sector and elucidate areas for further investigation. A special section of the study will cover the financing of rural housing production and upgrading.

9. Assess the activities and structure of the housing finance sector vis-a-vis local capital markets. Discuss the mobilization of primary resources for housing finance, including domestic savings generation, government outlays, external and other sources of funds. Describe constraints which currently limit the flow of additional funds to the sector and implicit and explicit policies and factors which have the effect of directing the flow of resources toward certain types of institutions building societies, commercial banks and other investments. This will include an analysis of the effects of tax policies and structure on the mobilization of savings by building societies, commercial banks and other key financial institutions. A special review of the effectiveness of the operation of the housing bond as an investment for channelling funds to the housing sector will be made.

10. Review previously prepared studies on the possible creation of a secondary mortgage market in Kenya and evaluate the current climate for the establishment of such a market. This will include a discussion of the role and trends in the securities market in Kenya. Should it be reaffirmed that a secondary mortgage market is feasible, the consultant will prepare in an annex a step-by-step scenario of actions, both legislative and regulatory, which must be taken to establish such a market and an estimated realistic timetable for each required action. (A critical path analysis is suggested).

12. Prepare specific recommendations for improving the functioning of the housing finance system and for attracting additional resources to the system.

C. <u>Qualifications of the Consulting Team.</u>

The Consulting Team shall consist of the following:

1. One housing finance and banking specialist (Team Leader).

2. One experienced macro-economist.

3. One management specialist and housing finance generalist with experience in quantitative analysis.

4. One housing economist.

5. One experienced practitioner in housing finance with an in-depth understanding of secondary mortgage markets.

In addition the Consulting Team will be assisted by two experienced local practitioners familiar with housing finance in Kenya. They will be separately contracted. Their qualifications will be approved by the Steering Committee referred to below.

E. Term of Performance

The pre-field portion of the assignment shall begin on January 13, 1986, the field assignment will commence on January 20 and terminate on February 14, 1986. The first draft report shall be completed by March 7, 1986.

F. Coordination, Relationships and Responsibilities

The study will be guided by a Steering Committee comprising the Ministry of Works, Housing and Physical Planning (in the chair), the Kenya National Housing Corporation, the Ministry of Planning and National Development, the Ministry of Finance, and USAID. The team leader will report at least every two days on progress to the Chair and USAID and the entire consultant team will report periodically to the full Steering Committee while in Kenya.

G. Reports

A final briefing session will be held with the Steering Committee prior to departure of the team from Kenya at which time an outline of the written study highlighting the main recommendations will be presented. A draft report will be sent to Kenya for comment within three weeks after the return of the team to the United States. Within one week from the receipt of comments from the Government of Kenya and RHUDO on the draft report, the final revision shall be completed. Fifty copies of the final report shall be reproduced.

Background Materials Reviewed for Study

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World Development Report 1985, many basic tables

UN, US Census Bureau, World Bank, various Kenya population estimates

Miscellaneous Kenya newspaper articles

Miscellaneous Annual Reports, Financial Statements and Brochures From Kenya Financial Institutions

ANNEX C

Chapter II
Overview of the Methodology

Reproduced from Preparing a National Housing Needs Assessment
by Robert A. Nathan Associates, Inc.
and the Urban Institute. Office of
Housing and Urban Programs, Agency
for International Development,
March 1984

CHAPTER II OVERVIEW OF THE METHODOLOGY *

The housing needs assessment methodology presented in this report addresses two fundamental issues:

- Physical housing needs in terms of numbers of dwelling units
- The investment necessary to provide the required number of units and its financing.

Any housing needs assessment must begin with an analysis of current housing needs and then project future housing needs taking into account demographic, social, and economic changes likely to occur over the course of the planning period, in this case twenty years. A simplified view, therefore, identifies two components of need: (1) current needs for housing upgrading, replacement, or construction based on the condition of the existing housing stock with the objective of providing a minimum acceptable level of housing to all the nation's people; and (2) future needs reflecting population growth, household formation, urbanization trends, and the rate of decay of the existing stock.

In this methodology, the physical needs are projected in the form of units per income group and location over a twenty-year period at five-year increments. The projections include separate estimates for the number of new dwelling units required to meet population growth, the number of upgradable units, the number of substandard units that are not upgradable and therefore require replacement, and the number of additional dwelling units required to alleviate overcrowding. The incremental investment requirements of a housing program designed to meet these needs is then computed. The investment requirement is further examined in terms of the portion of investment that will be recoverable through affordable payments by households, and the subsidy required to bring all households up to a minimum standard housing level determined by the policymaker.

To provide for the implementation of the housing needs assessment methodology, a relatively simple mathematical model and a computer program to solve that model have been prepared. The computer program has been written in BASIC to permit its easy adaption to almost any microcomputer system meeting the modest storage requirements described in the accompanying user's manual. In fact, the model has already been implemented on two microcomputers, the Hewlett-Packard and Wang Personal Computers. It is a flexible program that allows use of detailed, disaggregated projections when these are available or generates some indicative results on the basis of less complete data and simplifying assumptions. Similarly, the mathematical and other calculations that make up the model can be complex if the values of a large number of the variables included in it change over time, region, or income category; but these can also be reduced to fairly simple form and solved by hand if a number of simplifying assumptions are made.

Discussion of the housing needs assessment methodology will be presented with reference to the microcomputer model and for the simplest case that can be used to illustrate the basic principles of its operation. Review of the user's manual[1] will enable the reader to appreciate more fully the computer model's extended capabilities.

A. Summary of the Calculations

The microcomputer program that has been developed is oriented primarily toward providing estimates of housing needs and investments, thus permitting evaluation of alternative housing strategies and identification of affordable options. A model of household formation and housing expenditures provides the logical framework for the calculations performed by the microcomputer. Like all models, this one is based on certain assumptions that should be clearly understood both in structuring the scenarios to be analyzed with the methodology and in interpreting the results it provides.

The most important aspect of the methodology to be kept in mind is that all calculations are based on the assumption that the total housing needs projected for each time period will be fully met with housing that satisfies minimum standards. In calculating investment, the model assumes that no future increments to the substandard housing stock will take place at any time following the base year chosen for the analysis.

If the methodology were oriented primarily toward forecasting and prediction, its applicability would be limited in some countries where future increments to the substandard stock--the continuing proliferation of squatter settlements--may be inevitable. However, since the model is in fact structured to facilitate the comparative evaluation of alternative approaches toward the satisfaction of projected housing needs, the stipulation that all housing programs analyzed meet minimum shelter needs, and therefore provide a common standard for strategy evalution, is entirely appropriate.

The model is designed to accept up to three regional disaggregations for the projection of housing needs and the configuration of appropriate housing programs. In Kenya, the most important disaggregations were "metropolitan" (including the two largest cities, Nairobi and Mombasa), "other urban" (including all other towns having at least 2,000 in population as of the latest census), and "rural." In Sri Lanka, a more appropriate disaggregation was defined by the categories "urban," "rural," and "estate."

Housing needs for these three areas are projected for each five-year period within a twenty-year planning period on the basis of population growth, interregional migration, household formation trends, and a program defined by the user to upgrade or replace substandard components of the base-year housing stock at a rate which the user determines.

The total cost of new housing units and upgrades of existing housing units required to meet total projected housing needs are calculated on the basis of unit costs provided by the user in accordance with the design standards specified for each strategy. To determine what level of public subsidy, if any, would be required to implement the program that has been specified, the planner compares these costs with the maximum housing values that households in each quintile of the income distribution are estimated to be able to afford.

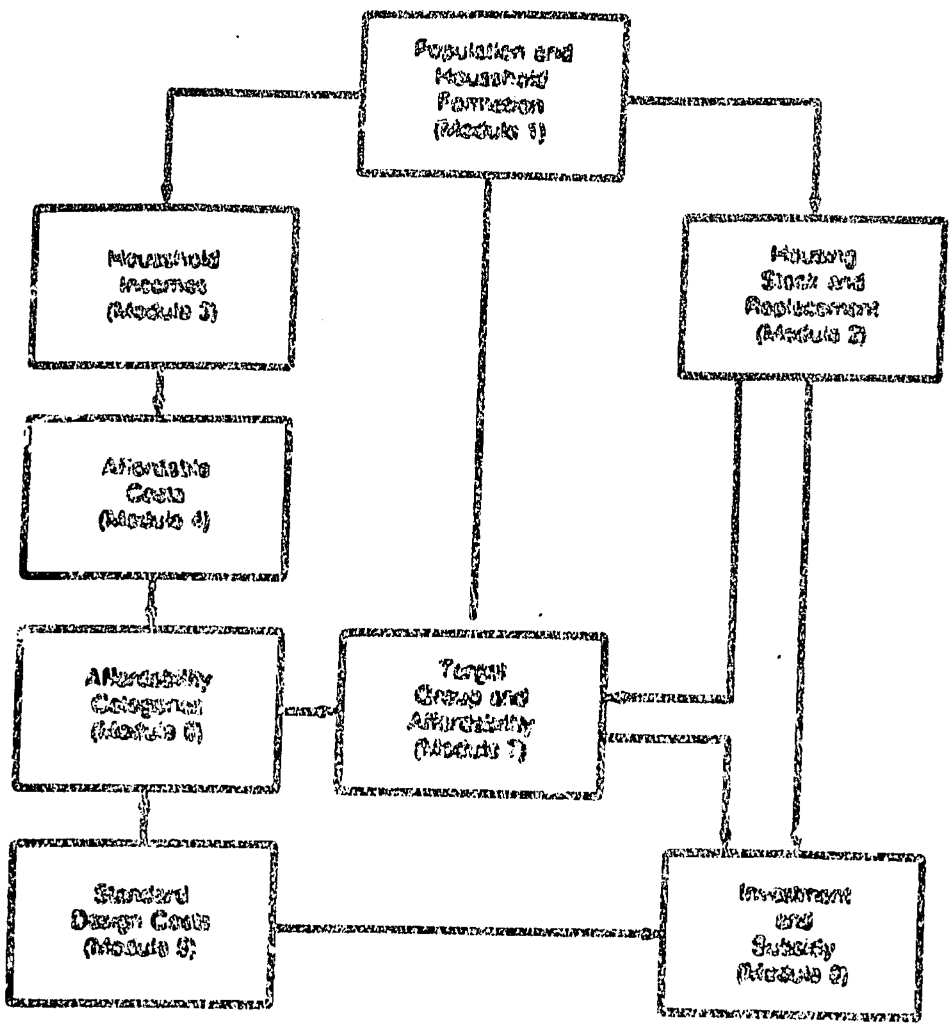
Key factors affecting the total cost of housing programs defined in this manner include growth in total household numbers, growth in rate of urbanization,[2] rates of escalation in construction costs and, especially, the minimum design standards and corresponding unit costs specified for the housing program.

Housing affordability increases (and subsidy requirements decrease) as household income increases, shares of income devoted to housing increase, financial lending terms become more favorable, and housing costs fall.

Of these variables, minimum housing design standards and costs lend themselves most directly to public policy intervention. The interplay of housing design standards, program costs, and housing affordability through successive iterations of the model can help housing planners and policy analysts structure a realistic approach that will satisfy basic needs through the adoption of standards which, while offering real improvement over informal sector living conditions, are also affordable by most low-income households.

Figure 1 identifies the main components of the model in somewhat greater detail.

Figure 1. Main Components of the Housing Needs Assessment Model



As has already been discussed, the major determinants of projected physical needs for shelter are future population growth, household formation trends, and the adequacy of the existing housing stock to meet the needs of the current population. As shown in figure 1, these estimates and projections are developed through modules 1 and 2 of the model. Together, these determine the scale of the housing program to be analyzed through subsequent calculations.

The affordability of alternative housing packages is determined by current and projected incomes of the various sectors of the population requiring housing, and by the costs of these alternatives. These elements of a housing needs assessment are considered in modules 3, 4, 5, and 6 of the model in the following manner:

- Module 3 projects household incomes for subsectors of the population by income distribution subgroupings.
- Module 4 calculates housing affordability for subsectors of the population based on household incomes, housing expenditure patterns, and terms of housing finance.
- Module 5 specifies the current and future costs of alternative shelter solutions defined on the basis of the dwelling standards established by planners.
- Module 6 classifies all households according to the housing standards that they can afford.

On the basis of total shelter needs and the housing standards that are affordable by various segments of the population, modules 7 and 8 are then used to--

-- Determine national housing investment requirements;

-- Identify those segments of the population which, on the basis of their inability to afford currently available, minimum standard, formal sector housing, make up the target group for housing programs; and

-- Estimate the level of direct subsidy, if any, that would be required to bring all housing to the chosen standard.

The information provided through these last two modules enables planners to evaluate the implications of alternative housing programs in relation to macro-level projections of investment and savings, public sector expenditures, formal sector loan volume, and other indicators.

B. Limitations of the Model

Although the model has been demonstrated to provide genuine insight on a variety of housing policy issues, several distinct limitations of the methodology must also be clearly kept in mind.

One limitation, already mentioned, is that the calculations do not permit future additions to the substandard stock. That is, the model assumes that there will be no lag in developing the capacity required to build enough units that conform to the minimum standards to satisfy incremental housing needs. In reality, it may take some time to bring formal sector building capacity up to the level required to meet 100 percent of needs, and additions to the substandard stock may be expected to make up the shortfall in the interim. Although this feature of the methodology may appear to be a limitation for forecasting purposes, it has no relevance to the comparative evaluation of alternative housing strategies. And, as the user's manual explains, more realistic forecasts can be made by manually adjusting the composition of the total projected housing stock and "restarting" the model at some future year when it is estimated that building capacity can realistically be brought up to the required 100 percent level.

Second, the logic behind the capitalization[3] of housing expenditures should be clearly understood. Although the analogy to mortgage financing is used throughout the discussion of the methodology, some households may not find the financing necessary to enable them to immediately acquire housing assets up to the full amount they can afford. Some households will secure mortgage financing at these levels, while others may gradually build up their housing assets through investments expended over a long period. By capitalizing these investment expenditures, we can estimate the present value of the assets these households will eventually command. As already noted, however, the fact that the incomes of these households will support their eventual acquisition of housing of a certain value does not necessarily imply that the financing to make this housing immediately available will be necessarily forthcoming. Financing to support the housing programs formulated with the assistance of the needs assessment methodology must be dealt with separately.

Third, because only five income groups per sector are represented in the model, it is difficult to simulate policies that affect less than very large parts of the population. The viewpoint of the methodology is distinctly macro and cannot substitute for more detailed project and subsector level studies.

Finally, in calculating estimated subsidy requirements to implement the various housing programs that may be analyzed, the methodology assumes that all government resources go only to households in the deficit groups, in exactly the required amounts, and that there is no substitution of government expenditures for expenditures that would, in the absence of subsidies, have been undertaken anyway by recipient households. In effect, the model presumes perfect targeting efficiency in the estimation of subsidy requirements, and therefore understates the resources needed to implement a real-world program where some leakage and waste are inevitable. The methodology is neutral in this respect between alternative housing strategies, but it still provides important evaluative guidance in a comparative sense. Also, the degree of understatement of subsidies is likely to be small, particularly when the estimated number of households needing subsidy under the housing program in question is small. In general, the larger a subsidy program, the larger the fraction of total subsidies that ends up going to those who don't need them. Therefore, the degree of subsidy underestimation in the model because of neglecting targeting inefficiencies is likely to increase with the size of the estimated subsidy program.

ANNEX D

Summary of Procedures
Used to Update the
1984 Kenya Housing Needs
Assessment
done by
Philip Rourk and
Andrew Roscoe of
Robert R. Nathan
and Associates

ANNEX D

This annex describes how the housing needs assessment originally conducted by Phillip W. Rourk and Andrew D. Roscoe was updated for this study, and presents the results of this update. The first section describes in detail the revisions made to the model's data inputs and how these changes are likely to affect needs estimates. The next section presents revised estimates of key need indicators and contrasts these with the Rourk and Roscoe (R&R) findings. The final section summarizes results, makes recommendations, and discusses factors to consider in conducting future needs assessments. A second annex follows this one; it presents an excerpt from Guidelines for the Preparation of a Housing Needs Assessment (Robert R. Nathan Associates, Inc. and The Urban Institute, 1984) which contains an overview of the methodology employed in the R&R study and this update. To get the most out of this annex, one should already be familiar with the R&R housing needs assessment. For practical purposes, this annex does not attempt to explain all of the inputs and underlying assumptions that went into the original study. Instead, it focuses on the changes implemented and their effect on the revised needs estimates.

This update utilizes sources of data which were not available at the time of the original R&R study including a variety of survey results, government housing policy reports, and revised CBS estimates. These data sources were carefully reviewed and new data was incorporated into the revision of the base case wherever practical. Since every

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1. All monetary amounts, unless otherwise noted, are in 1983 Ksh.

possible change could not be implemented given the time and resource constraints we were working under, we tried to focus on those items that have a relatively large impact on the needs estimates. These items include: the condition of the existing housing stock; costs of new core housing units; national income and capital expenditure estimates; and the program to reduce overcrowding, replace dilapidated units, and upgrade substandard units.

Little was known about the size and condition of Kenya's housing stock at the time of the R&R study. Rourk and Roscoe relied heavily on a study by Lloyd W. Morris (1983) for guidance on estimating housing stock figures.[1] For this update, two previously unavailable surveys -- The 1983 Urban Housing Survey (UHS) and the 1976 Second Integrated Rural Survey (IRS-2) -- yielded data which could ~~be used~~ to classify dwelling units into permanent, upgradable, and non-upgradable categories albeit in a crude fashion.[2]

Table D-1, which is based on UHS data, categorizes urban dwelling units into three categories depending on the type of housing. According to the authors of the UHS, permanent units include houses, maisonettes, and flats; semi-permanent units include those in swahili-type structures; and inadequate units include shanties and other temporary structures. Furthermore,

> housing units are considered upgradable when they lack basic water and sanitary facilities and such

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1. Lloyd W. Morris, A Computer-Based Model of Basic Housing Needs in Kenya, USAID Office of Housing and Urban Programs, September 1983.

2. The UHS also contained estimates of the total urban housing stock in the base year, 1983, but sampling and definitional problems prevented us from using these figures. The UHS covered 89% of the 1979 urban population.

TABLE D-1

TOTAL URBAN DWELLING UNITS, BY TYPE OF CONSTRUCTION[1] AND AREA (percent)

	Permanent	Semi-Permanent	Inadequate	Total
Metropolitan[2]	54.3	28.0	17.7	100.0
Other Urban[3]	52.8	8.5	38.7	100.0

1. "Permanent" includes houses, maisonettes, flats; "semi-permanent" includes swahili-type units; "inadequate" includes shanties and other temporary structures. It is generally believed that many households described their units as "houses" even though they occupied other types of structures.
2. Includes Nairobi and Mombasa.
3. Includes all other towns with 2000 or more persons.

Source: Urban Housing Survey, 1983 (CBS and MoP&ND, 1986), Table 2.4, p. 51.

> infrastructural services as sewage, electricity and roads. The status of these units can be upgraded with the provision of the said facilities and services .... [T]he type of housing units which lack the above facilities most are shanties. Only a very limited number of houses, maisonettes, flats and swahili type houses lack these facilities. (CBS and MoP&ND, 1986, p. 54)

Table D-2 shows what share of units did not have either a private or communally owned source of water. Assuming that nearly all of these are shanties, and that there is a high correlation between not owning a source of water and having inadequate sanitation facilities, then roughly a third of the metropolitan units and half the other urban units which are labeled "inadequate" in table D-1 could be characterized as being non-upgradable.[1] The remaining "inadequate" units could be considered upgradable. The permanent and semi-permanent units could be placed together into a single permanent category.

For rural areas, we can use data from IRS-2 to categorize dwelling units.[2] Table D-3 displays various characteristics of rural dwelling units in 1976. While a good deal of variation exists across provinces it is clear that for the country as a whole rural housing is largely constructed of non-durable materials. Nearly 70 percent of all main dwelling units had thatched roofs, about 88 percent had mud or wood walls, and over 90 percent had earth floors. Since replacing all such

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1. The metropolitan area includes Nairobi and Mombasa. The other urban area includes all other towns with 2000 or more persons. About 18 percent of all urban units had toilet facilities other than a private flush, pit, or communal flush (CBS and MoP&ND, 1986, p. 113).

2. Although IRS-2 was initiated in 1976, the proportions of households and dwelling units falling into various categories were assumed to apply to the 1983 base year housing stock.

TABLE D-2

PERCENTAGE OF TOTAL URBAN DWELLING UNITS
WITH NO PRIVATE OR COMMUNALLY OWNED
SOURCE OF WATER, BY AREA

	Percent
Metropolitan[1]	5.5
Other Urban[2]	17.5
Country	10.8

1. Includes Nairobi and Mombasa.
2. Includes all other towns with 2000 or more persons.

Source: Urban Housing Survey, 1983 (CBS and MoP&ND, 1986), Table 3.6(b), p. 110.

TABLE D-3

PERCENTAGE DISTRIBUTION OF MAIN DWELLING UNITS, BY TYPE OF CONSTRUCTION AND PROVINCE

	Coast	Eastern	Central	Rift Valley	Nyanza	Western	National Total
Type of Roof							
Thatched	91.7	63.3	32.4	75.8	81.4	85.3	68.8
Tin Can/debe	0.0	1.0	8.3	1.2	0.3	0.0	2.1
Corrugated iron	3.4	35.2	56.6	18.1	18.3	14.1	27.1
Other	4.9	0.5	2.7	4.9	0.0	0.6	2.0
Total = 100%	100.0						
Type of Walls							
Mud	84.9	73.6	71.4	79.3	89.2	93.1	81.3
Wood	0.0	5.4	14.7	13.1	1.9	1.0	7.0
Stone, brick concrete	6.8	18.7	11.8	6.9	4.2	4.9	9.0
Other	8.3	2.3	2.1	6.7	4.7	1.0	2.7
Total = 100%							
Type of Floors							
Earth	92.3	89.4	87.0	89.5	92.8	93.5	90.5
Concrete	7.7	10.5	11.9	9.8	7.2	6.2	9.1
Other	0.0	0.1	1.0	0.7	0.0	0.3	0.4
Total = 100%							

Source: CBS and MEP&D (1982), Table 7.13.

units is unthinkable, we again examine water accessibility and sanitation facilities as principal indicators of housing quality.

Table D-4 reveals that 38 percent of all rural households versus about 3 percent of urban households have no sanitation facility. Virtually all of the remaining rural households rely on pit latrines. Thus, at a minimum, we can say that 38 percent of the rural housing stock could be upgraded or replaced. However, accessibility to water is also a problem in some rural areas and this should be taken into account. Table D-5 shows the distances households must travel to reach a water source during the dry season. Nearly three-quarters have a water source within one kilometer. About a sixth of the remaining households (3.8 percent at the national total) have to travel over 4 kilometers for water. If we treat all dwelling units where households have to travel more than 1 kilometer to obtain water as requiring upgrading or replacement, and add these to the 38 percent of the rural housing stock that we already consider to need upgrading or replacement because of a lack of sanitation facilities, we can establish an upper bound of about 64 percent for upgradable and totally deficient units. Since some of these problems are likely to overlap we arbitrarily decided that 50% of the rural housing stock needed at least an upgrading; those units where households have to travel greater than 4 kilometers were considered non-upgradable.

Table D-6 summarizes the results of these extrapolations from the UHS and IRS-2 data. It shows what share of units fall into permanent, upgradable, and non-upgradable categories for metropolitan, other urban,

TABLE D-4

PERCENTAGE DISTRIBUTION OF HOUSEHOLDS, BY TYPE OF SEWAGE DISPOSAL AND PROVINCE

	Coast	Eastern	Central	Rift Valley	Nyanza	Western	National Total	
							Rural	Urban
Main Sewer	1.8	0.0	0.0	0.8	0.0	0.2	0.4	39.5
Septic Tank	0.7	0.4	1.8	1.1	0.9	0.6	1.0	23.0
Pit Latrine	22.5	56.4	89.0	32.5	71.5	65.9	60.3	34.6
Bucket Latrine	0.0	0.0	0.2	1.0	0.1	0.0	0.3	0.3
No Sanitation	75.0	43.2	9.0	64.6	27.5	33.3	38.0	2.6
Total = 100%	100.0							

Source: CBS and MEP&D (1982) Table 7.19.

TABLE D-5

PERCENTAGE DISTRIBUTION OF HOUSEHOLDS, BY DISTANCE TO WATER SOURCE IN DRY SEASON AND PROVINCE

	Coast	Eastern	Central	Valley	Nyanza	Western	National Total
On Holding	28.4	27.3	67.5	62.1	41.3	65.5	50.7
0-1 Km	12.8	37.7	20.7	15.1	26.8	22.9	23.8
1-2 Km	29.7	15.2	10.3	9.6	19.9	9.1	14.2
2-4 Km	16.2	11.9	1.5	7.9	10.3	1.7	7.5
4-8 Km	8.3	6.9	0.0	4.3	1.7	0.8	3.1
8+ Km	4.6	1.0	0.0	1.0	0.0	0.0	0.7
Total = 100%	100.0						
Average Distance of Water Source from Holding (Km)	2.7	1.8	0.9	2.1	1.4	1.0	1.7

Source: CBS and MEP&D (1982), Table 7.15.

TABLE D-6

PERCENTAGE OF URBAN DWELLING UNITS
THAT ARE PERMANENT, UPGRADABLE, AND
NON-UPGRADABLE BY AREA

	Permanent	Upgradable	Non-Upgradable	Total
Metropolitan	82.3	12.2	5.5	100.0
Other Urban	61.3	21.2	17.5	100.0
Rural	50.0	46.2	3.8	100.0

Source: Authors' calculations based on Tables A-1 through A-5.

and rural areas. In comparison, R&R estimated that for both metropolitan and other urban areas 70 of all units were acceptable, 20 percent were upgradable, and 10 percent were non-upgradable. For rural areas R&R judged only 20 percent to be acceptable, 70 percent to be upgradable, and 10 percent to be non-upgradable. The biggest difference between the R&R and the revised housing stock estimates lies with the rural figures, where R&R considered only 20 percent of the stock to be permanent versus the 50 percent presented as the revised estimate. This has strong implications for needs estimates when you consider the fact that the size of the rural housing stock is four-and-a-half times that of the metropolitan and other urban areas combined in the base year 1983. Rourk and Roscoe also assumed that about 16 percent of dwelling units in metropolitan areas were overcrowded, about 11 percent in other urban areas, and only around 5 percent in rural areas. These overcrowding estimates were retained for this update.

The program for improving or replacing the substandard stock is once again assumed to take place at a constant rate over the entire 20-year planning period, such that all of the non-upgradable stock is replaced, the upgradable stock is upgraded, and overcrowding is relieved at a rate of 5 percent per year.

Rourk and Roscoe assumed that permanent dwelling units in each area would decay at the rate of 2 percent per year. In the revised base case this figure was raised to 3 percent for rural areas to reflect the fact that a larger share of the permanent dwelling stock is made of non-durable materials compared to urban areas. The 2 percent rate for metropolitan and other urban areas was retained in the update.

Another key part of any housing needs assessment is the cost of a minimum standard core dwelling unit. Table D-7 presents a breakdown of the cost of a 21 square meter, two-room unit for urban areas. The design features concrete foundation and floors, concrete block or dressed stone walls, asbestos sheet roofs, and waterborne sewage connected to septic tanks; the unit is extendable up to five rooms. The design is one of many described in the government's recent low-income housing report, which is a product stemming from the government's review of the low-income housing by-laws.[1] As a simplification, the same cost estimate was applied to both metropolitan and other urban areas. Although land costs are appreciably higher in metropolitan areas, especially Nairobi, this is offset to some degree by higher building material transportation costs in other urban areas. For the update, all construction costs for rural areas and the cost of upgrading units in urban areas remained unchanged from the R&R base case.

The model also requires as an input the cost of a minimum standard unit that is available from the private sector (sometimes referred to as the formal sector). This input is required for each area in order to establish the target group. The target group includes all households who cannot obtain a unit from private suppliers even if they could afford a unit meeting minimum standards from the public sector. In Kenya, private financial institutions are generally unwilling to lend money for homes costing less than Ksh 120,000 regardless of area chiefly

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1. See Housing Department MoWH&PP (1985a) and MoWH&PP (1985).

TABLE D-7

COMPONENTS OF CORE HOUSING UNIT COST FOR METROPOLITAN AND OTHER URBAN AREAS

Component	Cost	
	Ksh	Percent
Land (8.33m x 16.00m plot size)	8045	15
Infrastructure		
Site investigation; survey; placing beacons	1838	
Severage; sewage disposal	6825	
Surface water drains	805	
Roads; footpaths	438	
Water supply	2345	
Misc. professional fees, contingencies construction finance interest	3338	
Total	15,589	29
Superstructure		
$21m^2$ at Ksh $1120/m^2$	23,520	
Misc. professional fees, contingencies, construction finance interest	6481	
Total	30,001	56
Total Unit Cost	53,635	100

Source: Infrastructure and superstructure costs were derived from prototype house T1 described in MoWH&PP (1985). Cost figures were deflated using a factor of .875 which was based on the assumption that average residential construction costs rose 6.9 percent per year between 1983 and 1985 (see Table A-8). Land was assumed to be 15 percent of total unit cost based on land's share of cost in the preliminary cost estimates for the USAID Umoja II project (see USAID, n.d.).

TABLE D-8

ANNUAL PERCENTAGE INCREASE IN BUILDING AND CONSTRUCTION COST INDICES*, 1982-1984

	Materials			Labour			Total Cost		
	1982	1983	1984	1982	1983**	1984	1982	1983	198[illegible]
Residential Buildings	12.7	8.2	0.8	22.3	—	43.5	14.1	6.9	6.[illegible]
Non-residential Buildings	11.7	5.1	0.7	22.3	—	43.5	13.7	4.1	8.[illegible]
All Buildings	12.2	6.7	0.8	22.3	—	43.5	13.9	5.6	7.[illegible]
"Other" Construction	17.0	6.8	11.6	22.3	—	43.5	18.7	4.7	21.[illegible]
Total Cost Index	14.6	6.8	4.2	22.3	—	43.5	15.6	5.2	12.[illegible]

*rom December to December
**No change between December, 1982 and December, 1983.

Source: Economic Survey 1985 (CBS and MoFP, 1985), Table 12.2.

because smaller loans are considered unprofitable.[1] This figure is used in this update for all areas. R&R used lower amounts of Ksh 90,000 and Ksh 50,000 for other urban and rural areas, respectively. This change should have the effect of enlarging the target group in the revised needs estimates; however, the subsidy required to bring all units up to the minimum standard should remain unchanged, all other things equal. Table A-9 summarizes the cost data used in the update.

Mortgage terms for the revised base case differ slightly from the original base case. The downpayment share remains 10 percent and the interest rate continues to be 16 percent for all areas, but the loan term has been adjusted downward from 25 years to 20 years in metropolitan and other urban areas to more closely resemble current lending practices. Data from the UHS reveals that the average term of mortgages held by owners in 1983 was about 15 years for those loans originated with HFCK, and 23 years for those originated with NHC. Averages for commercial banks and "other" institutions were about 7 and 13 years respectively. (CBS and MoP&ND, 1986, Table 4.5, p. 135). For rural areas the loan term remains unchanged at 20 years. The primary effect of shorter terms, other things equal, is to reduce affordability levels, and thereby increase subsidy requirements.

The final major area of refinement deals with gross domestic product (GDP) and levels of housing investment in the base year. Table 10 displays GDP and gross fixed capital formation (GFCP) in housing

1. In practice, home loans are almost non-existent in rural areas. The type of housing currently not offered by the GOK or the private sector is in the 55 to 120 thousand Ksh range. These figures are applicable to 1983 as well.

TABLE D-9

SUMMARY OF HOUSING COST INPUTS
FOR THE REVISED BASE CASE
(1983 Ksh)

New	Metropolitan	Other Urban	Rural
Upgrade	15,500	10,000	4,500
Core House	53,635	53,635	26,000
Formal Sector House	120,000	120,000	120,000

Source: Core house and upgrade costs are based on Table D-7 and Rourk and Roscoe (1984); the cost of a formal sector house was based on conversations with the Housing Division of the MoWH&PP.

TABLE D-10

GROSS DOMESTIC PRODUCT AND GROSS FIXED CAPITAL FORMATION IN HOUSING AT CURRENT PRICES, 1979-1984

(K£ millions)

	1979	1980	1981	1982	1983	1984
Gross domestic product (GDP)	1,977	2,232	2,582	2,911	3,327	3,701
Total gross fixed capital formation (GFCF)	540	622	725	668	721	836
As percentage of GDP	27.3	27.9	28.1	22.9	21.7	22.6
Total gross fixed capital formation in dwellings	93	106	120	125	113	127
As percentage of GDP	4.7	4.7	4.6	4.3	3.4	3.4
Traditional	40	44	51	54	66	78
Modern	53	62	69	71	47	49
As percentage of GDP	2.7	2.8	2.7	2.4	1.4	1.3

*Provisional

Source: Economic Survey 1985 (CBS and MoFP, 1985), Table 3.9.

for the period 1979 to 1984. The provisional 1983 estimates of GDP and GFCF in dwellings used by R&R have been replaced by the final estimates from this table.[1] The overall GDP annual growth rate projection remains the same at 4.9 percent through 1988 and 6 percent thereafter. We assumed that agricultural GDP growth would average 4 percent annually over the planning period.[2] The final base year GDP estimate was about six percent lower than that used by R&R, and this should negatively affect affordability levels in the needs estimates especially in the latter years of the planning period since income growth is compounded.

The Revised Housing Needs Estimates

The previous section documented the modifications made to the original R&R base case; this section highlights some of the key estimates of the revised base case. To facilitate comparisons with the R&R base case, a complete set of tables describing the revised needs estimates is included in Annex G. Some of these tables are referred to in this section.

The revised base case continued to use the population estimates generated by R&R. For the country as a whole, the base year annual population growth rate is about 3.9 percent. This rate is expected to decline to around 3.5 percent by the end of the century.[3] R&R assumed a continuation of intercensal trends in annual growth rates of

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1. GDP was Ksh 66,540 million in 1983; GFCF in dwellings was Ksh 2,260 million. Total public capital expenditures were Ksh 380 million. One Kenya pound equals twenty Kenya shillings.

2. R&R had assumed a 4.4 percent annual growth rate for agricultural GDP during the first 5-year planning period.

3. R&R used the CBS declining fertility/mortality scenario contained in Population Projections for Kenya 1980-2000, CBS and Ministry of Economic Planning and Development, March 1983.

metropolitan areas (about 5 percent) and other urban areas (about 7.4 percent). They projected the annual rural growth rate to decline over the 20-year period from about 3.4 percent to 2.6 percent. These figures are broadly consistent with population projections and urbanization trends developed by the World Bank.[1]

Household projections also remained identical to the R&R base case, since projected average household sizes are the same. By 1988, we expect roughly 140 thousand new households to be formed annually of which 27 percent will occupy urban areas. Because of rapid population growth and urbanization, over 100 thousand new households are expected to be formed annually by 2003 in urban areas alone. This would represent nearly half of all new households formed in Kenya. Table E-1 summarizes population and household formation estimates for the planning period.

Affordability was affected by the decrease in the cost of new urban units, the shortening of mortgage terms in urban areas, and a slight reduction in projected incomes due to the GDP revisions. The income reduction over the planning period was so small as to have a negligible effect on affordable dwelling costs. Similarly, the shortening of lending terms in urban areas had little effect on affordability.

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1. See The World Bank (1985) Tables 19 and 22. The World Bank estimates an average annual population growth of 3.9 percent during the period 1980 to 2000. Between 1983 and 2000 it expects the population to rise from around 19 million to about 36 million. It calculated the average annual growth rate of the urban population to be about 7.3 percent for the period 1965 to 1973 and 8.0 percent for the period 1973 to 1983. Table 2.2 of the UHS (CBS and MoP&ND, 1986) suggests that an almost constant share of population will reside in urban areas (around 14 to 15 percent) through the year 2000, assuming the population reaches 36 million by then. This seems implausible given the observed and anticipated trends in urbanization.

However, as can be seen in Table E-7 the new lower standards in metropolitan areas make it possible for households in the third income quintile to afford new core units (affordable level 2) half way into the planning period.[1] Previously, these households could only afford the cost of an upgrade (affordable level 1).

On the other hand, because the cost of a minimum standard unit available from the private sector (affordable level 3) increased for other urban and rural areas to Ksh 120,000, households in the highest income quartiles which previously could afford level 3 units can now only afford level 2 units. While these households do not require subsidies to afford standard housing, they become a part of the target group. That is, they are among those who cannot afford a standard unit provided by the private sector.

While the overall size of the target groups in the revised case are roughly the same size as those in the R&R study, the subsidy required to bring those within the target groups up to the minimum standard has dropped about 20 to 30 percent over the planning period. Most of this drop is attributable to the new lower standards in urban areas. Tables E-9 and E-10[2] summarize the subsidy requirements and total housing expenditures of the target group. Subsidy levels, that is, the gap between the amount households can afford to pay and the cost of a minimum standard unit, are still high in spite of the lower standards. For example, nearly Ksh 2600 million would be required annually by 1988

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1. This table can be compared to Table 10, p. 77 in Rourk and Roscoe (1984).

2. This table can be compared to Table 14, p. 54 in Rourk and Roscoe (1984).

to satisfy needs. The amount of subsidy expressed as a percent of public capital expenditures remains virtually the same as in the R&R base case (26 to 37 percent) since total public capital expenditures were revised downwards.

Total housing expenditure levels in the revised base case differ little from the original R&R study, when all of the changes are combined. The effect of lower standards in urban areas was largely offset by an increase in required production levels. A comparison of Table -4 with Table 2 in Rourk and Roscoe (1984) reveals that while new construction remains at about the same level for metropolitan and other urban areas, it increases about 16 percent in rural areas over the entire planning period. As was mentioned earlier, the biggest change in the composition of Kenya's housing stock involved the number of units of acceptable construction in rural areas. The relatively large increase in the number of acceptable rural units in the base year, in conjunction with the increase in the rural housing decay rate from 2 to 3 percent, resulted in a large increase in the number of new units required for annual planned replacement. This increase in new construction over the planning period is chiefly responsible for offsetting the gains achieved by lowering urban housing standards. As a result, housing investment as a share of GDP remains at about 10 to 11 percent over the 20-year period.

Conclusions and Recommendations

The revisions made to the original R&R base case provided us with new estimates of housing demand and required production levels for the period 1983-2003. In the revised base case, gains produced by lower standards in urban areas were largely offset by greater new construction requirement in rural areas. Overall investment levels remained about the same even though subsidy requirements fell.

A sharp increase in the prices of units available from the private sector enlarged the size of the target group somewhat. Financial institutions are simply not willing to finance "middle-income" units in the Ksh 55,000 to Ksh 120,000 range, because they view such loans as unprofitable. This middle-income group, which also is not served by government programs, poses several difficulties for the GOK. It is these households that are most likely to buy out participants in low-income housing schemes. The government has little chance of succeeding in any low-income homeownership project until this middle-income group's housing demand is satisfied. Furthermore, this segment of the target group, which comprises about a quarter to a third of the urban target group over the course of the planning period, places a burden on the government that could be relieved if the private sector could be induced to build and finance units in the Ksh 55,000 to Ksh 120,000 range. The problem described here is largely an urban phenomenon; it is less of an issue in rural areas where housing demand is supported mainly through informal measures.

The assessment of rural housing needs remains a problem with any housing needs assessment performed for Kenya. Data on rural areas is extremely poor especially with respect to income and expenditures. Although the recently initiated rural housing survey and recently completed (through still unavailable) nationwide budget survey will shed greater light on rural housing needs, other problems will remain.[1] One area that deserves special attention is the development of more affordable rural housing designs. Trying to achieve anything approaching urban standards in rural areas is an unrealistic goal given the low income levels of the rural population and the overwhelming presence of non-durable materials that characterizes most of the existing rural housing stock.[2]

All needs estimates for Kenya are extremely sensitive to changes in rural data. This, of course, is a reflection of the rural character of Kenya.[3] The importance of this sensitivity cannot be overstated. For example, if the cost of a rural dwelling unit could be cut to Ksh 10,000 as was suggested by R&R in one of their scenarios, subsidy levels could be cut by more than half for much of the planning period and the resulting share of GDP going to housing would drop to between 9 and 10 percent over this period.

While further refinements to the base case are possible now and in the future, they are not likely to alter the overall picture of Kenya's housing situation. Kenya's future housing needs are enormous no matter how they are viewed, in large part because they are demographically driven. Well over half of all new construction during the course of the planning period is needed just to accommodate new households being

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1. Not the least of which will be reporting problems such as those encountered during the execution of the 1983 Urban Housing Survey.

2. It is anticipated that the Rural Housing Improvement Programme currently being developed by the Housing Department of the MoWH&PP will contain new low-cost designs. See Housing Department, MoWH&PP (1985).

3. The rural character of Kenya is often overlooked and housing needs studies often focus on urban areas. See, for example, Ibanda (1978) and CBS and MoP&ND (1986).

formed out of the growing population. Thus, it is no surprise that while various components of needs changed, the overall picture presented in the revised base case differs little from the original R&R base case. As a result, the main conclusions of the R&R report remain valid today.

On the other hand, further updates of certain parts of the needs model could be useful for future policy analyses. In particular, as new data becomes available, refinement of rural needs estimates could complement recently initiated government efforts in rural areas such as the Rural Housing Improvement Programme. Another area deserving greater attention involves the definition of a household. The census based definition, which is used in this and other needs studies to project units required by newly-formed households, does not require a single household to occupy a single dwelling unit. That is, a household can share a unit with other households (e.g., lodgers) or it can occupy more than one dwelling unit. As more detailed analysis is performed on the UHS (and on the rural housing survey once it becomes available), it may become possible to develop an estimate of the average number of occupants per dwelling unit. Such a number would form a better basis for needs estimates.[1] Other data that should be available from the UHS, but which is currently not tabulated, includes information on overcrowding and the size of the housing stock. The latter could be generated if existing estimates were adjusted for changes in

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1. This "dwelling group" concept was applied in a housing needs assessment performed for Zimbabwe by Manson and Katsura (1985).

administrative boundaries. Currently, population projections for urban areas do not refer to the same areas covered by the UHS.

The USAID housing needs assessment methodology remains a useful device that forces planners and policymakers to think about the relationships between their policies and a variety of key economic and social indicators. It is particularly useful for investigating the impact of alternative policies especially with respect to building standards. It is also a technique that can provide insight into how Kenya's housing sector might be affected by events such as shifts in rural-to-urban migration patterns and swings in the economy. In addition, the process of implementing the methodology has contributed and can continue to contribute to a greater understanding of Kenya's housing situation. We hope that Kenyan planners and policymakers continue to make use of this methodology in developing strategies to address Kenya's housing problems.

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ANNEX E

Revised Needs Estimates

REVISED KENYA BASE CASE
POPULATION AND HOUSEHOLD FORMATION

Table E-1

	1983	1988	1993	1998	2003
Metropolitan Area					
Population (1000s)	1458.00	1857.00	2367.00	3019.00	3856.00
Annual Growth Rate %	0.00	4.96	4.97	4.99	5.02
Average Household Size	4.25	4.40	4.55	4.60	4.50
Total Households (1000s)	343.06	422.05	520.22	656.30	856.89
New Households per Year	0.00	15.80	19.63	27.22	40.12
Other Urban Areas					
Population (1000s)	1398.00	1993.00	2856.00	4059.00	5758.00
Annual Growth Rate %	0.00	7.35	7.46	7.28	7.24
Average Household Size	4.43	4.65	4.75	4.85	5.00
Total Households (1000s)	315.58	428.60	601.26	836.91	1151.60
New Households per Year	0.00	22.61	34.53	47.13	62.94
Rural Areas					
Population (1000s)	15890.00	18805.00	21985.00	25393.00	28925.00
Annual Growth Rate %	0.00	3.43	3.17	2.92	2.64
Average Household Size	5.65	5.65	5.65	5.65	5.65
Total Households (1000s)	2812.39	3328.32	3891.15	4494.34	5119.47
New Households per Year	0.00	103.19	112.57	120.64	125.03
Country					
Population (1000s)	18746.00	22655.00	27208.00	32471.00	38539.00
Annual Growth Rate	0.00	3.86	3.73	3.60	3.49
Average Household Size	5.40	5.42	5.43	5.42	5.41
Total Households (1000s)	3471.02	4178.97	5012.63	5987.55	7127.96
New Households per Year	0.00	141.59	166.73	194.98	228.08

REVISED KENYA BASE CASE
NATIONAL AND HOUSEHOLD INCOMES

Table E-2

	1983	1988	1993	1998	2003
National Income (Constant Units)					
GDP (Millions of units)	66540.00	84520.16	113107.00	151362.70	202557.[illegible]
GDP Ann. Growth Rate %	0.00	4.90	6.00	6.00	6.00
Agricultural GDP (Mill.)	21492.42	26150.54	31817.00	38703.43	47094.55
Non Agri. GDP (Mill.)	45047.58	58369.63	81290.01	112659.20	155462.8[illegible]
Metropolitan Ares					
Mean Annual Disposable Income All Households (1000s)	50.70	53.40	60.33	66.28	70.05
Annual Growth Rate of Mean Household Inomce %	0.00	1.04	2.47	1.90	1.11
Quintile Mean Incomes (1000s) 1	9.89	10.41	11.76	12.92	13.66
2	17.49	18.42	20.81	22.87	24.17
3	32.45	34.18	38.61	42.42	44.83
4	52.73	55.53	62.75	68.93	72.85
5	140.95	148.45	167.73	184.25	194.74
Other Urban Areas					
Mean Annual Disposable Income All Households (1000s)	34.50	32.91	32.68	32.53	32.63
Annual Growth Rate of Mean Household Income %	0.00	-0.94	-0.15	-0.09	0.06
Quintile Mean Incomes (1000s) 1	8.28	7.90	7.84	7.81	7.83
2	16.56	15.80	15.68	15.62	15.66
3	25.36	24.19	24.02	23.91	23.98
4	38.47	36.70	36.43	36.28	36.38
5	83.84	79.98	79.40	79.06	79.28
Rural Areas					
Mean Annual Disposable Income All Households (1000s)	16.10	16.55	17.23	18.14	19.38
Annual Growth Rate of Mean Household Income %	0.00	0.56	0.80	1.04	1.33
Quintile Mean Incomes (1000s) 1	4.02	4.14	4.31	4.54	4.85
2	8.05	8.28	8.61	9.07	9.69
3	12.08	12.41	12.92	13.61	14.54
4	17.71	18.21	18.95	19.96	21.[illegible]
5	38.64	39.73	41.34	43.54	46.51

REVISED KENYA BASE CASE
DESIGN STANDARDS AND COSTS

Table E-3

	1983	1988	1993	1998	2003
Average Inflation Rate %	0.00	12.00	12.00	12.00	12.00
Construction Cost Esc. %	0.00	12.00	12.00	12.00	12.00
Metropolitan Area					
Price Minimum Standard Formal Sector Housing (Level 3)	120.00	120.00	120.00	120.00	120.00
Design Cost New Housing Unit (Level 2)	53.64	53.64	53.64	53.64	53.64
Design Cost Upgrade Existing Unit (Level 1)	15.50	15.50	15.50	15.50	15.50
Value of an Upgradable Unit (Add. to upgrade cost)	7.00	7.00	7.00	7.00	7.00
Other Urban Areas					
Price Minimum Standard Formal Sector Housing (Level 3)	120.00	120.00	120.00	120.00	120.00
Design Cost New Housing Unit (Level 2)	53.64	53.64	53.64	53.64	53.64
Design Cost Upgrade Existing Unit (Level 1)	10.00	10.00	10.00	10.00	10.00
Value of an Upgradable Unit (Add. to upgrade cost)	5.00	5.00	5.00	5.00	5.00
Rural Areas					
Price Minimum Standard Formal Sector Housing (Level 3)	120.00	120.00	120.00	120.00	120.00
Design Cost New Housing Unit (Level 2)	26.00	26.00	26.00	26.00	26.00
Design Cost Upgrade Existing Unit (Level 1)	4.50	4.50	4.50	4.50	4.50
Value of an Upgradable Unit (Add. to upgrade cost)	2.50	2.50	2.50	2.50	2.50

REVISED KENYA BASE CASE
HOUSING STOCK AND REPLACEMENT

E-4

Table E-4

Metropolitan Area

Dwelling Units by Construction Standard

	1983	1988	1993	1998	2003
Acceptable Construction	242.79	346.84	470.08	631.24	856.89
(Annual Planned Repl.)	0.00	4.86	6.94	9.40	12.62
Non-Upgradable Construct.	16.23	12.17	8.11	4.06	0.00
(Annual Planned Repl.)	0.00	0.81	0.81	0.81	0.81
Upgradable Construction	35.99	26.99	18.00	9.00	0.00
(Planned Ann. Upgrading)	0.00	1.80	1.80	1.80	1.80
Total Dwelling Units	295.00	386.00	496.19	644.29	856.89
Total Overcrowded Units	48.06	36.04	24.03	12.01	0.00
Planned Annual Construction to Relieve Overcrowding	0.00	2.40	2.40	2.40	2.40
New Households/Year	0.00	15.80	19.63	27.22	40.12
Construction New Units/Yr	0.00	23.87	29.79	39.63	55.96
Total Construction/Year	0.00	25.67	31.59	41.63	57.76

Other Urban Areas

Dwelling Units by Construction Standard

	1983	1988	1993	1998	2003
Acceptable Construction	174.71	322.95	530.83	801.69	1151.60
(Annual Planned Repl.)	0.00	3.49	6.46	10.62	16.03
Non-Upgradable Construct.	49.88	37.41	24.94	12.47	0.00
(Annual Planned Repl.)	0.00	2.49	2.49	2.49	2.49
Upgradable Construction	60.42	45.32	30.21	15.11	0.00
(Planned Ann. Upgrading)	0.00	3.02	3.02	3.02	3.02
Total Dwelling Units	285.00	405.67	585.98	829.27	1151.60
Total Overcrowded Units	30.58	22.93	15.29	7.64	0.00
Planned Annual Construction to Relieve Overcrowding	0.00	1.53	1.53	1.53	1.53
New Households/Year	0.00	22.61	34.53	47.13	62.94
Construction New Units/Yr	0.00	30.12	45.01	61.77	83.00
Total Construction/Year	0.00	33.14	48.03	64.79	86.02

REVISED KENYA BASE CASE
HOUSING STOCK AND REPLACEMENT (CONTINUED)

Rural Areas

Dwelling Units by Construction Standard

Acceptable Construction	1340.00	2224.03	3154.96	4126.24	5119.47
(Annual Planned Repl.)	0.00	40.20	66.72	94.65	123.73
Non-Upgradable Construct.	101.84	76.38	50.92	25.46	0.00
(Annual Planned Repl.)	0.00	5.09	5.09	5.09	5.09
Upgradable Construction	1238.16	928.62	619.08	309.54	-0.00
(Planned Ann. Upgrading)	0.00	61.91	61.91	61.91	61.91
Total Dwelling Units	2680.00	3229.03	3824.96	4461.24	5119.47
Total Overcrowded Units	132.39	99.29	66.19	33.10	0.00
Planned Annual Construction to Relieve Overcrowding	0.00	6.62	6.62	6.62	6.62
New Households/Year	0.00	103.19	112.57	120.64	125.07
Construction New Units/Yr	0.00	155.10	191.00	227.00	260.57
Total Construction/Year	0.00	217.01	252.91	288.91	322.47

TOTAL COUNTRY

New Construction/Year	0.00	209.09	265.80	328.60	399.48
Total Construction/Year	0.00	275.82	332.53	395.33	466.20

REVISED ... BASE CASE
AFFORDABLE CAPITAL COSTS

Table E-5

Metropolitan Area

Interest Rate (%)	16.00
Loan Term (Years)	20.00
Downpayment Required (%)	10.00

Thousands of Currency Units	1983	1988	1993	1998	2003
Quintile 1					
Mean Annual Income	9.89	10.41	11.76	12.92	13.66
% Available for Housing	25.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	0.18	0.18	0.21	0.23	0.24
Affordable Dwelling Cost	13.98	14.73	16.64	18.28	19.32
Quintile 2					
Mean Annual Income	17.49	18.42	20.81	22.87	24.17
% Available for Housing	25.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	0.31	0.33	0.37	0.40	0.43
Affordable Dwelling Cost	24.74	26.05	29.44	32.34	34.18
Quintile 3					
Mean Annual Income	32.45	34.18	38.61	42.42	44.83
% Available for Housing	25.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	0.57	0.61	0.68	0.75	0.79
Affordable Dwelling Cost	45.89	48.33	54.61	59.99	63.40
Quintile 4					
Mean Annual Income	52.73	55.53	62.75	68.93	72.85
% Available for Housing	25.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	0.93	0.98	1.11	1.22	1.29
Affordable Dwelling Cost	74.57	78.54	88.74	97.48	103.03
Quintile 5					
Mean Annual Income	140.95	148.45	167.73	184.25	194.74
% Available for Housing	20.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	2.00	2.10	2.38	2.61	2.76
Affordable Dwelling Cost	159.47	167.96	189.77	208.46	220.33

REVISED GROWTH BASE CASE
AFFORDABLE CAPITAL COSTS

Other Urban Areas

Interest Rate (%)	16.00
Loan Term (years)	20.00
Downpayment Required (%)	10.00

Thousands of Currency Units	1983	1988	1993	1998	2003
Quintile 1					
Mean Annual Income	8.28	7.90	7.84	7.81	7.83
% Available for Housing	25.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	0.15	0.14	0.14	0.14	0.14
Affordable Dwelling Cost	11.71	11.17	11.09	11.04	11.07
Quintile 2					
Mean Annual Income	16.56	15.80	15.68	15.62	15.66
% Available for Housing	25.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	0.29	0.28	0.28	0.28	0.28
Affordable Dwelling Cost	23.42	22.34	22.18	22.09	22.15
Quintile 3					
Mean Annual Income	25.36	24.19	24.02	23.91	23.98
% Available for Housing	25.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	0.45	0.43	0.43	0.42	0.42
Affordable Dwelling Cost	35.86	34.21	33.97	33.82	33.91
Quintile 4					
Mean Annual Income	38.47	36.70	36.43	36.28	36.38
% Available for Housing	25.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	0.68	0.65	0.65	0.64	0.64
Affordable Dwelling Cost	54.40	51.90	51.53	51.30	51.45
Quintile 5					
Mean Annual Income	83.84	79.98	79.40	79.06	79.28
% Available for Housing	20.00				
% Needed for Recurr. Exp.	15.00				
Monthly Income for Mortg.	1.19	1.13	1.12	1.12	1.12
Affordable Dwelling Cost	94.85	90.49	89.84	89.45	89.70

REVISED TENTH BASE CASE
AFFORDABLE CAPITAL COSTS

Rural Areas

Interest Rate (%)	16.00
Loan Term (Years)	20.00
Downpayment Required (%)	10.00

Thousands of Currency Units	1983	1988	1993	1998	2003
Quintile 1					
Mean Annual Income	4.02	4.14	4.31	4.54	4.85
% Available for Housing	20.00				
% Needed for Recurr. Exp.	10.00				
Monthly Income for Mortg.	0.06	0.06	0.06	0.07	0.07
Affordable Dwelling Cost	4.82	4.96	5.16	5.43	5.80
Quintile 2					
Mean Annual Income	8.05	8.28	8.61	9.07	9.69
% Available for Housing	20.00				
% Needed for Recurr. Exp.	10.00				
Monthly Income for Mortg.	0.12	0.12	0.13	0.14	0.15
Affordable Dwelling Cost	9.64	9.91	10.32	10.87	11.61
Quintile 3					
Mean Annual Income	12.08	12.41	12.92	13.61	14.54
% Available for Housing	20.00				
% Needed for Recurr. Exp.	10.00				
Monthly Income for Mortg.	0.18	0.19	0.19	0.20	0.22
Affordable Dwelling Cost	14.47	14.87	15.48	16.30	17.41
Quintile 4					
Mean Annual Income	17.71	18.21	18.95	19.96	21.32
% Available for Housing	20.00				
% Needed for Recurr. Exp.	10.00				
Monthly Income for Mortg.	0.27	0.27	0.28	0.30	0.32
Affordable Dwelling Cost	21.22	21.81	22.70	23.91	25.54
Quintile 5					
Mean Annual Income	38.64	39.73	41.34	43.54	46.51
% Available for Housing	20.00				
% Needed for Recurr. Exp.	10.00				
Monthly Income for Mortg.	0.58	0.60	0.62	0.65	0.70
Affordable Dwelling Cost	46.29	47.59	49.53	52.16	55.72

REVISED KENYA BASE CASE
AFFORDABLE COSTS BY INCOME CLASS AND REGION

Table E-6

(Thousands of Currency Units)

Metropolitan Area

Affordable Costs by Quintile

	1983	1988	1993	1998	2003
1	13.98	14.73	16.64	18.28	19.[illegible]
2	24.74	26.05	29.44	32.34	34.1[illegible]
3	45.89	48.33	54.61	59.99	63.[illegible]
4	74.57	78.54	88.74	97.48	103.0[illegible]
5	159.47	167.96	189.77	208.46	220.[illegible]

Other Urban Areas

Affordable Costs by Quintile

	1983	1988	1993	1998	2003
1	11.71	11.17	11.09	11.04	11.0[illegible]
2	23.42	22.34	22.18	22.09	22.15
3	35.86	34.21	33.97	33.82	33.9[illegible]
4	54.40	51.90	51.53	51.30	51.45
5	94.85	90.49	89.84	89.45	89.7[illegible]

Rural Areas

Affordable Costs by Quintile

	1983	1988	1993	1998	2003
1	4.82	4.96	5.16	5.43	5.8[illegible]
2	9.64	9.91	10.32	10.87	11.6[illegible]
3	14.47	14.87	15.48	16.30	17.4[illegible]
4	21.22	21.81	22.70	23.91	25.54
5	46.29	47.59	49.53	52.16	55.72

REVISED KENYA BASE CASE
QUINTILE DESIGN COSTS CLASSIFICATION

Table E-7

	1983	1988	1993	1998	2003
Metropolitan Area					
Quintile 1					
Affordable Costs	13.98	14.73	16.64	18.28	19.32
Affordable Level	0.00	0.00	0.00	0.00	0.00
Design Cost	0.00	0.00	0.00	0.00	0.00
Quintile 2					
Affordable Costs	24.74	26.05	29.44	32.34	34.18
Affordable Level	1.00	1.00	1.00	1.00	1.00
Design Cost	15.50	15.50	15.50	15.50	15.50
Quintile 3					
Affordable Costs	45.89	48.33	54.61	59.99	63.40
Affordable Level	1.00	1.00	2.00	2.00	2.00
Design Cost	15.50	15.50	53.64	53.64	53.64
Quintile 4					
Affordable Costs	74.57	78.54	88.74	97.48	103.03
Affordable Level	2.00	2.00	2.00	2.00	2.00
Design Cost	53.64	53.64	53.64	53.64	53.64
Quintile 5					
Affordable Costs	159.47	167.96	189.77	208.46	220.33
Affordable Level	3.00	3.00	3.00	3.00	3.00
Design Cost	120.00	120.00	120.00	120.00	120.00

REVISED (ENVM BASE CASE
QUINTILE DESIGN COSTS CLASSIFICATION (CONTINUED)

Other Urban Areas
Quintiles

Quintile 1					
Affordable Cost	11.71	11.17	11.09	11.04	11.07
Affordable Level	0.00	0.00	0.00	0.00	0.00
Design Cost	0.00	0.00	0.00	0.00	0.00
Quintile 2					
Affordable Cost	23.42	22.34	22.18	22.09	22.15
Affordable Level	1.00	1.00	1.00	1.00	1.00
Design Cost	10.00	10.00	10.00	10.00	10.00
Quintile 3					
Affordable Cost	35.86	34.21	33.97	33.82	33.91
Affordable Level	1.00	1.00	1.00	1.00	1.00
Design Cost	10.00	10.00	10.00	10.00	10.00
Quintile 4					
Affordable Cost	54.40	51.90	51.53	51.30	51.45
Affordable Level	2.00	1.00	1.00	1.00	1.00
Design Cost	53.64	10.00	10.00	10.00	10.00
Quintile 5					
Affordable Cost	94.85	90.49	89.84	89.45	89.70
Affordable Level	2.00	2.00	2.00	2.00	2.00
Design Cost	53.64	53.64	53.64	53.64	53.64

REVISED KENYA BASE CASE
QUINTILE DESIGN COSTS CLASSIFICATION (CONTINUED)

Rural Areas
Quintiles

Quintile 1					
Affordable Costs	4.82	4.96	5.16	5.43	5.80
Affordable Level	0.00	0.00	0.00	0.00	0.00
Design Cost	0.00	0.00	0.00	0.00	0.00
Quintile 2					
Affordable Costs	9.64	9.91	10.32	10.87	11.01
Affordable Level	1.00	1.00	1.00	1.00	1.00
Design Cost	4.50	4.50	4.50	4.50	4.50
Quintile 3					
Affordable Costs	14.47	14.87	15.48	16.30	17.41
Affordable Level	1.00	1.00	1.00	1.00	1.00
Design Cost	4.50	4.50	4.50	4.50	4.50
Quintile 4					
Affordable Costs	21.22	21.81	22.70	23.91	25.54
Affordable Level	1.00	1.00	1.00	1.00	1.00
Design Cost	4.50	4.50	4.50	4.50	4.50
Quintile 5					
Affordable Costs	46.29	47.59	49.53	52.16	55.72
Affordable Level	2.00	2.00	2.00	2.00	2.00
Design Cost	26.00	26.00	26.00	26.00	26.00

REVISED KENYA BASE CASE
TARGET GROUP IDENTIFICATION

Table G-8

Thousands of Households	1983	1988	1993	1998	2003
Metropolitan Area					
Affordable Level 0	0.00	5.38	6.57	8.58	11.80
Affordable Level 1	0.00	10.77	6.57	8.58	11.80
Affordable Level 2	0.00	5.38	13.14	17.15	23.60
Subtotal, Target Group	0.00	21.54	26.27	34.31	47.21
Affordable Level 3	0.00	4.13	5.31	7.32	10.55
Total	0.00	25.67	31.59	41.63	57.75
Other Urban Areas					
Affordable Level 0	0.00	6.63	9.61	12.96	17.20
Affordable Level 1	0.00	19.89	28.82	38.87	51.61
Affordable Level 2	0.00	6.63	9.61	12.96	17.20
Subtotal, Target Group	0.00	33.14	48.03	64.79	86.02
Affordable Level 3	0.00	0.00	0.00	0.00	0.00
Total	0.00	33.14	48.03	64.79	86.02
Rural Areas					
Affordable Level 0	0.00	43.40	50.58	57.78	64.49
Affordable Level 1	0.00	130.20	151.74	173.34	193.46
Affordable Level 2	0.00	43.40	50.58	57.78	64.49
Subtotal, Target Group	0.00	217.01	252.91	288.91	322.43
Affordable Level 3	0.00	0.00	0.00	0.00	0.00
Total	0.00	217.00	252.90	288.90	322.43

REVISED KENYA BASE CASE
TARGET GROUP INVESTMENT AND SUBSIDY REQUIREMENTS

Table E-9

	1983	1988	1993	1998	2003
Country					
Target Households (1000s)					
Not Requiring Subsidy	0.00	95.27	112.73	127.30	144.70
Requiring Subsidy	0.00	176.41	214.48	260.70	310.95
Total	0.00	271.68	327.21	388.00	455.66
Target Group Cost (Millions)					
Subsidy Portion	0.00	2583.91	3187.64	3829.82	4495.53
Supported by Target Group	0.00	4459.49	5841.87	7465.36	9501.69
Total	0.00	7043.40	9029.51	11295.18	13997.22
Metropolitan Area					
Target Households (1000s)					
Not Requiring Subsidy	0.00	6.28	13.59	17.60	24.05
Requiring Subsidy	0.00	15.25	12.69	16.70	23.15
Total	0.00	21.54	26.27	34.31	47.21
Target Group Cost (Millions)					
Subsidy Portion	0.00	357.74	377.03	462.36	611.88
Supported by Target Group	0.00	728.73	963.40	1309.16	1851.45
Total	0.00	1086.47	1340.43	1771.52	2463.33
Other Urban Areas					
Target Households (1000s)					
Not Requiring Subsidy	0.00	8.44	11.42	14.77	19.02
Requiring Subsidy	0.00	24.70	36.61	50.02	67.00
Total	0.00	33.14	48.03	64.79	86.02
Target Group Cost (Millions)					
Subsidy Portion	0.00	574.09	864.63	1191.94	1595.13
Supported by Target Group	0.00	1071.72	1579.90	2151.20	2886.53
Total	0.00	1645.81	2444.53	3343.14	4481.66
Rural Areas					
Target Households (1000s)					
Not Requiring Subsidy	0.00	80.55	87.73	94.93	101.63
Requiring Subsidy	0.00	136.46	165.18	193.98	220.80
Total	0.00	217.01	252.91	288.91	322.43
Target Group Cost (Millions)					
Subsidy Portion	0.00	1652.08	1945.98	2175.52	2286.52
Supported by Target Group	0.00	2659.04	3298.57	4005.00	4765.72
Total	0.00	4311.12	5244.55	6180.51	7052.24

REVISED KENYA BASE CASE
HOUSING INVESTMENT IN RELATION TO GDP

Table E-10

	1983	1988	1993	1998	2003
(Millions of Currency Units)					
Country					
Total Housing Expend.	13524.02	16879.65	21762.63	28116.11	36404.19
Non-target Group Invest.	0.00	693.76	1008.48	1526.73	2324.09
Target Group Investment	0.00	6416.07	8284.69	10572.61	13482.09
Subsidy Required	0.00	2583.91	3187.64	3829.82	4495.53
Total Housing Investment	0.00	9693.73	12480.81	15929.16	20301.71
Metropolitan Area					
Total Housing Expend.	3285.03	4256.52	5927.96	8215.51	11336.90
Non-target Group Invest.	0.00	693.76	1008.48	1526.73	2324.09
Target Group Investment	0.00	890.05	1231.49	1772.19	2582.95
Subsidy Required	0.00	357.74	377.03	462.36	611.88
Total Housing Investment	0.00	1941.55	2616.99	3761.27	5518.93
Other Urban Areas					
Total Housing Expend.	2088.69	2706.38	3769.11	5223.58	7208.22
Non-target Group Invest.	0.00	0.00	0.00	0.00	0.00
Target Group Investment	0.00	1377.71	1988.89	2676.17	3568.09
Subsidy Required	0.00	574.09	864.63	1191.94	1595.13
Total Housing Investment	0.00	1951.80	2853.52	3868.11	5163.22
Rural Areas					
Total Housing Expend.	8150.30	9916.74	12065.56	14677.02	17859.08
Non-target Group Invest.	0.00	0.00	0.00	0.00	0.00
Target Group Investment	0.00	4148.31	5064.32	6124.26	7331.04
Subsidy Required	0.00	1652.08	1945.98	2175.52	2288.52
Total Housing Investment	0.00	5800.39	7010.30	8299.78	9619.56
Total Housing Investment in the Base Year	2260.00				
Subsidy as a Percent of Public Expenditures	0.00	37.12	34.22	30.72	26.95
Total Housing Investment as a Percent of GDP	3.40	11.47	11.03	10.52	10.02

REVISED KENYA BASE CASE
COMPONENTS OF TARGET GROUP HOUSING COST

Table E-11

	1983	1988	1993	1998	2003
(Millions of Currency Units)					
Country					
Cost of Upgrading Existing Units	0.00	336.69	336.69	336.69	336.69
of which:					
Infrastructure component	0.00	327.02	327.02	327.02	327.02
Construction component	0.00	9.67	9.67	9.67	9.67
Cost of New Housing Unit	0.00	6706.71	8692.82	10958.49	13660.54
of which:					
Land component	0.00	683.40	906.65	1171.62	1507.19
Infrastructure component	0.00	2106.25	2719.56	3414.04	4232.50
Construction component	0.00	3917.06	5066.62	6372.83	7920.85
Target Group Housing Cost	0.00	7043.40	9029.51	11295.18	13997.23
Metropolitan Area					
Cost of Upgrading Existing Units	0.00	27.89	27.89	27.89	27.89
of which:					
Infrastructure component	0.00	24.27	24.27	24.27	24.27
Construction component	0.00	3.63	3.63	3.63	3.63
Cost of New Housing Unit	0.00	1059.58	1312.53	1743.63	2435.43
of which:					
Land component	0.00	158.79	196.88	261.54	365.32
Infrastructure component	0.00	306.99	380.63	505.65	706.28
Construction component	0.00	592.80	735.02	976.43	1363.84
Target Group Housing Cost	0.00	1086.47	1340.43	1771.52	2463.33

REVISED KENYA BASE CASE
COMPONENTS OF TARGET GROUP HOUSING COST (CONTINUED)

Other Urban Areas

Cost of Upgrading Existing Units	0.00	30.21	30.21	30.21	30.21
of which:					
Infrastructure component	0.00	24.17	24.17	24.17	24.17
Construction component	0.00	6.04	6.04	6.04	6.04
Cost of New Housing Unit	0.00	1615.60	2414.32	3312.93	4451.45
of which:					
Land component	0.00	242.34	362.15	496.94	667.72
Infrastructure component	0.00	468.52	700.15	960.75	1290.92
Construction component	0.00	904.74	1352.02	1855.24	2492.81
Target Group Housing Cost	0.00	1645.81	2444.53	3343.14	4481.66

Rural Areas

Cost of Upgrading Existing Units	0.00	278.59	278.59	278.59	278.59
of which:					
Infrastructure component	0.00	278.59	278.59	278.59	278.59
Construction component	0.00	0.00	0.00	0.00	0.00
Cost of New Housing Unit	0.00	4032.53	4965.97	5901.93	6773.66
of which:					
Land component	0.00	282.28	347.62	413.14	474.16
Infrastructure component	0.00	1330.74	1638.77	1947.64	2235.31
Construction component	0.00	2419.52	2979.58	3541.16	4064.19
Target Group Housing Cost	0.00	4311.12	5244.55	6180.51	7052.24

NAIROBI HOUSING PROGRAMS

A brief description of HDD-developed and administered projects, including financing source, are as follows:

IBRD -	Dandora - 6000 serviced plots with wet cores and associated building material loans. Phases 1 & 2 nearing completion and occupancy.
IBRD -	Kayole - 6000 serviced plots now being allocated.
IBRD -	Mathare North - 1500 serviced plots which have been allocated with construction of units through building material loans underway.
AID-HG -	Umoja I-3000 units completed and occupied
AID-HG -	Umoja II-4306 units
EEC -	Huruma-890 units

The HDD has several divisions which are responsible for technical design, supervision of infrastructure construction, assistance to beneficiaries in self-help construction and extending building material loans, allocation and settlement of plots and administration and collection of all loans.

All of the projects listed above are externally financed. In the case of the World Bank the terms are set by the Bank. For the Dandora project listed above the World Bank loan is made at 8 1/2% to the government. The Bank loan doesn't cover all of the cost of the project and the government finances the difference through the Ministry of Local Government.

The City gets World Bank money at 8% and Ministry of Local Government money at 6 1/2%. When blended it is about 8%. The HDD lends to beneficiaries at 8 1/2%. For those earning between KShs. 280 - 450 the repayment period is 30 years, for those between KShs. 450 - 600 it is 20 years.

In the case of the AID Housing Guaranty covering Umoja I, the City borrowed directly from the US lender in 1977 at a time when KShs. 7+ = $1. The interest rate was 8.7%. Because the KShs. rate is now 16 = $1, the City has increased the interest rate to beneficiaries (or those now owning the houses) to 19%. Houses originally sold in the neighborhood of KShs. 35,000 but it was reported that they would now sell for maybe KShs. 150,000.

Plots for HDD projects are leasehold from the City for 99 years. They are sub-leased to beneficiaries for the same term less 3 days. The individual will take the house as a tenant purchaser.

HDD is planning to start a Housing Development Fund when external financing runs out. The means to raise funds has not yet been determined. One possibility includes a surcharge on the house price, say 10% over cost. The City does not feel that it can borrow commercially; it's too expensive. It is again trying to be included in the World Bank's Fourth Urban Project which is aimed at areas outside of Nairobi.

There are 30% arrearages in Dandora, the first site and service project to be completed. Since these are low income families it is difficult to evict. With a concerted program it is felt that HDD could get arrearages down to 10-15%. When HDD took over the Umoja I project delinquencies were 50% but

NEW BANK LEGISLATION

Annex G

PART I - PRELIMINARY

Section 2 is amended to provide a definition of a "representative office".

PART II - LICENSING

Section 4 amended to broaden the powers of the Minister in granting licenses.

Section 5 (1) amended to provide that application for licensing are routed to the Minister through the Central Bank.

Section 5 (1) (a) an addition to the Act requiring that a license be activated within one year of approval.

Section 5 (A) replaces Section 5 (3) and puts licensing fees under a "schedule" authorized by the Act.

Section 6 (b) amended to broaden the powers of the Minister to revoke a license.

Section 7 (a) amended to increase from 5% to 7½% the ratio requirement between capital/reserves and deposits.

Also amended to increase minimum capital for a bank from £500,000 to Kshs.15 million. Section 7 (1) (b) amended to increase capital requirement of foreign banks to Kshs.150 million with a minimum of Kshs.30 million assigned to Kenyan branch.

Section 7 (2) (a) amended to require NBFI's to have capital of Kshs.7.5 million and requires that capital/reserves must equal 7½% of deposits.

Section 7 (2) (b) foreign controlled NBFI's must have minimum capital of Kshs.75 million with minimum Kshs.15 million assigned to Kenya.

Section 7 A (1) new: allows authorities to prescribe ratios to be maintained between capital and loans.

Section 7 A (2) new: failure to comply with 7 A (1) attracts a fine up to Kshs.50,000/=.

Section 7 B (1) new: the imposition of an additional reserve fund computed as:

(a) 12½% of net profit as long as the reserve fund is less than the capital.

(b) 10% when the reserve fund is equal to or higher than the capital.

Section 7 B (2) new: reserve fund must be invested in approved securities.

Section 8 (1) amended to include CBK in the approval process for the siting of banks.

PART III - PROHIBITED BUSINESS

Section 10 (1) (d) new: explains the language concerning loans to directors.

Section 10 (2) new: deals with loan restrictions regarding people or groups capable of influencing credit decisions.

Section 10 (4) new: holds directors jointly liable for unsecured/ partially secured loans made to directors.

Section 10 (5) sets potential Kshs.100,000 fine for violations of Section 10.

Section 11 (a) new: expands language on restriction of investments in other companies by banks and NBFI's. Provides that this may be exceeded for satisfying debt or taking equity in corporations established for development purposes.

Also restricts purchase of immovable property to that which is necessary for the operation of the financial institution. If you are in violation when this Act becomes Law you must advise CBK within 90 days and must come into compliance within 12 months.

Section 11 (b) new: a financial institution may not own shares of a bank.

Section 12 is amended to include financial institutions in the existing restrictions concerning the limitation on real estate loans. i.e. maximum 25% of deposits.

PART IV - DIVIDENDS & ACCOUNTS

Section 14 expands language on bad debts - must be done before declaring profit. Must be an adquate (?) provision. Also defines bonus shares as being the same as the payment of a dividend.

Section 15 amended to give CBK further powers regarding reporting requirements.

PART VII - AUDIT

Section 21 (5) expanded to hold auditors accountable for compliance with CBK regulations.

PART VII A:

This is a new Section dealing with the establishment of a Deposit Protection Fund administered by a Board chaired by the Central Bank Governor. The Minister sets the level of the Fund. The Board determines the annual contribution which shall not be less than Kshs.100,000 nor more that .4% of the average deposits per annum. The contribution must be paid within 21 days failure to do so attracts a penalty of 1% per day. If an institution is behaving in a detremential fashion the Board may increase it's individual contribution beyond the maximum set or may terminate the protection coverage.

The Minister determines and gazettes the extent of coverage per customer. Any payments made give the Fund a prior lien over other creditors in a liquidation. The Board is empowered to rescue an insolvent bank. i.e. it can lend, place deposits, guarantee, or purchase assets.

PART VII B NEW:

Expands the powers in controlling foreign owned representative offices.

Section 27 new: The Central Bank is empowered to restrict the activities of a person who is an officer of more than one bank.

This new legislation has as it's objective the establishment of an orderly and controlled banking environment in an attempt to prevent a reoccurance of the market upheaves occassioned by the demise of Rural & Urban Credit Finance Company in December 1984.

The Ministry of Finance is the licensing approval agency while the Central Bank plays a monitoring role. Heretofore; the Central Bank could audit, observe and comment on any given bank's behaviour but has had no real power to enforce compliance with accepted finance procedures.

The new legislation sets out to correct this anomoly. It does so by firstly including Central Bank of Kenya in licensing approval procedure. It also allows for the imposition of fines for certain basic violations. But, the broadest powers are vested in a new body to be known as the Deposit Protection Fund Board. It will be chaired by the Governor of the Central Bank and any institution seen to be operating in a manner detrimental to the depositors can find itself subject to intervention by the fund.

Other aspects of this legislation are designed to address recognized weaknesses known to exist in the present system. Namely they are:-

1. To correct excessive leverage, the capital and unimpaired reserves must equal at least 7½% of the total deposit liabilities Since the greatest percentage of the financial institutions probably exceed this ratio they have two courses of action. One is an additional injection of capital, the other is to reduce the level of deposits. One will probably see a combination of these actions with the injection of capital mandatory in some cases because the law also raises the minimum capital requirement from Kshs.5 million to Kshs.7.5 million in repsect of NBFIs. Banks must increase capital from Kshs.10 million to Kshs.15 million.

   One would expect this to impact on the market in two ways. Firstly, many financial institutions will reduce the level of new loan applications so that loan repayments exceed new loans in an amount sufficient to reduce deposits levels.

This is going to produce a credit squeeze of an unknown magnitude, but certainly strong enough to impinge on the growth and development of the private sector.

The deposit decline should take some of the heat out of the current market, lower interest rates on deposits being the end result.

2. The legislation also imposes an additional Reserve Fund. These monies will be domiciled in the capital account thereby contributing to the 7½% capital to deposit ratio. But, they cannot be withdrawn as part of the dividend stream and they must be invested in "approved securities". (Probably Treasury Bills). These accounts will be allowed to build up over time by an annual extraction from profit; 12½% of profit until the Reserve Fund equals the capital and 10% of annual profit thereafter. This in essence is designed to create an additional hidden reserve as a buffer against excessive loan losses. If these funds can be applied against the existing 24% reserve requirement there will be no impact on the earnings of the financial institutions. If not, then the difference between the interest on the "approved securities" and that which could accrue from lending the money, will become a reduction in revenue. But, mainly it prevents shareholders from removing dividends disproportionate to the earnings thereby impinging on the natural growth of the capital account.

3. A new section has been created concerning "Prohibited Business". This addresses the issue of shareholders making loans to themselves ala Rural & Urban. It carries the concept even further by restricting borrowing by people who might not be Shareholders/Directors but who are seen to be capable of influencing credit decisions. The most meaningful aspect of this section however, is Section 10 (4) i.e. all directors can be held personally liable for any unsecured or partially secured loans made to any of the directors.

4. Part IV of the Act deals with the dividends and the accounting procedures. Bad and doubtful loans must be provisioned for before profits are declared. Bonus Shares are defined as a form of dividend. Of interest to the auditing firms is the fact that they are now to be held accountable to ensure compliance with the CBK regulations.

5. The aforementioned Deposit Protection Fund is found in Part VII of the Act. It establishes an administrative board and they determine the level of contribution from each financial institution within a range from kshs.100,000/= to an amount not to exceed .4% of the average deposits. This replicates the Federal Deposit Insurance Corporation scheme in the U.S. The local board is empowered to call for additional contributions when an institution is seen to be misbehaving or they can terminate the converage. If the Fund does step in to pay depositors they automatically have a prior lien over other creditors in a liquidation. The board is also empowered to rescue a financial institution with liquidity problems by lending to it, placing deposits with it, or by guaranteeing loans from other entities. The board can even purchase the assets. Broad powers indeed by a very stabilizing aspects of great importance in a market as small as that of Kenya.

SUMMARY

Good legislation in the long run with enough powers vested in GOK to make compliance a must. Abuse of such power cannot be ruled out. However, the post independence track record of the GOK would suggest that this is only a very remote possibility.

Those institutions that cannot come into compliance and still sustain profitability may well be absorbed by strong institutions

Deposits rates should soften increasing gross yields, a more healthy situation than having large placers of money dictating rates.

Loan growth will contract for the near term to the detriment of the economy. But the increased use of Treasury Bills as an investment vehicle should act positively on the GOK's requirements.

As for AID, there are some opportunities in this type of scenario. For example, the establishment of a secondary money market could be more attractive. But the greatest benefit by far for Kenya would be to get the Rural Private Enterprise Project activated. To the banks the proceeds are loan funds, not deposit funds. This eliminates any concern for maintaining a 7½% capital to deposit ratio. These funds would also be employed at a time when the financial institutions are not capable of acquiring deposits as a source of loan expansion.

W.K. WOOD
PRIVATE SECTOR ADVISOR

PRINCIPAL INTEREST RATES, 1979-1984

	31st December				
	1979	1980	1981	1982	1983.84
CENTRAL BANK OF KENYA					
Discount Rate for Treasury Bills	4.60	6.03	13.03	13.35	15.12
Advances against Treasury Bills	7.50	8.00	14.50	13.43	14.50
Bills and Notes under Crop Finance Scheme:					
Discounts	7.00	8.50	14.60	13.75	13.75
Advances	6.00	8.00	15.00	14.00	15.00
Other Bills and Notes:					
Discounts	7.50	8.50	14.50	14.50	14.00
Advances	7.50	8.00	15.00	15.00	15.00
KENYA COMMERCIAL BANKS					
Time Deposits:					
Minimum 30 days (7 days notice)	6.13	(b)	(b)		
12 months (KShs250,000-1,000,000)	5.875	6.50	8.875		
Savings Deposits	5.00	6.00	8.00 (b)	12.50	12.50
Loans and Advances (Maximum) /a	10.00	11.00	14.00	16.00	15.00
OTHER FINANCIAL INSTITUTIONS					
Kenya Post Office Savings Bank Deposit	5.00	6.00	11.00	11.00	11.00
Agricultural Finance Corporation, Loans	9.00	9.00	12.00	12.00	12.00
(a) Land Purchase	-	9.00	14.00	16.00	14.00
(b) Seasonal Crop Loan	-	11.00	14.00	14.00	14.00
(c) Other	9.00/c	10.00	13.00	13.00	13.00
Hire-Purchase Companies and Merchant Banks:					
Deposits (time)	5.00- 8.00	8.00-11.00	14.00-16.50	13.25-16.25	14.00-16.50
Loans /d	10.00-12.00	10.00-14.00	Up to 20.00	16.00	20.00
Buildings Societies:					
Deposits	6.00- 8.50	6.00- 9.50	15.10-15.50	15.25	15.00-15.50
Loans	8.00-12.00	11.00-16.00	16.00	16.00	16.00

Source: Central Bank of Kenya.

/a Loans and advances for less than three years.
/b Subject to negotiation.
/c Early 1982, 10%.
/d Until 1983 chargeable at "flat" rate effectively doubling the nominal rate.

Kenya: Commercial Banks' Liquidity, 1979-83

(In millions of Kenya shillings)

	1979		1980		1981		1982		1983			
	June	Dec.	June	Dec.	June	Dec.	June	Dec.	March	June	Sept.	Dec.
Deposit liabilities subject to requirements	14,463	12,542	12,845	12,104	13,440	13,723	14,464	16,520	16,123	15,884	16,883	16,804
Liquid assets	2,740	2,938	2,358	2,205	2,598	2,760	2,498	4,271	3,517	3,441	3,886	3,408
Of which: cash and deposits at Central Bank of Kenya	(948)	(1,184)	(888)	(1,204)	(907)	(985)	(1,035)	(1,832)	(857)	(941)	(1,094)	(1,302)
	(In percent)											
Liquid assets	24	23	18	18	19	20	17	26	22	2[illegible]	23	20
Minimum statutory requirement	18	16	16	16	15	15	15	15	20	20	20	20
Excess	6	7	2	2	4	5	2	11	2	2	3	--
Cash ratio	7	9	7	10	7	7	7	11	5	6	6	8

Source: Central Bank of Kenya.

GOVERNMENT SECURITIES
(Nominal values in Kshs millions)

	1980 June	1981 June	1982 June	1982 Dec.	1983 June	1983 Dec.	1984 May	%
A. Government Stock Holders:								
Public Bodies								
N.S.S.F.	3,651.08	4,292.19	5,015.50	5,003.50	5,373.42	5,473.42	5,456.18	28.4
Central Government	538.20	699.93	803.31	786.43	844.36	891.45	936.72	4.9
Local Government	11.43	10.93	11.24	11.24	11.24	10.37	10.37	0.1
Post Office Savings Bank	350.38	415.94	321.31	303.31	303.31	303.31	303.31	1.6
Former E.A. Community Bodies	223.61	359.22	608.08	570.38	570.38	570.38	570.38	3.0
Central Bank	847.16	847.16	847.16	490.92	5,235.53	5,232.93	5,232.93	27.2
Other	196.84	196.84	55.82	30.93	23.73	23.78	22.79	0.2
Sub-Total	5,818.70	6,822.21	7,662.22	7,196.91	12,367.72	12,510.84	12,536.81	65.3
Private Bodies								
Commercial Banks	639.08	627.34	616.77	224.95	267.68	262.68	247.48	1.3
Insurance Companies	270.16	276.45	275.44	250.87	245.97	230.27	225.37	1.2
Other Companies	208.62	332.72	329.81	337.40	337.40	318.82	356.36	1.9
Private Individuals	5.72	6.13	2.80	2.50	2.44	2.02	2.22	-
Sub-Total	1,123.58	1,242.64	1,224.62	825.72	833.29	813.59	832.43	4.4
Total Stocks	6,942.30	8,064.85	8,886.84	8,032.63	13,201.01	13,324.63	13,369.24	69.[illegible]
B. Treasury Bills Holding	1,442.20	1,940.30	5,413.60	2,929.60	4,512.30	4,947.20	5,929.60	30.[illegible]
Total Government Securities	8,334.58	10,005.15	14,300.24	10,962.23	17,713.31	18,271.53	19,297.34	100.

Source: CBK Economic and Financial Reviews.

GOVERNMENT SECURITIES: ANALYSIS OF TREASURY BILLS HOLDINGS
(Nominal values in KShs millions)

Holders	1980 Dec.	1981 June	1981 Dec.	1982 June	1982 Dec.	1983 June	1983 Dec.	1984 May	%
Central Bank of Kenya	93.0	70.0	3,354.6	3,298.4	-	20.0	-	-	
Commercial Banks	977.3	1,465.8	1,642.3	312.0	2,070.0	2,255.0	1,910.0	2,000.0	34.3
Financial Institutions	239.3	404.5	365.9	1,275.5	717.6	1,544.9	1,815.7	1,398.2	35.3
Parastatals	-	-	-	141.3	100.0	106.3	239.1	561.6	9.6
Insurance Companies	-	-	-	65.0	..	41.9	35.9	43.9	0.8
National Social Security Fund	-	-	-	24.9	15.0	225.0	681.9	1,045.2	17.9
Kenya Post Office Savings Bank	-	-	-	48.0	-	200.1	203.0	140.9	2.4
National Hospital Insurance Fund	-	-	-	24.3	15.0	14.0	14.0	14.0	0.2
Local Government Loans Authority	-	-	-	-	-	50.0	70.0	55.0	0.9
Pensions, Provident and Trustee Funds	-	-	-	204.0	-	8.9	38.3	38.0	1.0
Others				20.0	6.0	6.7	21.0	21.8	0.4
Total Outstanding Position as at Period End	1,309.8	1,940.3	5,345.6	5,413.4	2,919.6	4,512.8	5,028.9	5,338.6	100.0

Source: CBK.

GOVERNMENT BORROWING FROM THE BANKING SYSTEM
(end year) 1975-1983
(KShs millions)

	1975	1976	1977	1978	1979	1980	1981	1982	1983
1. Central Bank Lending	905	711	1,052	1,336	1,272	2,133	4,351	8,000	6,455
2. Commercial Banking Lending	677	1,192	1,963	1,805	2,216	1,556	2,133	2,544	[illegible]
3. Total	1,582	1,903	3,015	6,156	3,488	3,689	6,484	10,544	8,576
(1)/(3)	57.2	37.4	34.9	21.7	34.5	57.8	67.1	75.9	72.3

Source: Central Bank of Kenya.

Limited Liability Housing Finance Companies

1) Housing Finance Company of Kenya

HFCK is the largest housing finance institution in Kenya. It was incorporated in November 1965 as a limited liability company, 60% owned by the British Government's Commonwealth Development Corporation (CDC) and 40% owned by the Government of Kenya. In 1970 the government brought its share of ownership up to 50%. HFCK converted to a non-bank financial institution under the old Bank Act in 1978.

Initially, HFCK's operations were restricted to Nairobi and Mombasa but it now has branches in Nakuru and Nyeri. It has financed houses in a number of other areas in addition to those cities where it has branches.

In addition to its long term mortgage financing, HFCK sponsors housing estate developments as well as provides bridging finance to individuals. It provides assistance in the entire process of housing development from planning right through the construction phase. The major purpose, however, is the long term financing.

In the twenty years of its existence through the end of 1985, HFCK made mortgage loans amounting to KShs. 1,882 million with the largest year being 1982 when mortgages totalling KShs. 275.4 million were approved. The mortgage amount outstanding at the end of 1985 totalled about KShs. 1.4 billion for some 7,000 loans. Total assets were almost KShs. 2 billion. In addition to mortgage loans HFCK has advanced about KShs. 14.8 million to a number of local authorities to finance tenant purchase housing schemes. During the most recent full year, 1985, HFCK approved almost 700 mortgage loans totalling KShs. 202.3 million. Over the years, some 15,000 families have benefitted from HFCK financing.

Generally HFCK requires a 10% down payment with a repayment period of 15 years although it can go 25. The maximum loan is KShs. 600,000. As noted in the previous section, the company quotes a 13 1//2% interest rate but, although payments are made monthly, repayment is calculated on an annual declining balance basis. This gives an effective annual interest rate of around 16%. As is the general practice, mortgage loan rates are variable and are adjusted to reflect the cost of funds.

To raise money, HFCK offers the standard variety of savings accounts and term deposits as well as issuing tax free interest housing bonds. HFCK also apparently has available a KShs. 300 million "line of credit" from the National Social Security Fund in the form of deposits on a long term basis which it must lend at a rate no more than 2% above the rate it pays NSSF.[1] HFCK has some 40,000

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1. This may have changed since NSSF is undergoing a review of its portfolio policy.

depositors and total deposits of KShs. 1.6 billion. Its average cost of funds is 11 1/2%.

HFCK itself does not directly undertake the development of housing projects but works closely with developers and provides a commitment of the long term, or take out, financing on projects it has "approved" or found acceptable. The leading developer in terms of units financed with which HFCK has worked to date is the government-owned National Housing Corporation although the CDC developed and HFCK financed the largest private housing estate in Kenya during the 1970's on the outskirts of Nairobi.

Shortly after it was created HFCK acquired the shares of First Permanent (EA) Ltd., an East Africa-based building society first incorporated in what was then Northern Rhodesia. First Permanent had a wholly-owned subsidiary called Kenya Building Society (KBS). KBS is now being used by HFCK as its development subsidiary and has been restructured so that its ownership is 50% HFCK and 50% CDC. Among other things KBS will embark soon on a 10,000 unit housing project in Nairobi to be developed over a 6-8 year period.

HFCK's market has essentially been middle income to date. Because of the problems with qualifications of potential borrowers cited in the previous section, HFCK is reportedly highly liquid, some KShs. 370 million in short term assets at the end of 1984. This liquidity position has supposedly continued to grow. As a result, HFCK apparently has not utilized its borrowing option from NSSF in over two years.

Increasingly, HFCK appears to be looking to its development subsidiary as an outlet for its funds and ultimately long term financing. In this respect it can certainly control the cost and affordability of housing that will be produced; the result will then be the same as where many of the other housing finance institutions appear to be heading (see discussions below) i.e. to play the role of developer as well as long term financer. But with the other institutions the motivation may be somewhat different; that is, many of these institutions believe development is where the profits are and the institution can be used for generating funds.

2) Others

The oldest housing finance institution in Kenya is the Savings and Loan Kenya Ltd., having been in business in one form or another since 1949. It was acquired in 1970 by the Kenya Commercial Bank and is a wholly-owned subsidiary of that institution, itself owned by the Government of Kenya.

SLK currently has some KShs. 840 million in total assets. It has a very low percentage of its deposits in regular savings accounts; most are in term deposits about KShs. 200 million of which is from the National Social Security Fund. Regular savings accounts, the individual saver, tend to be more stable and SLK management feels that it needs reliable deposits; as one official put it, deposits that won't "walk off". Presumably SLK would have access to back-up funds from KCB if the need arose although this point wasn't raised.

You do not have to have an account at SLK to get a loan. SLK uses the CBK branches around the country to take applications and to receive collections which permits it a much broader coverage at considerably lower cost than other housing finance institutions. SLK currently charges 16% on its mortgage loans which puts it in the same class as HFCK and East African Building Society, the other old line housing finance institutions in Kenya. All of the other housing finance institutions charge the maximum rate of 19%,

Home Savings and Mortgages (HSM) was created in July 1982 and is owned by individual investors. It now has total assets of KShs. 250 million with outstanding mortgage loans of some KShs. 130 million. Its capital is KShs. 10 million with deposits of KShs. 240 million. Most of the remainder of HSM's assets, after mortgage loans, are in deposits with other financial institutions.

It appears to be a well established institution after almost four years and to date has been conservatively run which is reflected in its almost 50% liquidity. Without the capacity to attract long term funds the HSM management has tended to maintain this conservative position. HSM will go as high as 15.5% to attract larger and longer term deposits. Under the new banking legislation, if implemented, HSM would have to double its capital. If it wants to continue to grow, it will have to increase its capital even more.

HSM's lending qualifications generally follow the industry norms; eligible for a loan after three months as a depositor, 80% LTV ratio, loan cannot exceed three times income, mortgage life insurance policy, etc. However, HSM has introduced a new element and one that could prove to be a key in establishing any type of secondary mortgage financing facility. That is, HSM has worked out a plan with the Kenya Commercial Insurance Company to underwrite private mortgage default insurance. No details were obtained as to premiums and exact coverage but this initiative is clearly of considerable importance.

Like so many of the housing finance institutions, HSM is also into the development business and this does entail some risk. A description of its most recent venture is contained in Annex F and is worthwhile examining in that it appears typical, at least in terms of unit prices, of such projects being developed by financial institutions. It's at a scale that, if the project doesn't sell, it could get HSM in trouble. It thus typifies the kind of problem that a number of housing finance institutions could be in.

The other non-bank financial institution specializing in housing is Kenya Savings and Mortgages Ltd. (KSM). KSM is a subsidiary of Jimba Credit Corporation, one of Kenya's largest merchant bank operations. It was licensed under the Banking Act in 1983 and started its lending operations in 1984. Besides its headquarters office in Nairobi, it has one branch in a town not far from Nairobi.

A wide-ranging discussion held with the Chief Manager of KSM provides some insight into the problems facing a new housing finance institution in Kenya at the present time and the directions such an institution is likely to take.

KSM has deposits of KShs. 93 million and paid-in capital of KShs. 6.1 million. It has 100 mortgage loans on its books with an outstanding balance of about KShs. 31 million or KShs. 310,000 per loan. The remainder of its funds, some KShs. 69 million, is in short term investments, again reflecting the high liquidity that such institutions feel they must maintain. In fact, KSM was caught a year ago when the National Social Security Fund pulled back a significant amount of deposits from different institutions as a result of the collapse of Rural Urban Credit Finance Company.

What KSM has done is to mount a major campaign to attract deposits from non-financial institution sources and has even established a full-fledged marketing department to do this. The result has been to increase operating costs to some 1.5% of assets while at the same time competing with the other institutions looking for the same accounts.

KSM has thus seen its average cost of funds go to 15%. Although lending at 19% for its mortgages, its average return on assets has been only 17% because of its high liquidity. When coupled with its operating costs of 1.5% plus other fees and costs, KSM has not been profitable. In addition, the new banking legislation will require some increase in capital.

The plan at KSM follows the pattern; get into the development business in a big way. To this end it has also created a development subsidiary which will engage in the full complement of activities that relate to development including sales. KSM will provide the financing, both bridging and long term. The subsidiary will also look at property management as a source of income. To finance this activity, KSM will continue its aggressive deposit mobilization efforts and try to lower its cost of funds.

Example of Housing Development Projects by Housing Finance Institutions

Home Savings and Mortgages Ltd.

HSM purchased a 40 acre site not far from downtown Nairobi for some KShs. 14 million on which it plans to construct 500 three bedroom townhouses to sell at KShs. 350,000. The first phase of 250 units is well underway. Infrastructure costs of some KShs. 6 million will be included in the sales price and 10% of the land must be given over to the city for such infrastructure and green spaces. Ultimately the roads and on-site water and sewage facilities will be turned over to the city. A real estage agent has been engaged to market the project at 2% commission. Some skeptics believe that with unit prices this high and a less desirable close-in location for this price house, the project will be very hard to market.

Family Finance Building Society

Family Finance Building Society purchased a property only 9 months after starting operations. It is located 8 miles from downtown Nairobi, cost KShs. 12 million plus KShs. 3 million to subdivide it into 1351 lots with road, electricity and water access. The building society intends to sell each lot for KShs. 15,000, for a total of KShs. 20 million. The building society will provide short term financing to purchase the lots/construct houses as well as long term mortgage financing. However, to qualify for financing, the borrower is required to open an account at FFBS and maintain a minimum balance for at least three months. FFBS's current depositors currently do not have access to loans, since most of the funds have been committed to this project. However, they are given priority to purchase these lots. Of the 1351 lots, 200 have already been sold although the subdivision work is a few months away from completion.

MAIN FEATURES OF THE BUILDING SOCIETIES ORDINANCE AND THE BUILDING SOCIETIES (AMENDMENT) ACT, 1985

1. FORMATION AND REGISTRATION: Ten or more persons may form a building society by applying to the Registrar of Building Societies in the prescribed form. The building society must renew its license with the Registrar annually by submitting the appropriate application. The annual license fees in Kenya Shillings are:

- For every building society:	50,000 Sh.
- For every branch office in Nairobi, Mombasa, Kisumu, Nakuru:	20,000 Sh.
- For every branch office in other areas/towns:	n/c

The Registrar issues a registration certificate to each building society approved, stating that it is in compliance with the provisions of the Ordinance.

2. BUILDING SOCIETY RULE REQUIREMENTS THAT MUST BE SET FORTH:

E.G.,

- Principal objectives;
- The manner in which a person can become a member;
- How funds are to be raised and how they are to be used;
- Classes of shares to be issued and the conditions of redemption or repayment of shares;
- The conditions upon which the society will accept and repay deposits;
- The conditions upon which advances upon the security of a mortgage are to be made;
- Whether money will be borrowed, and, if so, is this borrowing within the limits prescribed by this ordinance;
- The limits of loans to or deposits by any one person;
- The manner of altering and rescinding the rules of the society and making additional rules.

3. MANAGEMENT REQUIREMENTS: A board of directors of at least three persons, of which the secretary can be one, is required. One or more auditors that are approved by the Registrar is required.

4. AUTRHORITY: Building societies are entitled to receive deposits or loans at interest from its members or other persons. The amount received as deposits and not repaid cannot exceed 2/3's of the amount secured to the society by mortgages from its members. At least one

month's notice is required by the society for repayment or withdrawal.

Advances to its members out of its funds upon the security of land is allowed, as long as this land is not already used as security for a mortgage.

Investment of its funds (not immediately required for its primary purpose) in stock/securities that are authorized by law for investment of trust moneys is allowed. A building society can also keep money on current account at one or more banks or with the Post Office Savings Bank.

With the Registrar's permission, a building society can borrow money at interest, other than in the form of deposit, from a bank, act as an insurance company agent or establish/manage a pension fund for its emloyees.

5. DIVIDENDS: Dividends can only be paid out of profits earned.

6. REGISTRAR POWERS: The registrar may, at any time, require the building society to produce such books, accounts, deeds and other documents relating to the business of the building society. If non-compliance occurs, a fine of up to 5,000 Shillings can be imposed by the Registrar. The Registrar is entitled to appoint an accountant, inspector or actuary to inspect the building society's records and report its findings to the Registrar.

Initial License or Branch Application

RBS, in conjunction with Treasury and the Central Bank, examines the background and experience of the proposed board of directors and management and the proposed operations of the new society or a branch.

Annual License Renewal

Annual fees are KShs. 50,000 for the head office, KShs. 20,000 for each branch located in Nairobi, Nakuru, Mombasa or Kisumu and nothing for branches located in other cities. This policy is designed to encourage the development of branch networks in more rural areas.

A renewal application, accompanied by the past year's financial statements, is submitted to the RBS. Neither the Building Societies Act or the 1985 Amendment set forth quantitative operating or financial criteria that must be met. Review of these criteria is currently left to the judgment of the RBS. To date no license has ever been rescinded and the stiffest penalty appears to be a six month probationary period to make a specific correction or improvement. No follow-up is made to check on whether a building society is actually carrying out what was suggested.

Application for a Loan Over KShs. 750,000

When a building society applies to make a loan over KShs. 750,000, the RBS looks at the number of loans originated in the past year; the number of large loans originated; and the rates of reserves to funds loaned. 25% is the benchmark used, although not a statutory requirement.

Meetings Conducted With Following Building Societies in Kenya During Period March 10 - 28, 1986

Family Finance Building Society
T. K. Muja, Chairman

The Agrarian Building Society
S. P. Kalenzi, Corporate Secretary

Pan African Building Society
B. C. Mwagiru, Operations Manager

Equity Building Society
Peter Mbue, Operations Director

East African Building Society
Lalit Pandit, Chairman and Managing Director

Alliance Building Society
John Mbue, Chairman

Cosmopolitan Building Society
Jerry S. Osodo, Managing Director

Nairobi Building Society (sponsored by Trade Bank)
John Munge, Manager

CURRENT LISTING OF LICENCED BUILDING SOCIETIES

1. Kenya Building Society
2. First Permanent Building Society
3. Kentsada Mutual Building Society
*4. East African Building Society
5. The Commonwealth Permanent Building Society
6. Century Building Society
7. United Kenya Building Society
8. Central Building Society
9. Kiambere Building Society
*10. Pioneer Building Society
*11. Homeloans Building Society
*12. Country Building Society
*13. Cosmopolitan Building Society
*14. Kenya Wide Building Society
15. Equator Building Society
*16. Nation Wide Building Society
*17. Estate Building Society
*18. Shelter Building Society
19. Budget Building Society
*20. Gitanga Building Society
21. Tropical Building Society
22. Sunrise Building Society
*23. Regional Loans Building Society
24. The Family Shelter Building Society
*25. Equity Building Society
26. Trust Building Society
27. Midlands Building Society
28. Family Finance Building Society
*29. The Provincial Building Society
*30. Citizens Building Society
31. Executive Forms Building Society
*32. Pan African Building Society

Notes:

* - operational

East African Building Society

The East African Building Society was created in 1959 and now has nearly KShs. one billion in deposits. It is headquartered in Nairobi with branches in Mombasa and Kisumu. As a mutual building society its deposit base is in share accounts of which it has some 35,000. In addition to share accounts which include both savings shares and "investment" shares which are in units of at least KShs. 500 and pay a slightly higher rate of interest, EABS has term deposits and issues housing bonds.

Like the other old line housing finance institutions with a relatively stable deposit base, EABS charges 16% on its mortgage loans (actually a 16.8% effective rate based on methods of calculation). It has made between 6000 and 7000 mortgage loans since it started in business. Currently there are about 1650 mortgage loans on the books. EABS lending activities appear to be similar to other housing finance institutions. Its maximum loan is KShs. 750,000, which is the maximum without going to the Registrar for approval.

Some of the EABS management is also associated with a company known as Akiba which finances real estate developments. Akiba is actually a non-bank financial institution which is capitalized at KShs. 10 million to finance its development activities.

Pro Forma Of A Building Society That Began Operations During the Past 2-3 Years

Deposits
Amount: KShs. 10-60 million

Number of Accounts *: 2,000 - 8,000

Average Balance/Account: KShs. 1,000 - 3,000

Types of Accounts: Savings, Investment, Fixed Deposit Save-As-You-Earn, Childrens **

Interest Rate Paid: 11% - 13.5%, except for Fixed Deposit Accounts (13% - 16%)

Average Cost of Funds: 14% - 15%

Mortgages/Loans Outstanding
Amount: KShs. 6 - 20 million

Number of Mortgages/Loans: Short term loans: 100 - 700
Mortgages: 25 - 300

Average Mortgage/Loan Size: Loans: KShs. 50,000 - 80,000
Mortgages: K.Sh. 100,000 - 300,000

Terms: 17% - 19%, Monthly declining balance amortization method ***
Short-term loans: 1 - 3 years
Mortgages: 15 - 20 years
10 - 20% downpayment required
Loan up to 80 - 90% LTVR/ 3-4x annual income
Security required: land valued at 1.5x the loan amount

Loan qualifications: Have an account for at least 3-6 months with minimum balance of KShs. 500 - 3,000

Cast/Short-term Investments: KShs. 2 - 15 million

Land, Buildings & Equipment: KShs. 5 - 15 million

Number of employees: 25 - 50

Number of branches: 2 - 6

Notes

* Most of the building societies while having 2000 - 8000 accounts mostly in the KShs. 1,000 to 3,000 range, have a few major depositors, which make up 60 - 95% of the deposit amount. These major depositors are financial institutions, parastatals, or pension funds which fulfill the Banking Act's liquidity requirements by depositing funds in building societies, mainly in fixed deposit accounts paying 14.5% to 15.5%.

** Savings accounts allow withdrawals once or twice per week. Investment accounts pay higher rates, because a higher balance is required. Save-As-You-Earn is where the employer sets up an account with the employee, deducts an agreed upon amount from each paycheck, and deposits it in an account in the employee's name. Children's accounts are savings accounts parents open for their children. Fixed deposit accounts are term accounts similar to certificates of deposit.

*** Most building societies use the monthly declining balance amortization method. Despite a directive from the Central Bank that all institutions use this amortization method, some institutions, such as Housing Finance Company of Kenya and Pioneer Building Society continue to use the annual declining balance amortization method.

Approaches Being Taken By New Building Societies to Attract Customers

- The speed of loan processing - 3 to 5 weeks versus 4 to 9 weeks for some of the larger, more established institutions

- Savings incentive schemes: For one society, if the saver keeps at least KShs. 1000 in his account for at least 6 months, he receives 13% instead of 12%. If he maintains over KShs. 5000 for at least 6 months, he receives 13 1/2%.

- Negotiable mortgage repayment schemes, for instance, to suit the farmer or small business owner who has irregular cash flows, e.g. tied to harvest seasons - an option offered by one society to farmers with mortgages (at no charge) to pay interest only for the entire year until their major crops are harvested, at which time principal for the last 12 months is paid.

- More personalized service (and higher interest rates provided for deposits) than what has heretofore been provided in many of the rural towns by commercial banks. The personalized service provided by some building society branches includes direct, fast access to the branch manager by all depositors and door-to-door marketing campaigns tailored to the interest and needs of the locality. The building societies see these features as being extremely important to depositors. People are frequently alleged to pay more attention to these features than to the interest rate or how one's mortgage payment is derived.

- "Founders'" shares are frequently available to depositors. In such shares, a depositor can be a member of the loan review committee and has voting rights at the annual meeting.