Overview and Analysis of the Kenyan Housing Finance Sector

Prepared for the Urban and Infrastructure Division

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Table of Contents

Annexes

Abbreviations and Acronyms

BAT	British-American Tobacco
CDC	Commonwealth Development Corporation
CF	Cooperative Finance Ltd.
CMA	Capital Markets Authority
CMC	Consolidated Mortgage Company
DPF	Deposit Protection Fund
EABS	East African Building Society
EIU	Economist Intelligence Unit
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
FFBS	Family Finance Building Society
HDBs	Housing Development Bonds
HFCK	Housing Finance Company of Kenya
HFI	Housing Finance Institution
HGP	Housing Guaranty Program
IFC	International Finance Corporation
KBS	Kenya Building Society
Kenya-Re	Kenya Reinsurance Corporation
KNA	Kenya National Assurance
NACHU	National Cooperative Housing Union
NBFIs	Non-Bank Financial Institutions
NCC	Nairobi City Council
NSSF	National Social Security Fund
PBS	Prudential Building Society
RBS	Registrar of Building Societies
RHUDO	Regional Housing and Urban Development Office
RoK	Republic of Kenya
SACCOs	Savings and Credit Cooperatives
S&L	Savings and Loan
UNCHS	United Nations Centre for Human Settlements
USAID	United States Agency for International Development.

List of Figures and Tables

Official Exchange Rates

	1987	1989	1991	Jan-June 1993	November* 1993
Ksh per US$	16.5	20.6	27.5	49.0	69.0

*Floating rate

Executive Summary

After nearly three decades of economic stability the Kenyan economy has witnessed major upheavals characterised by rapid inflation and high interest rates. This report assesses the impact that this volatile environment has had on the operations of public and private housing finance institutions (HFIs).

First, the report looks at the history and growth of formal housing finance, focusing on the factors that allowed HFIs to grow and prosper up to the early 1980s and the reasons for the subsequent instability. Second, it examines the recent operations of HFIs, especially those that surround their role as intermediaries, within the context of the prevailing high rates of inflation and interest, and the current regulatory and supervisory regime. Third, the report assesses the immediate future of HFIs and recommends how the performance of the sector could be improved, bearing in mind the need to cater for lower-income groups.

The formal housing finance system, as is the wider financial sector, is well-established and comprises both public and private institutions. The principal public institution is the National Housing Corporation, a parastatal which provides housing finance largely via local authorities. Playing a subsidiary role are a number of other public institutions which include a mortgage finance company, two insurance companies and the National Social Security Fund.

Private institutions fall into two categories. The first consists of two mortgage finance companies which are incorporated under the Companies Act but licensed under the Banking Act. The second is made up of ten active building societies. Other private institutions which deserve mention, because of their financial support to the sector, are savings and credit cooperatives, commercial banks, large employers and insurance companies.

The report reviews the performance of the NHC, noting not only its failure to meet development plan targets but also the alarming level of arrears on loans made to local authorities. These arrears and the recent decline in government housing loans to the NHC have severely undermined the financial integrity of that corporation and substantially diluted its role in the housing sector.

In its historical overview of private housing finance, the report gives a brief account of the instability that faced the mortgage industry around the time of independence in 1963 and discusses the subsequent phase of consolidation and growth which lasted for about two decades. The most notable feature of the mid-1980s was the proliferation of building societies which was spurred by the coffee price 'boom' of 1976-77 and the ease of entry into the financial sector that this type of financial institution enjoyed. Persistent instability in the mortgage industry set in 1984 brought about by a number of factors: first, some building societies went headlong into property development without taking due account of the risks that awaited them; second, the operations of new societies were undercut by the withdrawal of institutional deposits; third, the number of building societies expanded too fast relative to the volume of available deposits; and, fourth, the regulatory and supervisory regime was weak.

The report arrives at a number of findings and conclusions, the more important of which are:

a) The impact of recent economic changes has been severely adverse, forcing HFIs to suspend lending. In particular, the cost of funds has outstripped interest rates on the existing mortgage portfolios. There has also been an outflow of deposits, triggered by the very high returns on treasury bills and bonds.

b) In spite of the liberalization of interest rates in 1991, real rates on HFI mortgage portfolios have been negative since then -- this has been brought about by the prevailing high rates of inflation and the impracticality of adjusting lending rates to match inflation levels.

c) The principal HFIs restrict their lending primarily to a small number of middle- and high-income borrowers in Nairobi and are therefore unlikely to act as an effective vehicle for extending housing finance to lower-income groups.

d) Although the mortgage industry has traditionally been dominated by three HFIs, the rapid growth of Prudential Building Society will soon allow that institution to challenge this dominance.

e) The supervision of HFIs is irregular and ineffective. There is also ambiguity in how the role of supervising building societies is shared between the Registrar of Building Societies and the Central Bank.

f) HFIs rely predominantly on short-term deposits -- with a maturity of up to one year -- and are therefore compelled to retain high levels of liquidity.

In summarising the main issues the report points out that, in the short-run, the principal concerns in the mortgage industry will continue to centre on inflation and interest rate levels. It concludes that unless interest rates around 20-25% start yielding real positive returns it is unlikely that there will be an upsurge in mortgage lending.

In the longer-term, the following issues will need to be confronted: redefining the role of the NHC; targeting low-income groups; expanding access to finance for rental housing; improving the regulatory and supervisory regime; containing the level of subsidies; addressing aspects of establishing a secondary market; and removing non-financial barriers. Recommendations are made on how to combat these issues, the more important of which are set out below.

a) <u>Redefining the Role of the NHC</u>

The report argues that the dual roles of the NHC, i.e. that of developer and long-term financier, should be separated primarily because the NHC has performed poorly as a provider of term finance. Accordingly, the Corporation should restrict its role to that of a developer, concentrating on the provision of infrastructure services to public and private residential land. As a complementary measure, the government should convert its existing loans to the NHC into income notes, i.e. loans with no redemption date.

b) Targeting Low-income Groups

Lending in the mortgage industry has not seen much innovation largely as a result of little competition among HFIs. Consequently, low-income groups do not have ready access to the lending programmes of mainstream HFIs. The report notes that there are two institutions that could make some headway with this problem. One is First Permanent, a subsidiary of HFCK, which is to be revived for purposes of lending to lower-income groups. The second is Cooperative Finance Ltd, a subsidiary of the Cooperative Bank. To help these institutions accomplish their objectives it is recommended that they be considered for future loans to be guaranteed by donors. To enable them mobilise savings, they should also be given authority to issue negotiable certificates of deposit

c) Finance for Rental Housing

As finance for rental housing is in short supply it is important for HFIs, including First Permanent and Cooperative Finance Ltd, to make short-term loans -- not exceeding 5 years -- to developers of lower-income rental housing.

d) Regulation and Supervision

To strengthen the regulatory and supervisory regime it is recommended that:

- on-site and off-site supervision of HFIs be made more consistent and regular;
- the present ambiguity in the supervision of building societies be resolved;
- smaller HFIs be allowed to issue housing development bonds.

e) Subsidies

Noting that subsidies in the housing sector are inequitable the report recommends that:

- in the short-run, local authorities should raise their rents to market levels; in the longer-term they should privatise their housing stocks;
- tax benefits to owner-occupiers ought to be reviewed with a view to making them more equitable.

f) Secondary Mortgage Market

HFIs show little immediate need for a secondary mortgage market, mainly because they do not experience liquidity problems. In the circumstance, a practical first step towards creating such a market is to start a discounting facility at the Central Bank that would allow HFIs to sell some of their mortgages.

g) Non-Financial Issues

Delays in planning approvals and land conveyancing act as costly barriers to housing development. It is recommended that technical assistance be given to the key local authorities and to the Department of Lands in order to help them streamline procedures relating to planning approvals and the registration of land titles.

1. Introduction

1.1 Objectives

Until comparatively recently, housing finance institutions (HFIs) operated within a relatively stable macroeconomic environment. Since 1991, however, there have been major economic upheavals, characterised by rapid inflation, high interest rates and stagnation in GDP growth.

This report attempts to gauge the impact that recent economic changes have had on formal housing finance, public as well as private. Three objectives may be distinguished. The first is to examine the history and growth of housing finance in the country, covering both public and private institutions. In doing so, the report is concerned to highlight the economic factors that allowed HFIs to prosper up to the early 1980's; and the reasons for the erratic patterns of growth and decline that set in thereafter.

The second objective is to provide a current assessment of the state of the housing finance sector and its ability to meet the housing demand of the country, in particular with respect to low-income shelter. The third objective is to assess the immediate future of the housing finance sector and to suggest ways in which the donor community could intervene to enable the sector cater for lower-income groups.

Formal housing finance, like the rest of the financial sector, is highly sensitive to the wider economic environment. Consequently, HFIs will prosper when key macroeconomic variables, mainly inflation and interest rates, are stable and predictable. High inflation has serious implications for financial systems: it erodes the value of financial assets thus inducing households to hold wealth in the form of non-financial assets; it raises significantly the risks of long-term contracts, such as those common to mortgage lending; and it undermines the information imparted by relative prices, thus impairing the ability of economic agents to make sensible investment decisions.

For its part, the rate of interest has important implications for savings mobilisation and the development of housing finance. Although the effect of high interest on the rate of saving is ambiguous[1] positive real interest rates -- defined as the difference between the nominal rate of interest and the rate of inflation -- encourage households to place their savings in financial institutions.

1.2 Macroeconomic Setting

Kenya achieved remarkable economic growth during its first decade of independence. Between 1964 and 1973 GDP registered an average real growth rate

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[1] See for instance Schmidt-Hebbel, K. et al. (1992)

of 7% per year, spurred by favourable international economic conditions, high returns in agriculture, and moderate prices for energy. Interest and inflation rates remained low and deposits held by HFIs earned 4-7% interest a year while lending rates ranged from 7.5-10%.

From 1974 to 1976 the economy stagnated as a result of the 1973 oil shock, international recession and drought. There was a resurgence of economic activity in 1976 and 1977 as a result of high prices for coffee and tea but between 1978 and 1984 recession set in once again. The half-decade to 1990 saw renewed growth but the economy declined steeply in 1991 and has not recovered since.

Between 1974 and 1991 interest rates on HFI loans grew steadily rising from an average annual rate of about 9% to 19%. For the most part, inflation outstripped the administratively set interest rates thus yielding negative returns on savings. The last two years have seen inflation climb to unprecedented levels, fuelled by a rapid expansion of money supply and the rapid depreciation of the Kenya shilling relative to foreign currencies.

Gross fixed capital formation in modern dwellings, as has capital formation generally, has declined steadily over the last few years, falling from K£114.24 million in 1989 to K£75.69 million in 1992 (figures in 1982 prices). Over the period, the share of modern dwellings in GFCF (modern sector) fell from 8.5% to 6.1%. Implicit in these figures is a switch from investment to consumption. Indeed, the share of private consumption in GDP rose from 63.9% in 1991 to 68.9% in 1992.[2] The conclusion to be drawn is that the declining investment in housing is unlikely to be reversed unless the high rates of inflation and interest are curbed.

The declining share of housing in GFCF has occurred when rapid urbanization makes it imperative for Kenyan towns to supply at least 100,000 dwellings a year, the majority of which will need to be affordable by lower-income groups. The capacity of the formal sector to provide a significant proportion of the houses required cannot be restored unless economic stability is assured.

1.3 Approach

The approach employed in this study comprised four main elements. First, relevant literature was reviewed, consisting largely of previous reports as well as published material on the principles of housing finance. Second, published data sets were assembled and analyzed: the main sources of data were annual reports and accounts of HFIs, and other official publications. Third, a brief questionnaire permitted the collection of additional data held in internal HFI records. Fourth, senior HFI officials and staff in other institutions with a bearing on housing finance were interviewed. Sets of questions prepared in advance for this purpose allowed structured discussions to be held with these officials. The following HFIs were

[2] ROK (1993)

interviewed: the three HFIs licensed under the Banking Act; three of the ten active building societies; and the National Housing Corporation.

1.4 Organization of the Report

The report is organised into five sections in addition to the executive summary. Section 2 examines public sector institutions involved in housing finance, principal among which are the National Housing Corporation and local authorities. A critical evaluation of these institutions is included there. Section 3, which looks at private HFIs, also provides an historical overview and analysis of the mortgage industry. The recent and current operations of HFIs are discussed in Section 4 in the context of recent macroeconomic changes. That section also sets out the main findings and conclusions. Section 5 pulls the main issues together and presents recommendations aimed at guiding further interventions in the housing finance sector. A number of annexes supplement the information in the main report.

2. The Public Sector

2.1 Policy Context

Since the publication of Sessional Paper No. 5 of 1966/67, Kenya has had a well-articulated housing policy. The principal long-term goal has been to ensure that every household has access to a "decent home, whether privately built or state sponsored, which provides at least the basic standards of health, privacy and security." This policy has been upheld in the various national development plans but refinements have been introduced to take account of changing economic and social circumstances.

Until the mid-1980s, donor agencies continued to play an active role in assisting government define and implement its housing policies. In particular, the World Bank and USAID were key partners in the financing and implementation of ambitious sites and services, settlement upgrading, and basic housing projects, in both principal and secondary towns. These projects, implemented largely between 1975 and 1985, deviated substantially from conventional public housing efforts by placing emphasis on cost recovery, private sector participation and policy reform.

In the main, policy implementation has been entrusted with the National Housing Corporation and the various local authorities. This section concentrates on a discussion and evaluation of the contributions that these institutions have made to housing finance. It also examines the roles played by other public institutions, such as the National Social Security Fund, and the Consolidated Mortgage Company. Private sector institutions are discussed in the next section.

2.2 National Housing Corporation

The NHC was established in 1966 to implement government housing policy. Between 1965 and 1989 it financed over 42,000 dwellings, acting either directly or via local authorities. Table 2.1 shows the distribution of these dwellings by type.

Table 2.1 Distribution of NHC Dwellings by Type: 1965-1989

Dwelling Type	No.	%
Rental	12,060	28.5
Tenant Purchase	8,330	19.7
Site and Services Plots	19,770	46.6
"Mortgage" Dwellings	2,180	5.2
Total	42,340	100.0

In all, total NHC expenditure amounted to over K£67 million with about 26% going to rental projects, 17% to tenant purchase schemes, 30% to sites and services projects and 27% to dwellings for sale on mortgage terms.

The Corporation depends almost entirely on the exchequer and external donors for loans to finance its projects. Government loans are made for 40 years at 6.5% interest per year (if for rental housing) and for 20 - 25 years if for tenant-purchase housing. External loans generally carry higher interest rates but these have usually been lower than 13%. The chart on the next page illustrates the flow of funds for public housing.

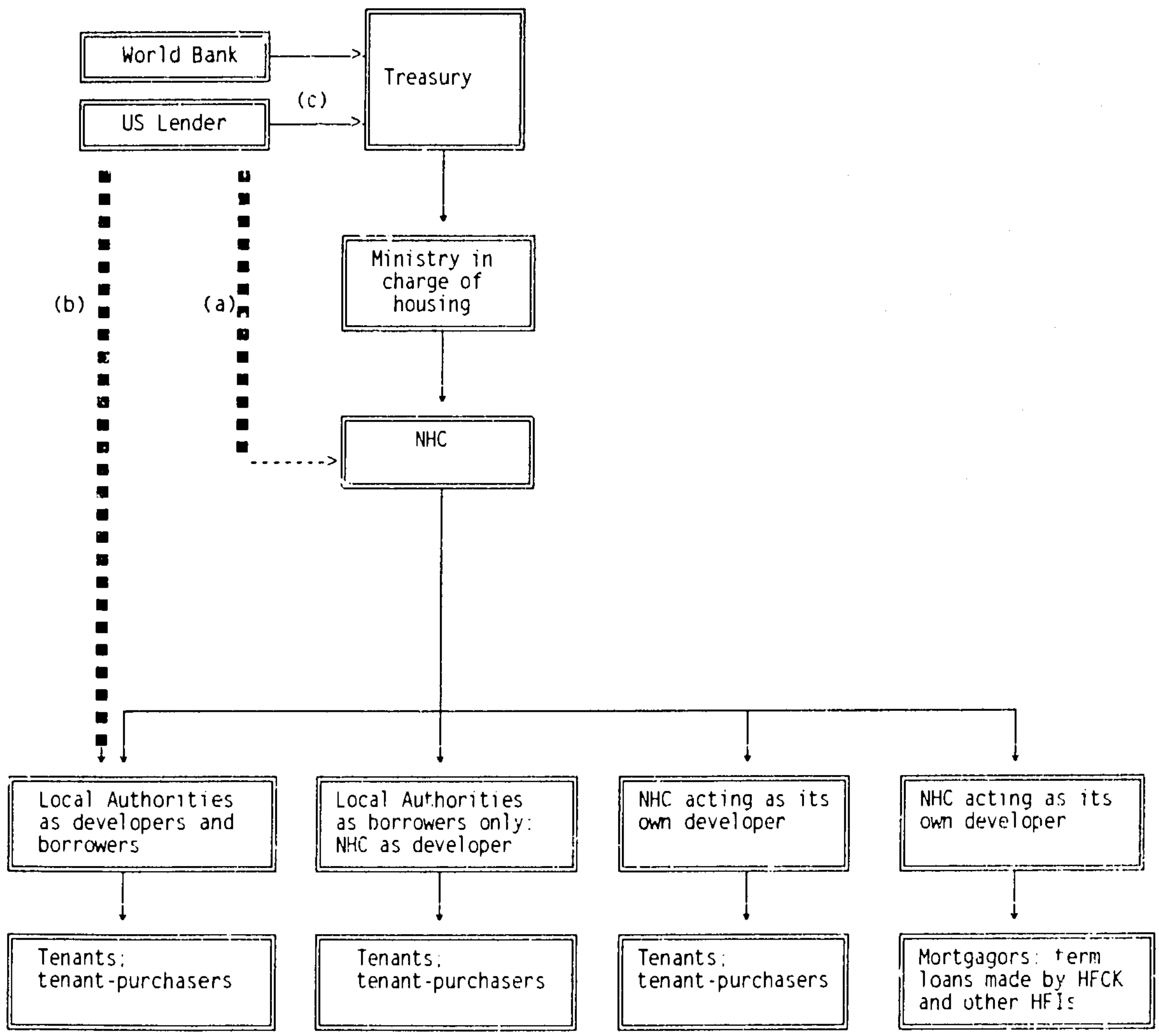
In on lending to local authorities the NHC allows for margins ranging from 0.5% to 2%[3]. As interest rates by HFIs are in the region of 21 - 25% it will be seen that NHC loans carry a substantial element of subsidy.

In recent years arrears owed by local authorities have risen dramatically, climbing from Ksh.89.6 million in 1983 to Ksh.775.1 million in June, 1992. Nairobi City Council, and Mombasa and Kisumu Municipalities remain the major defaulters, accounting for 85% of arrears.

[3] On the other hand, recent loans to tenant-purchase contained interest rate spreads of around 5%.

Figure 2.1

Flow of Funds for Public Housing



(a) Broken line shows past direct borrowing by the NHC for example under USAID Housing Guaranty loan, HG-004

(b) Broken line shows past direct borrowing by the Nairobi City Council under USAID Housing Guaranty loans HG-001, HG-003 and HG-005.

Note: To keep the chart simple, repayment flows have not been shown.

(c) Model employed in USAID HG.006.

Some progress has been made in the last few years in recovering outstanding debt charges, following amendments to the Housing Act which empowered the NHC to take over the direct management of local authority housing. The "knock-on" effect of the high level of delinquency is that NHC arrears on government loans have mounted sharply, growing from Ksh 622.7 million in June 1990 to Ksh.887.1 million in June, 1992. Further, the NHC has incurred foreign exchange losses on a $5 million loan contracted in the mid-1970s.[4]

[4] The exchange rate at the time of borrowing was about Ksh 8 to the US$ as opposed to the current Ksh 69 to the US$.

The NHC's financial position remains precarious and plans to address this situation include the launching of a financial subsidiary to operate on a commercial basis, along the lines of private HFIs. A more detailed description of the NHC is given in Annex 2.

2.3 Local Authorities

Local authorities depend on the NHC for housing loans but in the past, the Nairobi City Council borrowed directly from foreign lenders under the USAID HG programme. Three of its projects have attracted HG loans exceeding US$30 million. These are the Kimathi tenant purchase scheme for which the NCC borrowed roughly US$2 million in 1969; Umoja I, whose implementation started in 1975 financed by a US$10 million loan; and Umoja II for which US$18.45 million was borrowed starting in 1985.

Local authorities have had a chequered history of collecting rents and debt charges from beneficiaries. At the one extreme, arrears on NCC rental housing have been modest, apparently reflecting the ability of the NCC promptly to evict tenants where they fall behind on payments. At the other extreme, Urban II in Mombasa, a World Bank-supported sites and services/upgrading project, presents a sharp contrast. There, actual loan repayments by beneficiaries as a percentage of expected repayments ranged from about 17% to 45% between 1988 and 1990.[5] In Umoja II, the repayment record was almost equally poor in 1988 when 50% of dwelling owners were reported to have been in arrears.[6] Consequently, plans by NCC and USAID to utilise 11% of Umoja II repayments to start a housing fund for the city were not successful.[7]

Local authority rents are highly subsidised and, in Nairobi, are generally about 50% of market rents for equivalent private dwellings. Equally, ownership finance by local authorities contains generous interest rate subsidies and land is conveyed to homebuyers at prices substantially below market levels.

2.4 National Social Security Fund

Established in 1965, the NSSF provides financial security to retired workers who are not covered by other pension and provident funds. Its governing legislation, the NSSF Act (Cap 258), gives it the following functions:

- identification of registrable employers and contributing members;

[5] Macharia, M. and Mutero, J.G. (1993).

[6] Hoek-Smit, M.C. (1989).

[7] ibid.

- collection of contributions from members;
- payments of benefits to qualified beneficiaries;
- investment of funds not required for immediate use.

In its early years, the Fund was administered as a department of the Ministry of Labour but it became a state corporation in 1988. Membership has expanded rapidly and, by mid-1990, contributing members were about one million drawn from some 40,000 employers. Employers and employees each contribute 5% of wages to the Fund subject to a maximum assessable wage of Ksh.1,600 per month. Annual contributions have grown more than fifty-fold, rising from Ksh.23 million in 1966 to roughly Ksh1.2 billion in June, 1990. By the latter date, the Fund's investments amounted to Ksh.22.6 billion.

In the terms of the NSSF Act, the Board of Trustees -- the Fund's governing body -- is allowed to determine how surplus funds should be invested but this power has often been usurped by the government. The NSSF has placed substantial deposits with HFIs and other financial institutions, amounting to about 14% of its investment portfolio in mid-1990. These deposits have, in the main, supported mortgage lending to middle- and higher-income groups. Acknowledging this, a recent study undertaken for UNCHS (Habitat) recommended that the Fund finance lower-income housing for workers, acting via existing HFIs.[8] In practice, the bulk of the Fund's investible surpluses have been used to buy government securities. Indeed, a recent directive by government requires the NSSF to apply all its investible funds towards that end. This policy came in the wake of accusations of financial impropriety on the part of the Fund.

2.5 Consolidated Mortgage Company

Following the onset of instability in the mortgage industry in the 1980s, four HFIs were acquired by Consolidated Bank in 1989, a wholly owned government bank set up to rescue failing financial institutions. The HFIs taken over were Kenya Savings and Mortgages, Home Savings and Mortgages, Citizens Building Society and Estate Building Society. In 1992, the four HFIs were converted into a subsidiary, Consolidated Mortgage Company (CMC).

CMC has not originated new mortgage loans since it was established and there are no immediate plans to do so. Its principal activity is the administration of the mortgage portfolio inherited from the four HFIs, valued at Ksh 46 million.

The company has not been able to mobilize additional savings to any appreciable extent: customers comprise 2,000 passbook holders as well as institutional investors, such as insurance companies and local authorities. In all, deposits stood at Ksh 77 million in March 1993. CMC has also recently received a call deposit of Ksh 38 million from its parent company on which it pays an annual interest rate of 19%.

[8] Jorgensen, N.O. and Mutero, J.G. (1992)

The company has a small professional staff consisting of 1 manager, 1 accountant and 2 supervisors. On the whole, its capacity as a player in the mortgage industry is limited.

2.6 Other Parastatals

Two other parastatals, Kenya National Assurance Company (KNA) and Kenya Re-insurance Corporation (Kenya Re), have employed a significant part of their funds in mortgage lending, primarily to middle- and higher-income groups. KNA makes mortgage loans to its own staff, policy holders and other homebuyers. Its loans are for up to 20 years but the usual term is 10-15 years; and the current lending interest rate is 26% per year

In 1991 the company had deposits worth Ksh. 117.2 million in building societies in addition to a portfolio of government securities worth Ksh. 157.7 million. Other investments included deposits with financial institutions and local authorities, quoted shares, and leasehold property.

In 1992 and 1991 the KNA made mortgage loans amounting to Ksh. 88.4 million and Ksh. 90.9 million, respectively. Although it used to lend to local authorities, the poor financial condition of these authorities has ruled out further loans.

Kenya-Re contributes to the housing sector via mortgage loans to its staff and members of the public, and through the development of residential estates for sale. It has so far developed 6 housing schemes in a number of principal towns. Its stock of mortgage loans to people other than staff members amounted to Ksh. 119 million in 1991. The company invests its surplus funds in government paper (40%), residential and commercial property (20%) and the remainder in shares and debentures.

2.7 Other Programmes

Other programmes consist of rental housing provided to employees of the central government and of the larger parastatals, such as Kenya Posts and Telecommunications, and Kenya Railways.

Government housing, for which data are readily available, consists of pool housing for general civil service use, and institutional housing, which is allocated to specific ministries. Between 1985/86 and 1990/91, 107 pool houses were completed at a total cost of Ksh 68.5 million while 2,655 institutional houses were built at a cost of Ksh.722 million.[9]

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[9] RoK (1991).

2.8 Analysis

Although government housing policy has been reasonably well-articulated, especially in regard to the needs of lower-income groups, programme implementation has lagged behind. So, while the 1970-74 national development plan expected the NHC to commit 33% of the total housing budget to sites and services projects, the actual expenditure was a mere 4%. Over the plan period 1974-78, the projected sites and services expenditure was 93% of the total budget but the actual share turned out to be 31%. Only during the 1979-83 development plan period did plans and outcomes show some convergence, diverging yet again between 1984 and 1988. Since then, policy has shifted away from sites and services programmes but efforts to issue a new sessional paper on housing policy have not been successful.

According to the NHC, the failure to meet development plan targets was explained by two main factors: targets had been too ambitious relative to implementation capacity; and that the funds actually voted to the NHC had fallen well short of projections in the development plans. But there clearly were political difficulties too. It has been argued that politicians believed that sites and services projects would inevitably degenerate into slums because of the priority they gave to the adoption of basic planning standards.[10] The view is also held by some analysts that too much emphasis was placed on home ownership by lower-income groups, at the expense of promoting rental housing. This policy, it is further argued, does not necessarily accord well with the aspirations and priorities of such groups.[11] By implication, therefore, finance for rental housing should be given more attention than has been the case to date.

Another important area of underperformance concerns the inability of the NHC to meet its debt obligations to the government, largely because of widespread defaulting by local authorities. In many cases, a substantial part of rents and debt charges collected by LAs is diverted to other pressing needs, such as payment of staff salaries. In other cases, as we saw earlier, LAs do not seem to have the capacity to enforce cost recovery in spite of the underlying subsidies to beneficiaries. As the amended Housing Act does not provide the NHC with alternative mechanisms for collecting arrears -- such as the power to dispose of local authority assets -- the Corporation will find the issue of arrears a difficult one to contain.

Moreover, since government loans to the NHC will inevitably continue to fall in the foreseeable future, the corporation's precarious financial position will persist. As a result, its ability to finance housing will decline substantially. Although its plan to launch a financial subsidiary is meant to arrest this decline, the plan appears ill-conceived for a number of reasons. First, the present economic environment of high inflation and high interest rates has not run its course. Consequently, it will be

[10] Werlin, H. (1974)

[11] See for instance Hoek-Smit, M.C. (1989)

some years before conditions again favour the establishment of a new financial institution.

Second, the NHC does not have the commercial experience to manage a financial institution driven by market forces. Still, it could well be argued that such an institution would be autonomous and that its behaviour would thus be shaped by the market and not by the administrative controls to which parastatals are subject. Experience, however, suggests that such an argument has little merit. Third, if the financial institution is to operate at "arms length" from the NHC, its financial surpluses cannot then be used to shore up the corporation's finances. Consequently, the creation of such a subsidiary would leave intact the basic financial difficulties that surround the provision of housing by a parastatal, especially via the local government system.

One way out of this quandary would be for the government, the NHC and other parastatals, and local authorities to agree on the settlement of mutual debts. There is nothing new in this proposal but its implementation remains in abeyance. The NHC should also re-structure its operations along the lines recommended in Section 5.

Arrears on NHC loans should be viewed in the context of the wider financial condition of local authorities. Following the Transfer of Functions Act of 1969, the responsibility for several major services, such as primary education and health, was transferred from local authorities to the central government. This transfer was accompanied by the abolition, between 1969 and 1974, of the Graduated Personal Tax (GPT), a payroll tax that constituted the major source of revenue for local authorities.

Although GPT was replaced with a compensating grant this was also reduced over time and finally abolished in 1978. Still, the larger municipalities continued to enjoy central government subsidies that went towards meeting the costs of primary education and health. These subsidies petered out in 1984/85. Since then, the financial condition of local authorities has deteriorated to the level where most of them are considered insolvent. It may be surmised, therefore, that the build-up of arrears was triggered by the abolition of GPT.

The poor financial position of local authorities has also undercut their ability to finance off-site infrastructure and, in the circumstance, this burden has often been off-loaded onto developers. The resulting impact on affordability is adverse as home buyers are asked to meet costs that would ordinarily be recovered from town-wide rates and user-charges.

In spite of their poor financial condition, local authorities continue to subsidize their tenants, often charging rents that are about a half of rents for equivalent private housing.

As for the application of NSSF funds towards lower-income housing, the binding constraint appears to be political and not technical. Present experience from other countries, notably Ghana, shows that where political will exists, social security funds can become an important source of long-term finance for workers' housing.

3. The Private Sector

3.1 Financial Sector

For its level of development Kenya has a sophisticated financial system comprising a broad range of institutions. Presently there are 30 commercial banks, 57 non-bank financial institutions, 26 building societies[12], several development finance companies, and the Kenya Post Office Savings Bank. The securities market is rudimentary but a 1984 study[13] by the International Finance Corporation and the Central Bank led to the establishment of the Capital Markets Authority in 1989. The CMA has the critical task of ensuring the orderly development of a capital market via which term finance will be mobilised for all types of investment, including housing.

Mention should also be made of the Nairobi Stock Exchange which, though small by international standards, has expanded significantly in recent years. Market capitalization was Ksh.12.7 billion at the end of 1991, Ksh.23.1 billion in 1992 and Ksh.27.7 billion in the first quarter of 1993.[14] New issues in 1992 consisted of 18 million shares by the Housing Finance Company of Kenya, 8.63 million by Crown Berger and 16 million by Uchumi Supermarkets. Further expansion is foreseen as the government's privatisation programme gets underway. Moreover, as debt finance is likely to command relatively high interest rates in the medium term, private companies have the incentive to go public. Hitherto, the development of the equity market has been suppressed by the availability of cheap credit from the banking system.

The housing finance institutions discussed in this section fall into two categories. First, there are two mortgage finance companies -- the Housing Finance Company of Kenya, and Savings and Loan -- which are incorporated under the Companies Act, but licensed under the Banking Act. In terms of the latter legislation a mortgage finance company is defined as "a company (other than a financial institution) which accepts, from members of the public, money on deposit repayable on demand or at the expiry of a fixed period or after notice" and is established primarily for purposes of making residential mortgage loans.[15] The second category comprises building societies. These are mutually-owned institutions which

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[12] Only 10 of these are active.

[13] Central Bank and IFC (1984)

[14] Gunesekera, D.C. (1993)

[15] The Banking Act makes a distinction between three types of institutions: banks, financial institutions and mortgage finance companies.

are registered under the Building Societies Act. The principal institution in this group is the East African Building Society but Premier Building Society is rapidly evolving into a significant institution in its own right.

A number of other institutions are also examined because they make housing loans, extend associated credit, such as bridging loans for construction, or act as potential investors in housing development bonds and related securities. The main ones are savings and credit cooperatives (SACCOs), commercial banks, large employers and insurance companies. Before analyzing the institutions, an historical overview of developments in the housing finance sector is presented.

3.2 Housing Finance : An Historical Overview

In the years immediately preceding independence in 1963, the housing finance sector was marked by instability, reflecting political uncertainty. In the event, HFI deposits plunged from K£10.4 million in 1959 to K£4.5 million in 1962. However, this period soon gave way to a phase of consolidation and the mortgage industry expanded substantially from 1964 onwards.[16] The principal HFIs at the time were the Housing Finance Company of Kenya, Kenya Building Society, and Savings and Loan. HFCK was incorporated in 1965 as a joint venture between government and the Commonwealth Development Corporation (of the United Kingdom); it took over the assets of First Permanent of East Africa and those of KBS.

S&L, the largest HFI at the time, experienced substantial setbacks around the time of independence and was taken over, initially by Pearl Assurance and, in 1970, by Kenya Commercial Bank, a parastatal. East African Building Society, a relatively small HFI which had opened for business in 1959, weathered the political uncertainties of the day and expanded rapidly in the years that followed.

HFCK, EABS and S&L, the principal HFIs, achieved fast growth during the 1970s. Between 1975 and 1980, for instance, HFCK deposits increased at an annual average rate of 20% and those of the EABS by 24%.[17] In mid-1981, following a general decline in the growth of deposits, tax-free housing development bonds were introduced to enable HFCK and S&L attract additional savings. These institutions also benefitted from deposits by the NSSF and from loans by the government.

Starting in the mid-1980's the mortgage industry witnessed major changes and upheavals. By 1986, the number of HFIs had grown to about 36, comprising four limited liability companies and 32 building societies but only 15 of the latter were active.[18] Taking into account that the country had for many years been served by

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16 See Jorgensen, N.O. (1970)

17 World Bank (1983)

18 Gardner et al. (1986)

only one building society, the growth in numbers of this type of HFI had been nothing short of dramatic. Gardner et al. have documented two reasons for this growth. The first is that the coffee price boom of 1976-77 provided the financial impetus for the rapid increase in number of such institutions. Second, licensing of financial institutions under the Banking Act was tightened in 1985 following the collapse of a financial company (see below). Thus, building societies remained the principal avenue readily open to entrepreneurs interested in entering the financial sector. Notwithstanding the proliferation of HFIs, the industry continued to be dominated by HFCK, EABS and S&L. Still, the newer institutions competed aggressively for savings.

In 1984, the country experienced its first post-independence failure of a financial institution, that of the Rural and Urban Credit Finance Company. In response, the government tightened the regulatory and supervisory regime. More specifically, a number of steps were taken via an amendment to the Banking Act (Cap. 488). First, stricter conditions were imposed concerning the level of paid-up capital, as well as that of unimpaired reserves relative to deposit liabilities. For instance, the level of paid-up capital for local non-bank financial institutions (NBFIs) was raised from Ksh 5 million to Ksh.7.5 million. Second, NBFIs were prohibited from owning shares in commercial banks. Third, a Deposit Protection Fund, domiciled at the Central Bank, was created but it did not become operational until seven years later.

These measures notwithstanding, a group of financial institutions, several building societies among them, failed in due course[19]. A combination of factors led to this failure, some political, others management related.

First, a good number of building societies had invested heavily in property development, an activity that was considered more profitable but which naturally carried a higher risk. A notable example is Pioneer Building Society which collapsed largely because of delayed house sales. Second, major institutional investors, such as the NSSF, withdrew their deposits from the new building societies, partly out of the need to comply with political directions but also as a result of genuine concern for the security of their deposits. Third, the number of building societies had expanded too rapidly relative to the volume of available deposits. Fourth, the regulatory and supervisory regime was weak and potential problems could therefore not be arrested in time. In particular, the Registrar of Building Societies did not possess the staff needed to assure effective supervision.[20]

Government intervened in 1989 and reorganised some of the failed institutions under the umbrella of a new bank, the Consolidated Bank of Kenya.[21] Potential crises

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19 See Annex 3 for a schedule of the financial institutions that failed and the year of failure.

20 Gardner et al. (1986)

21 See Annex 3 for a schedule of the institutions that were taken over by the Consolidated Bank of Kenya.

were averted in the years that followed but, in the first half of 1993, a number of financial institutions were placed under receivership including one HFI.[22]

In spite of these setbacks, the mortgage industry registered some expansion. HFCK saw its public deposits grow, in nominal terms, from Ksh.1.89 billion in 1987 to Ksh.3.4 billion in 1992. However, in real terms -- that is, after making adjustments for inflation -- growth was marginal. As for mortgage lending, advances increased from Ksh.204.5 million in 1984 to Ksh.614.0 million in 1992. Even so, there was stagnation between 1986 and 1988 but lending rebounded in 1989 and 1990, registering nominal growth rates of 34.2% and 52.3%, respectively. Stagnation set in once again in 1991. With some variations, EABS and S&L shared a similar experience.

In the early 1980s USAID attempted to launch a private sector housing programme but this initiative was abandoned in 1990, ultimately frustrated by rising construction costs and the increasing difficulties of the government to borrow on foreign markets. The intention had been to channel Housing Guaranty (HG) programme loans via selected HFIs for purposes of providing term finance to lower-income groups.

Arguably the most important development in the last three decades was the freeing of interest rates in July, 1991, a measure taken to ensure a more efficient allocation of resources.[23] Hitherto, interest rates were controlled by the Central Bank but they nevertheless remained positive in the years leading to 1990. The liberalisation of interest rates, however, has been overshadowed by the very high rate of annual inflation in 1993, conservatively estimated to have averaged around 40%[24] but to have peaked at roughly 100%.[25] Since HFIs are not able to lend at rates exceeding 30% -- because there is little demand at that level -- real interest rates have turned sharply negative. The response of HFIs has been to suspend new mortgage lending altogether, choosing instead to invest in high yielding treasury bills. Section 4 takes up this subject in some detail.

3.3 Regulatory and Supervisory Framework

This subsection first looks at the regulation and supervision of mortgage finance companies before turning to building societies and insurance companies.

The regulation and supervision of mortgage finance companies is entrusted primarily with the Central Bank of Kenya. The Banking Act is the centrepiece of the

[22] See Annex 3

[23] RoK (1993)

[24] BIU (1993)

[25] Economic Review of 8-14th November, 1993 citing a World Bank estimate.

supervisory and regulatory framework for these companies. Its main provisions focus on the following aspects: licensing of institutions;[26] defining prohibited businesses; setting out requirements for reserves and dividends; accounts and audit; information and reporting requirements; inspection and control of institutions; and the operations of the Deposit Protection Fund and its Board.

A number of provisions in the Act are worth highlighting because they impinge on the operations of mortgage finance companies:

a) Mortgage finance companies are required to restrict their lending to property development and to secure their loans by means of a mortgage on the land in question. In addition, 75% of loans must be for residential purposes.

b) Individual loans may not exceed a maximum amount set by the minister for finance. The current ceiling is Ksh.1.5 million or 90% of the property value, whichever is the less.

c) The capital and unimpaired reserves must not be less than 7 1/2% of total deposit liabilities.

d) Institutions are required to comply with minimum ratios set by the Central Bank, as between their capital and unimpaired reserves on the one hand, and their assets on the other.

e) Institutions are also required to comply with minimum levels of liquidity as set by the Central Bank. In this connection, treasury bills and bonds of a maturity not exceeding 91 days qualify as liquid assets.

f) Audited accounts should be submitted to the Central Bank not later than 6 months after the end of the relevant financial year.

g) The Central Bank has the power to take over the management of an institution for a period not exceeding 6 months, and for a longer period with the authority of the High Court.

The Deposit Protection Fund safeguards the interests of depositors and gives full protection, at the moment, to deposits of up to Ksh.100,000. It is worth emphasizing, however, that building societies are not members of this fund and their deposits do not therefore enjoy this protection. All licensed institutions must contribute annually to the fund an amount not less than 0.4% of the average of the total deposit liabilities over the twelve months preceding payment. The Fund is managed by a board chaired by the governor of the Central Bank.

Since 1985, the supervision of building societies has been brought within the remit of the Central Bank but the registration of such societies remains the responsibility

[26] According to the Act an institution means a mortgage finance company, a financial institution or a bank.

of the Registrar of Building Societies. There is some ambiguity, however, on how these two bodies share and coordinate their responsibilities. Although the Building Societies Act gives the Registrar's office wide powers the lack of experienced staff has constrained its ability to control the behaviour of building societies.

Recent amendments to the Act allow these societies direct involvement in property development an activity that hitherto could only be undertaken via subsidiaries. Like other HFIs, building societies cannot operate current accounts nor can they issue bearer certificates of deposit or engage in foreign exchange transactions.

Interviews of HFI officials revealed divergent opinions on whether or not HFIs should be allowed to broaden their range of financial products and activities. On the one hand, one major HFI favoured specialisation in mortgage lending and related business activities, such as hazard underwriting. On the other hand, another HFI advocated for allowing HFIs to engage in some of the business activities currently confined to commercial banks. South Africa and the United Kingdom were mentioned as examples of countries that had elected to follow the latter course.

Interviews also revealed that, on the whole, on-site supervision of HFIs is unsystematic, infrequent and not very effective. At times, it is also entrusted to staff that are not fully expert in the task at hand. The lack of consistent feedback from the Central Bank was also cited. Still, HFIs send their returns to the Bank on a regular basis.

Insurance companies are supervised by the Commissioner for Insurance in accordance with the provisions of the Insurance Act. Although these companies enjoy some latitude in structuring their investment portfolios, they are not allowed to invest in shares and stocks. Further, they are required to place at least 30 percent of their investible funds in government securities. They have recently exceeded this limit in response to the very high returns that these securities command.

3.4 Building Societies

During the last decade, the upheavals in the financial sector led to the collapse of seven building societies (see Annex 3). Today, there are 10 active societies with EABS being the largest and oldest. This sub-section provides a brief profile of EABS. More detailed statistics on this society and two other institutions, the medium-sized Prudential Building Society, and Family Finance Building Society, a small institution, are given in Annexes 4, 5 and 6, respectively.

EABS, which presently has 6 branches in the country, opened for business in 1959 following its registration the year before. It is licensed under the Building Societies Act and its main business is to mobilise savings for homeownership. In 1992 it also ventured into estate development after the Building Societies Act had been amended to allow direct participation in such business. It has already developed and sold 170 houses on Mombasa Road (Nairobi).

EABS collaborates with Akiba Loans and Finance -- though at "arms length" -- and estate developments by the latter are usually acceptable to EABS for end finance.

In 1991 the Society's mortgage assets stood at Ksh. 982.8 million up from Ksh.887.4 million the year before, and public deposits rose from Ksh 1.9 billion in 1991 to Ksh 2.4 billion in 1992, making EABS the second largest HFI.

3.5 Institutions Licensed under the Banking Act

There are two HFIs licensed under the Banking Act, the Housing Finance Company of Kenya, and Savings and Loan. Although government has equity interests in the two institutions, indirectly in the case of S&L, their behaviour resembles more that of private firms than parastatals -- hence their classification under the rubric of private institutions. What follows are highlights of the two HFIs but details are given in Section 4 and in Annexes 7 and 8.

3.5.1 Housing Finance Company of Kenya

Until 1992, when the company was partially privatised, HFCK's equity was jointly owned by, and equally divided between the government and CDC. Then, the company offered 18 million new ordinary shares to the public, an issue that was oversubscribed more than three times. The public now holds 39.2% of HFCK's share capital while the government and CDC own 30.4% each. The injection of new funds raised the company's nominal share capital from Ksh.140 million to Ksh.230 million. Although it is too early to determine what impact partial privatisation has had, the company appeared alert to the importance of performing to its shareholders' expectations.

The company's mortgage assets and public deposits stood at Ksh.3.2 billion and Ksh.3.4 billion in 1992, respectively, making HFCK the largest of the three principal HFIs in the country. Although lending for housing remains its core business, the company now also offers finance for a limited range of commercial properties. Soaring inflation has, however, compelled management to put a temporary stop to lending, a measure that has also been taken by other HFIs. In 1992 profits after taxation reached Ksh.71.5 million up from Ksh.42.4 million the year before. As investible funds have now been placed in high yielding government securities profits are likely to rise substantially in 1993.

As part of a policy to mobilise additional savings and extend customer service, two new branches were opened in 1993, in Kisumu and Meru. This brings to seven the total number of branches in the country. All branches are on-line with the mainframe computer at the head office thus ensuring cost-efficiency and a faster response to customers' needs. The company has a complement of well-qualified and experienced staff.

A wholly owned subsidiary, Kenya Building Society, acts as the property development arm. KBS has developed phases IV and V of Buru Buru Estate, and Koma Rock Estate on the outskirts of Nairobi. The company's clientele has traditionally been middle-income households but more recently, through the development of Koma Rock, the company has been able to reach home buyers in a lower-income band. There are also plans to revive another subsidiary, First Permanent, to offer mortgages exclusively to lower-income borrowers. While operational details of the subsidiary have not yet taken form it is envisaged that collateral requirements will be relaxed; and that cashflow-based techniques will be employed in a manner akin to practice in lending to small enterprises by commercial banks. This approach is grounded in the realization that low-income housing is a robust source of income and that its rate of return is high.

3.5.2 Savings and Loan

Before 1957, S&L was known as Savings and Loan Society. In 1969 it was licensed as a financial institution under the 1968 Banking Act and, in 1972, it was acquired by Kenya Commercial Finance Company, a wholly owned subsidiary of Kenya Commercial Bank (KCB). Later, it was acquired by KCB.

In 1992 the company advanced loans equal to Ksh 277 million raising its mortgage assets to Ksh.1.6 billion. That year, its public deposits stood at Ksh. 1.7 billion making it the third largest HFI in the country. Although housing finance continues to be its core activity the company does offer finance on a range of commercial properties.

3.6 Commercial Banks

Except for the long-term mortgage loans they make to their staff, commercial banks do not provide term finance to home buyers. In the context of this report, these banks are important for two reasons. The first is that they extend bridging finance to developers of residential property. The customary procedure is for a developer to secure the commitment of an HFI to provide long-term finance and, on the strength of such an undertaking, to approach a commercial bank for construction finance.

Second, commercial banks play an important role in financing rental housing, the predominant tenure in urban areas. Loans to finance investments in rental housing are usually short-term -- about 3 years -- with a roll-over facility in some cases. It has been observed that when made, these loans are ostensibly meant for other purposes but are diverted to rental housing because of the high returns that this tenure enjoys.[27]

[27] See Struyk, R.J. (1986)

3.7 Savings and Cooperative Societies

Although the cooperative movement has remained predominantly rural the recent past has seen a dramatic growth of urban-based savings and credit cooperatives (SACCOs). These are credit unions that provide savings and credit facilities to members. They are quite often formed by persons with a common bond, such as the same employer, and are to be found at practically all major institutions, public and private.

The number of SACCOs grew from roughly 130 in 1971 to over 2,000 in 1989, with Nairobi alone accounting for 50% of the total. The largest SACCO in 1988 was Harambee, with a membership of 84,000 civil servants and a share capital of Ksh.535.2 million. The other principal SACCOs, Afya and Ukulima, had a share capital of Ksh.322.0 million and 287.1 million, respectively[28].

Loans to members, almost invariably for periods not exceeding 36 months at an interest rate of 1% per month, increased from Ksh.5 million in 1971 to Ksh.7.6 billion in 1989. Loans were made for a wide range of purposes but the more important of these included the payment of deposits on houses and the purchase of plots. Indeed, a survey conducted in 1983 showed that the share of SACCOs in construction funds committed to housing was about 18%.[29]

Returns on SACCO investments, as reported in a 1984 study, tend to be low with some projects, such as office buildings, being undertaken more as a matter of prestige than as profitable enterprises.[30] This trend appears to have persisted.

A number of the larger SACCOs, such as Harambee, have also ventured into housing development. A recent project by that society, Ushirika Estate in Nairobi, consists of 326 maisonettes and flats selling for between Ksh. 850,000 and 1,540,000 per unit. Buyers are drawn from a wide cross-section consisting of members and non-members alike, although the latter must pay a higher price. Recently the society also advertised a site and service scheme, comprising nearly 1,400 plots in Nairobi, for sale to members. As plots will be sold outright, lower-income members are unlikely to benefit unless they are able to arrange for term loans from financial institutions. Were it operational, Cooperative Finance (see next sub-section) would have been well-placed to provide such loans.

In the main, developments by SACCOs have been financed with middle-income groups in mind. On the other hand, lower income groups have been catered for, though to a limited extent, by housing cooperatives affiliated to the National

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[28] Alila, P.O. et al. (1990)

[29] Rok (1983)

[30] UNCHS (1984)

Cooperative Housing Union (NACHU). NACHU is an apex technical services organization that promotes the development of low-income housing via cooperatives. Notable examples of projects it has sponsored are two small-scale upgrading projects in Kisauni and Freetown in Mombasa, and a project in Kariobangi in Nairobi where 108 small houses belonging to the Kariobangi Cooperative Society were built at a cost of about Ksh 15 million. An innovation proposed for the latter project is the cooperative housing mortgage which, if considered feasible, will be written by the Cooperative Bank of Kenya utilising its own financial resources as well as those of USAID and the National Social Security Fund.[31]

In principle, this mortgage instrument has a number of advantages: in a given project, it allows the writing of one mortgage thus making it unnecessary for several sales contracts to be prepared; and costs of land survey and registration of individual titles can be deferred as the pledge to repay is secured by one title. Transaction costs are held down further since information need not be collected on the creditworthiness of individual cooperative members; and where the cooperative is small, peer pressure is expected to motivate members to repay their loans promptly. Still, collective borrowing constrains the lender's recourse in the event of default as foreclosure cannot be applied selectively.

3.8 Cooperative Finance Ltd

Until recently the Cooperative Bank of Kenya was not allowed to make long term loans to cooperatives and could not therefore assist its members in house purchase. The establishment of Cooperative Finance Ltd, a subsidiary authorised to make long-term finance, will now make it possible for the Bank to participate in mortgage lending, albeit indirectly. CF is not yet operational and details were not available on its plans for the future. It is believed that it will promote the wider adoption of the cooperative housing mortgage referred to earlier, thus building on the pioneering work of the Cooperative Bank, NACHU and USAID.

3.9 Institutional Investors

Information on 10 major investors in the country, composed mainly of insurance companies, pension funds, and bank trustees, shows that they prefer investing in government securities and property to placing funds in equities, debentures or fixed interest deposits.[32] All together, these investors had under their management a fund amounting to Ksh. 42 billion in 1992. Their portfolios were structured as follows:

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[31] See Degroot, D. (1992) for more details

[32] CMA et al. (1992)

	% of Portfolio
Equities	10 - 30
Government Securities	20 - 60
Property	40 - 60
Debentures	10 - 15
Fixed Interest Deposits	10 - 30

There are no details on the type of property preferred but it is reasonable to suppose that because of its higher returns commercial property would have precedence over residential developments.

3.10 Major Employers

On the whole, private employers have been reluctant to get involved in developing housing for their workers. A recent exception is BAT which is developing some 840 dwellings in a medium income development on Mombasa Road (Nairobi) for sale to its staff and to members of the public. The average market selling price will be around Ksh. 820,000 (in 1993 prices) but a lower price will be offered to BAT workers. HFCK has agreed to provide end finance to qualified buyers.

This section has described the main private HFIs and other institutions whose operations have a bearing on housing finance In the section that follows we turn to an examination of the recent operations of HFIs in the context of current economic changes.

4. Recent and Current Operations of HFIs

4.1 Recent Macroeconomic Changes

November, 1991, was a watershed in Kenya's recent economic history. Then, donors suspended quick-disbursing aid, a measure that severely eroded the country's balance of payments. Over the next 18 months the value of the shilling depreciated rapidly against hard currencies as foreign exchange reserves all but ran out. The rate of inflation soared, fuelled by the cost of imported merchandise and a rapid expansion of money supply. In 1992, for instance money supply expanded by 35% outstripping substantially the nominal growth in GDP.[33]

External factors aside, the economy has been disrupted by civil disturbances in some districts, ongoing political reform, poor management and drought. As a result, annual GDP growth plunged to 0.4% in 1992, the lowest rate in three decades.

From the standpoint of housing finance, four related developments have assumed overriding importance since early 1993. The first is the very high rate of inflation;

[33] ROK (1993)

the second is the unprecedented level of returns on treasury bills and bonds; the third is the steep rise in principal interest rates; and the fourth is the rapid escalation of construction costs.

As noted earlier, inflation in 1993 is conservatively estimated to have averaged 40% but to have peaked at 100%. To arrest this trend, government has employed two principal measures. The first is the sale of high yielding bills and bonds. Yields on treasury bills peaked at about 73% in the second quarter of 1993 but have since fallen to around 50%. At the same time, the average yield on 1 year treasury bonds exceeded 60% in September. The second measure is the raising of the cash ratio[34], currently (November, 1993) standing at 12%. As we see later in this section, the very high returns on treasury bills and bonds have had a dramatic adverse impact on HFIs.

4.2 Sources and Cost of Funds

4.2.1 Sources

The main sources of funds in 1992 are shown in Table 4.1 for five HFIs. It will be seen that all of them rely predominantly on fixed deposits. Savings deposits are the next most important source followed by deposits placed by the NSSF. While housing development bonds (HDBs) and insurance companies are important sources for the larger HFIs, this is not the case for the smaller institutions. HDBs are fixed interest debt instruments secured by the mortgage assets of HFIs. They are issued only to individuals[35] and the maximum holding per individual is Ksh 500,000. Their maturities range from 3 to 60 months.

[34] This is the ratio of a bank's balances at the Central Bank to its net deposit liabilities.

[35] In the early years of their introduction HDBs could also be held by legal persons, such as limited companies and partnerships.

Table 4.1 Sources of Funds: 1992

Ksh. million

	EABS	%	HFCK	%	S&L	%	PBS	%	FFBS	%
Savings Deposits	614.2	25.6	688.6	21.0	418.2	24.3	34.8	3.5	51.0	39.4%
NSSF	250.0	10.4	1266.3[a]	38.6	274.0	15.9	200.0	19.8	20.0	15.4%
HDBs	145.0	6.0	219.1	6.7	198.4	11.5	0	0	0	0
Insurance Companies	150.7	6.3	-[b]		264.0	15.3	22.0	2.2	0	0
Other Fixed deposits[c]	1237.1	51.7	989.1	30.2	566.1	33.0	750.9	74.5	58.6	45.2%
Trust Funds	0	0	117.5	3.5	0	0	0	0	0	0
Total	2397.0	100.0	3278.6	100.0	1720.7	100.0	1007.7	100.0	129.6	100.0

[a] Long term deposits from various sources

[b] Insurance companies account for about 6% of total deposits -- separate figure not available

[c] Fixed deposits by individuals, companies, parastatals and local authorities.

Time series data for the five institutions show some interesting trends. First, HDBs appear to have declined in importance as a source of funds. For instance, S&L raised Ksh.276.6 million from this source in 1988 but only Ksh.198.4 million in 1992. Although the nominal figures for EABS have seen little change over the last five years this source fell in relative importance. The team was informed that the decline of HDBs as a source of funds is explained by the introduction of withholding tax on interest earned; by their non-transferability; and also by the ineligibility of limited companies and partnerships to invest in such bonds.

A second trend, as shown in Table 4.2, is that the three principal HFIs have by far been more successful than the PBS and FFBS in mobilising household savings. Of the latter two, on the other hand, FFBS has mobilised more savings in spite of its much smaller size in terms of total deposit liabilities.

Table 4.2 Mobilisation of Household Savings: 1988 - 1992

Ksh million

	1988	1989	1990	1991	1992
EABS	502.4	549.6	577.7	342.4	614.2
HFCK	414.4	465.4	520.2	619.7	688.6
S & L	220.0	268.0	302.4	362.2	418.2
PBS	11.3	15.6	22.7	25.3	34.8
FFBS	26.1	25.0	35.6	39.0	51.0

Funds available to HFIs -- with the exception of PBS and HFCK -- were predominantly of short maturity as shown in Table 4.3.

Table 4.3 Maturity Structure of Deposits: December 1992

	Percentages				
	EABS	HFCK	S&L	PBS	FFBS
Upto 1 year	91	54	63	23	100
1 - 5 years	9	10	37	8	0
6 - 10 years	0	)	0	69	0
11- 15 years	0	) 36[a]	0	0	0

[a] This is made up of long-term deposits, some of which are repayable over 10-15 years while others have no maturity.

4.2.2 Cost of Funds and Lending Interest Rates

Between 1988 and 1992 interest rates on fixed deposits, the main source of funds, rose gradually from around 11-14% to about 15-18%. On the whole, EABS and FFBS tended to offer the higher rates. Interest rates on housing development bonds were marginally lower, growing from 10-12% in 1988 to about 16.5% in 1992; and savings deposits attracted the lowest rates ranging from 10-11% in 1988 and 12-14% in 1992.

Lending rates increased steadily from about 14.5% in 1988 to around 21% in 1992, giving HFIs a margin of at least 3% on the cost of funds. Contrary to expectations, lending rates did not rise steeply following the abolition of interest rate controls in July, 1991.

In the years leading to 1991, real interest rates on building society loans were positive, turning negative that year as a result of soaring inflation and the difficulties of instituting a corresponding adjustment to interest rates. Table 4.4 gives the relevant figures.

Table 4.4 Real Interest Rates on Building Society Loans: 1988-1992

Percentages			
Year	Nominal Interest (Maximum)	Inflation Rate	Real Interest
1988	14.5	12.3	2.2
1989	18.0	13.3	4.7
1990	19.0	15.8	3.2
1991	19.0	19.6	-0.6
1992	21.0	27.5	-6.5

Source: 1993 Economic Survey

In 1993, the dramatic macroeconomic changes described earlier had a severe impact on the mortgage industry. First, real interest rates turned sharply negative as nominal rates lagged substantially behind the rate of inflation. HFIs interviewed pointed out that it was pointless to raise lending rates above 25% as there would then be little demand for loans and arrears would mount.[36] Second, the very high yields on treasury bills not only induced a movement of funds away from HFIs but also raised the cost of funds: it was reported that major depositors were unlikely to roll-over their funds unless they were offered rates in the region of 40%. The outflow of deposits was spurred further by the sale of treasury bills in denominations as low as Ksh 50,000 (nominal value). Third, construction costs accelerated, placing projects in the pipeline in jeopardy. In the 3rd quarter of 1993 HFIs responded to these adverse conditions by suspending lending.

4.3 Portfolio Diversification

As HFIs lend long and have limited sources of long-term funding, they may be expected to maintain a high degree of liquidity in order to protect themselves against

[36]However, various fees charged by HFIs raise the effective lending rate.

the risk inherent in the maturity mismatch between their assets and liabilities. Table 4.5 shows the diversification of HFI portfolios in 1989 and 1992.

Table 4.5 Portfolio Diversification: 1989 and 1992

Percentages

		EABS[a]	HFCK	S & L	PBS[b]	FFBS
Cash	1992	1.1	0.9	0.4	14.0	2.5
	1989	0.9	1.1	0.1	1.6	8.9
Treasury bills and bonds	1992	3.0	1.0	8.6	7.7	0
	1989	3.6	2.3	2.4	0	0
Short-term investments	1992	39.4	15.1	0.6	31.5	26.1
	1989	41.5	14.0	10.8	35.8	18.2
Stocks and shares	1992	1.9	0.2	0.1	0	0
	1989	2.4	0.3	0.1	0	0
Mortgages	1992	42.5	77.2	88.1	46.8	71.4[c]
	1989	44.7	68.9	85.7	2.6	72.9[c]
Others[d]	1992	12.1	5.6	2.2	0	0
	1989	6.9	13.4	0.9	0	0

[a] Figures are for 1991; [b] Figures are for 1993; [c] Short-term loans; [d] Includes buildings, land and equipment.

The table reveals some interesting patterns. Among the three principal institutions, EABS had the largest holding of liquid investments[37] and cash -- 45.4% in 1992 and 48.4% in 1989. The respective figures for HFCK and S&L are much lower. Conversely, the latter two hold a much larger proportion of their portfolios in mortgages: 77.2% for HFCK and 88.1% for S&L in 1992.

The share of mortgages in PBS' portfolio in 1989 was 2.6%, jumping to 46.8% in 1993. The low figure for 1989 is explained by the PBS having been in operation for only 3 years and therefore in the early stages of building up its mortgage portfolio. Its cash holding had also risen substantially by the latter date, standing at 14.0%, a level that must have restrained the society's profitability. A significant proportion of PBS's portfolio was in treasury bills and bonds in 1993, reflecting the increasingly higher returns commanded by these securities. Figures for 1993 are not available for the other institutions but discussions with HFIs revealed that investments in such securities had gone up. It will also be observed that stocks and shares are not very popular: they accounted for about 2% of EABS' portfolio in 1992 and for a substantially much lower figure in the case of HFCK and S&L. These levels are markedly lower than the 10-30% favoured by the 10 major investors referred to in Section 3.9.

Overall, the figures demonstrate that HFIs in the country hold a significant part of their portfolio in liquid investments.

[37] Comprising treasury bills and bonds, short-term investments, and stocks and shares.

4.4 Operations

4.4.1 Lending

The three major HFIs and PBS typically make variable rate mortgages for 15 years. The minimum residential loans made in 1992 were Ksh 200,000 by both EABS and S&L, Ksh 250,000 by HFCK and Ksh 800,000 by PBS. The monthly payments implicit in these minimum loans were not affordable by an urban employee earning a median wage, that is, about Ksh 2,000 per month.[38] Assuming an interest rate of 21%, a 10% deposit and level payments, the monthly repayments are as follows: EABS and S&L: Ksh. 3,340; HFCK: Ksh. 6,350; PBS: Ksh. 13,365. To afford these repayments, homebuyers would need to have monthly incomes ranging from Ksh 13,360 to Ksh 53,460 assuming that 25% of income is committed to housing. Although the minimum loan for FFBS was Ksh 20,000 its loans are almost invariably for land purchase and are restricted to a term not exceeding 3 years and in many cases to 1 year.

Table 4.6 demonstrates further that lower income groups do not have access to loans made by HFIs: it shows the distribution by size of loans made in 1992 by HFCK, S&L, PBS and FFBS.

Table 4.6 Distribution of Loans by Size: 1992

Percentages

Loan Size:Ksh	HFCK	S&L	PBS	FFBS
Up to 250,000	3.0	15.3	0	94.0
250,001 - 500,000	8.0	24.5	0	4.0
500,001 - 750,000	54.7	13.6	0	0
750,001 - 1,000,000	26.7	9.1	0.4	2.0
More than 1,000,000	7.6	37.5	99.6	0
Total	100.0	100.0	100.0	100.0
n*	787	339	245	50

* n represents the total number of loans in each case.

PBS had the most skewed distribution of loans by size, with practically all its loans exceeding Ksh 1 million. Although FFBS had the highest proportion of loans in the lowest loan bracket its lending term, as mentioned earlier, is limited to no more than 3 years. Of the other two HFIs, S&L had the higher proportion of loans in the highest loan bracket; and HFCK loans approximated a bell-shaped (i.e. normal) distribution. All together, the four HFIs made just over 1,400 loans in 1992, a highly limited number relative to the 100,000 dwellings required in urban areas every year.

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[38] RoK (1991)

In terms of geographical distribution, Nairobi gets the major share of loan funds, indeed to an extent very much out of proportion with its share of the total urban population, which is about 45%. Table 4.7 shows the distribution of loan amounts by town in 1991 and 1992.

Table 4.7 Geographical Distribution of Loans: 1991 and 1992

Percentages

Town	Year	EABS*	HFCK	S&L*	PBS	FFBS
Nairobi	1992 1991	89.8 92.8	93.6 90.8	78.2 78.5	100.0 100.0	62.7 46.5
Mombasa	1992 1991	7.8 6.0	2.4 3.6	5.0 5.4	0 0	0 0
Kisumu	1992 1991	2.4 1.2	0.5 0.4	6.0 5.8	0 0	0 0
Eldoret	1992 1991	0 0	0.8 0	5.1 4.8	0 0	0 0
Nakuru	1992 1992	0 0	2.1 2.7	3.2 2.9	0 0	0 0
Other towns	1992 1992	0 0	0.6 0.5	2.5 2.7	0 0	37.3 53.5

* Figures refer to the distribution of mortgage assets.

It will be seen that with the exception of FFBS, HFIs confine their lending almost exclusively to Nairobi. For its part, FFBS is typical of the small building societies that started business in the 1980s, supported to a significant degree by rural savings derived largely from coffee and tea sales. It therefore has a strong rural affiliation and, naturally, a substantial proportion of its loans goes to borrowers in small towns.

4.4.2 Mortgage Administration

Interviews with some HFIs revealed that mortgage administration was becoming increasingly difficult as a result of rising interest rates. When loan repayments are adjusted to take account of the higher rates of interest, a significant number of borrowers are not able to pay the new instalments. This has led to substantial increases in arrears in the past two years. Moreover, high inflation has put pressure on household budgets and therefore contributed to rising arrears even in those instances where interest rates have not been revised.

Foreclosure has not been the answer as it has not been easy to sell the repossessed properties in public auctions, especially on account of the temporary stop in lending.

S&L suggested counselling the defaulters as one way of alleviating the problem: alternatives were to extend the repayment term or to ask the borrower to occupy the property as a tenant after the order for repossession has been granted.

4.5 Main Findings and Conclusions

The analysis in the previous two sections leads us to the following findings and conclusions:

a) The impact of recent economic changes has been severely adverse, forcing HFIs to suspend lending. In particular, the cost of funds has outstripped interest rates on the existing mortgage portfolios. There has also been an outflow of deposits from HFIs, triggered by the very high returns on treasury bills and bonds.

b) The introduction of high yielding treasury bills had the effect of inverting the yield curve -- in other words, short-term investments started commanding higher yields than longer- term investments.

c) In spite of the liberalization of interest rates in 1991, real rates on HFI mortgage portfolios have been negative since then -- this has been brought about by the very high rates of inflation and the impracticality of adjusting lending rates to match inflation levels.

d) There are no formal interest rate "caps" on mortgage lending but HFIs have not found it practical to raise lending rates much beyond 25% fearing that arrears on existing loans would go up.

e) The principal HFIs restrict their lending primarily to a small number of middle- and high-income groups in Nairobi and are therefore unlikely to act as an effective vehicle for extending housing finance to lower-income groups. S&L is somewhat atypical in that it makes loans of a smaller size and has slightly larger lending programmes in other main towns besides Nairobi.

f) Although the mortgage industry has traditionally been dominated by three HFIs, the rapid growth of PBS will soon allow that society to challenge this dominance.

g) The supervision of HFIs is irregular and ineffective. There is also ambiguity in how the role of supervising building societies is shared between the Registrar of Building Societies and the Central Bank.

h) The proliferation of building societies in the 1980s was followed by a drastic reduction in number as societies succumbed to poor management, the outflow of deposits spurred by political interference and ineffective supervision.

i) There are divergent views on whether HFIs should have their operations restricted to mortgage lending and directly related activities or whether they should be permitted to expand into some of the areas currently reserved for commercial banks.

j) HFIs rely predominantly on short-term deposits -- with a maturity of up to one year -- and are therefore compelled to maintain high levels of liquidity.

k) Housing development bonds have declined in importance as a source of funds, largely because of the introduction of withholding tax on interest earned.

l) Although it is too early to establish the effect of partial privatisation on the operations of HFCK, the company is alive to the need to satisfy the expectations of shareholders.

5. Main Issues and Recommendations

5.1 Introduction

Previous sections of this report have discussed formal housing finance in the context of public policy, the institutional framework and the economy. In particular, the severe effects of recent economic changes have been noted.

The purpose of this section is two-fold. The first is to pull together the main issues and constraints that underlie formal housing finance. The second is to make recommendations that will allow a programme of action to be embarked upon.

Given the present volatility of the economy, two perspectives will be distinguished. The first is the short-run -- extending for a year or so -- during which the key issues will continue to centre on inflation, the interest rate regime and the returns on treasury bills and bonds. The intention here is not to discuss the wider issues that surround the recent economic upheavals but to focus on the consequences for housing finance. The second perspective will concern itself with issues that are endemic to the housing finance sector and which will need to be addressed on a continuing basis.

5.2 The Short-run

The overriding issues in the short-run are the very high rates of inflation and interest, and the unprecedented yields on government paper. Recent movements in these variables have had a number of severe impacts on housing finance, which we shall recapitulate. First, HFIs have had to suspend lending, choosing instead to place their loanable funds in high yielding treasury bills and bonds. Second, for similar reasons, many investors have withdrawn some of their deposits from HFIs and invested them in these securities. Third, rapidly rising construction costs have undercut residential developments in the pipeline -- in one case a building society elected to sell serviced plots, instead of proceeding with full development, as there no longer was a good market for complete dwellings. Fourth, the demand for mortgage loans has fallen sharply in response to high interest rates.

It appears unlikely that mortgage lending will resume on a significant scale until inflation has been curbed and interest rates around 20-25% start yielding a real return. There are no reliable projections as outcomes will depend on the consistency and effectiveness of government measures to stabilise the economy; and on the extent to which donors will release quick-disbursing aid following the lifting of the aid embargo in November, 1993. An earlier projection by the Ministry of Finance that the inflation rate would fall below 10% by the end of 1993 proved to be too optimistic and some analysts now expect it to be around 25% in 1994.[39] In the event, mortgage lending will resume but it will be some time before pre-1993 levels

[39] BIU (1993)

are attained. If high interest rates persist, it is unlikely that HFIs will be able to embark on full-scale lending.

5.3 Long-standing Issues

Beyond these immediate concerns there is a wide range of other issues which have a longer-term perspective and which will need to be addressed on a continuing basis. It is to these that the report now turns.

5.3.1 Redefining the Role of the NHC

Until comparatively recently the public sector played a major direct role in housing provision, an approach which is increasingly being called into question. With the recent onset of economic difficulties, government has not found it feasible to maintain previous levels of budgetary support to housing. Consequently, the ability of the NHC to finance its projects has been severely impaired. Moreover, local authorities are so financially handicapped that they are not able to expand their housing stock. In any case, as we saw in Section 3, public housing programmes have been undermined by indifferent loan servicing, and arrears have risen dramatically. By contrast, arrears in the private sector, as exemplified by HFI mortgage loans, have been modest.

It is doubtful, therefore, whether conventional public housing projects are sustainable, a question that brings into sharp focus the need to redefine the roles of the public and private sectors. A strategy that is gaining wider acceptance calls for the scaling back of the direct involvement of public agencies in construction. Accordingly, they would concentrate on the regulation of development activities meant to improve the functioning of housing markets; and on the provision of infrastructure. In turn, the construction/development role would be assigned to the private corporate sector, cooperatives and individuals.

However, these general principles need to be framed in specific and concrete terms in order to make them implementable. In doing so, it would be naive to expect the NHC, the main public housing institution, to surrender its role to the private sector. What follows, therefore, is a proposal on how the role of the NHC could be redefined so that corporation can make an effective contribution to housing delivery.

With the falling off of subsidised loans from the government and the financial burden imposed by local authority arrears, the NHC is at a cross-roads. Unless it re-defines its role it will cease to be an important player in the housing sector. This report has argued that the Corporation's plans to establish a financial subsidiary are unlikely to be viable, especially given the current economic environment, the NHC's lack of commercial experience and the regulatory framework to which it is subject.

The point of departure in recommending change is to recognise the NHC's dual role -- that of developer and provider of long-term finance. The combination of these roles, particularly in a parastatal, is not conducive to the attainment of cost-efficiency.[40] This is so because the Corporation presently provides subsidised ownership finance for all its developments -- with the exception of dwellings for sale via HFIs -- and is therefore under little pressure to be cost-competitive. Moreover, the NHC has performed poorly in its role of long-term financier, as the level of arrears on its loans amply demonstrates.

These reasons strongly suggest that the two roles should be separated so that the Corporation retains the role of developer, surrendering that of long-term financier to the private sector.

In its role of developer the NHC should give priority, not to conventional housing for sale, but to the provision of infrastructure services, both to public and private residential land. Where there is little public land, especially in the main towns, the NHC should enter into joint-ventures with private land owners. The details of such ventures would need to be worked out and technical assistance for this purpose could be provided by international agencies, such as USAID and Shelter Afrique. In particular, international experience on land pooling and land re-adjustment models should be studied with a view to applying it locally.

As soon as they become operational, Cooperative Finance Ltd and First Permanent could be expected to extend term-finance to beneficiaries of NHC programmes. Thus, together with other HFIs, they would assume the Corporation's present role of long-term financier.

A number of measures should be taken to help the NHC make a success of its redefined responsibilities. First, government should convert its existing loans to the Corporation into income notes, i.e. loans with no redemption date. While this move would not give the NHC immediate financial relief, because of its poor loan recovery, it would be beneficial in the longer-term since the underlying interest rates are highly subsidised. Second, the NHC ought to sell-off its existing rental housing stock in order to raise additional funds. Third, international agencies should provide technical assistance to the NHC, especially in the design of joint-venture agreements with private land owners.

In summary, we recommend that the NHC surrender its role of long-term financier to the private sector and instead concentrate on providing infrastructure services to public and private residential land. We further recommend that technical assistance be given to the Department of Housing to prepare a national housing strategy setting out, among other things, practical mechanisms for expanding the role of the private sector in housing development. USAID, UNCHS and Shelter Afrique are well-placed to provide such assistance.

[40] There is evidence, for instance, that construction costs per square metre in recent NHC projects at Kibera and Pumwani in Nairobi were substantially above industry norms.

5.3.2 Targeting Low-Income Groups

A major barrier to effective shelter delivery has been the reluctance, as we have already seen, of HFIs to extend loans to lower-income groups. A number of factors have contributed to this state of affairs: small loans are relatively more expensive to make than larger ones; in the eyes of some HFIs, dwellings affordable by lower-income groups have a limited life and, as a result, pose a greater credit risk than higher-income dwellings; and the mortgage industry is not competitive -- there are only four principal institutions (including PBS) -- as a result of which the industry has been slow to innovate.

Although many sound arguments have been put forward to demonstrate that loans to lower-income groups can be profitable, our investigations strongly indicated that the mainstream HFIs are unlikely to accommodate this category of potential borrowers in their lending programmes. One exception to this is HFCK which intends to revive its subsidiary, First Permanent, primarily to make loans to lower-income groups. However, it will be some time before this subsidiary is fully operational. Another promising avenue is Cooperative Finance Ltd but again it is not yet operational. These institutions, once they start lending, will be well-placed to provide long-term ownership finance to beneficiaries of programmes by the NHC and NACHU. ***We therefore recommend that, at the right time, they be considered for local loans to be guaranteed by donors. To enable them to mobilise savings they should also be given authority to issue negotiable certificates of deposit.***

5.3.3 Finance for Rental Housing

Renting, as pointed out earlier, is the predominant form of urban tenure. Yet the emphasis in the financial sector has been on ownership finance. As returns on lower-income rental housing investments are quite high, a strong case can be made for short-term loans -- not exceeding 5 years -- to individuals and corporate developers to finance such housing. One advantage of short-term loans is that limited funds can be recycled faster as a result of which a larger group of people would benefit. ***We recommend that, when appropriate, First Permanent and Cooperative Finance be given access to local loans to be guaranteed by donors.***

5.3.4 Regulation and Supervision

The failure of financial institutions is a matter of considerable concern as it tends to erode the confidence of the public in the financial system. To be sure, business failure is an inherent part of economic enterprise, especially where private firms are neither able to manage risk nor to make profits in the long-term. By regulating and supervising financial institutions, central government authorities try to ensure compliance not only with acceptable prudential standards but also with wider public policy.

The team formed the strong view that while the supervisory framework is satisfactory, its application is neither consistent nor effective. First, the supervision of HFIs appeared to have been given a lower priority than that of commercial banks ostensibly because the latter are considered more strategic; moreover, both the Central Bank and the Registrar of Building Societies are short of qualified staff. Second, there is some ambiguity on how the responsibility of building society supervision is being shared between CBK and RBS. Third, the quality of HFI assets and mortgage underwriting standards are not subject to much scrutiny, leaving substantial room for abuse.

As regards regulation, the environment in which HFIs operate is now more liberal than has hitherto been the case: interest rates are now decontrolled; and building societies can undertake residential development directly. Still, HFIs are required to comply with certain prudential requirements set by the Central Bank; to restrict lending to not more than 90% of the property value; and not to engage in transactions normally confined to commercial banks, such as dealings in foreign exchange and operating current accounts. The smaller HFIs are also not allowed to issue housing development bonds and this puts them at a disadvantage in savings mobilisation.

Unlike building societies, HFIs licensed under the Banking Act are required to become members of the Deposit Protection Fund (DPF). The Act makes provision for institutions to be surcharged if their affairs are conducted in a manner detrimental to the interests of depositors: the intention here seems to be to give protection against the problem, well-known in insurance, of moral hazard.[41] Institutions consulted reported that they had not been consulted on matters relating to the management of the DPF, nor had there been sufficient feedback on the operations of the Fund.

Following from the above our recommendations are as follows:

- ***On-site and off-site supervision of HFIs ought to be made more consistent and regular.***
- ***HFIs should make more effective use of their trade association, the Kenya Union of Housing Finance Institutions, to ensure that constraints on their operations are kept under constant review by supervisory and regulatory authorities.***
- ***The ambiguity in the supervision of building societies should be resolved.***
- ***Smaller HFIs should be allowed to issue housing development bonds.***

5.3.5 Subsidies

There are deeply entrenched subsidies in the housing sector, mainly in the form of below-market rents for local authority housing, below-market interest rates on home

[41] For instance, the HFI could engage in more risky undertakings than would be the case in the absence of deposit insurance -- hence the penalty in the law to curb such behaviour.

ownership loans made by the NHC and by local authorities, tax savings enjoyed by owner-occupiers and write-downs on public land. The taxation of land, which is based on unimproved site value, introduces yet another subsidy.

As they are not well-targeted, these subsidies are often confined to households other than those in the lower-income strata and are therefore inequitable. Moreover, as valuation rolls are not updated regularly, the taxation of land on the basis of unimproved site value promotes the holding of land for speculative purposes and therefore frustrates the allocation of such land to its best use.

We recommend that:

- ***In the short-run, local authorities should raise their rents to market levels.***
- ***In the longer-term, local authorities should privatise most of their rental housing stock via sales to individuals and cooperatives. The revenue from sales could go towards settling NHC arrears and financing infrastructure services. International agencies, such as USAID, UNCHS and Shelter Afrique should be approached for technical assistance on how privatisation ought to proceed.***
- ***Tax benefits to owner-occupiers ought to be reviewed with a view to making them more equitable.***
- ***In disposing of land, public agencies should employ market prices. Further, rating should be based on improved site values.***

5.3.6 Secondary Mortgage Market

In the last decade efforts to establish a formal secondary mortgage market have not succeeded and debate concerning the merits of establishing such a market has largely been inconclusive. Proponents of a secondary market have, in their favour, the well-known advantages that secondary trading brings about: enhancing liquidity; containing the risk of "borrowing short" to "lend long"; and offering the investor a secure and profitable area of investment.

Opponents have countered that of greater priority, at the moment, is the need to improve the primary mortgage market, e.g. by cutting down on HFI administrative costs; ensuring that loans can be foreclosed promptly, where necessary; introducing innovative mortgage instruments that broaden the access of lower-income groups to housing finance; and improving the regulatory and supervisory regime so that smaller HFIs can prosper.

Interviews conducted by the study team showed that while the introduction of a secondary mortgage market hinges critically on the initiative of the principal HFIs these institutions do not see the immediate need for such a development, a perception that is not difficult to apprehend. First, the larger HFIs do not experience liquidity problems as they are able to attract deposits from institutional and other investors with little difficulty; and where they are forced by circumstances they are able to borrow using part of their extensive mortgage portfolios as collateral.

Second, cashflows from their assets allow the principal HFIs to maintain a credible level of lending, especially considering that they restrict themselves to a narrow band of middle- and higher-income housing. Third, secondary mortgage markets are not well-understood and this acts as a real barrier to their endorsement by HFIs. Fourth, the present and prospective economic environment makes such a market unfeasible as government securities, fixed deposits and investments in commercial property give better yields without compromising security.

The Capital Markets Authority put forward a number of important points to the study team. One is that the market for long-term securities is very thin. Another is that there is a case for establishing a new institution, preferably with external backing, that would mobilise housing finance via the issue of convertible debentures of short maturity. However, such securities would lose their attraction unless they were to be exempted from stamp duty upon transfer. Lastly, the development of a formal secondary market is contingent upon the establishment of independent merchant (i.e. investment) banks, of which there are none.

This gloomy outlook aside, it is worth reporting that the first mortgage brokerage firm opened for business about two years ago. One of its objectives is to promote the growth of a secondary mortgage market and it has already conducted seminars on the subject. In addition, the firm has prepared a mortgage document that could form the basis for standardization in the future. The firm also reported that it was in a position to attract foreign investors but foreign exchange controls were a real bottleneck

A practical first step towards creating a fully fledged secondary mortgage market is to start a discounting facility at the Central Bank that would allow HFIs to sell some of their mortgages. This recommendation has been made in previous other studies but no action has been taken.

We also recommend that seminars on secondary mortgage markets be held from time to time, with HFIs and other financial institutions as participants. This measure would raise the level of understanding on how such markets work and would prepare the ground for their eventual introduction.

5.3.7 Non-Financial Issues

There are a number of non-financial issues that constrain mortgage lending. These mainly have to do with the granting of planning approvals by local authorities and the conveyancing of land by the Ministry of Lands and Settlement. It was the view of HFIs that these processes are frustrating, time consuming and, therefore, costly.

A previous study made a number of observations which are as valid today as they were then, namely:[42]

- that although the building code requires that a decision on a planning application be made and communicated to a developer within one month, the process could take as long as two years;
- that there is no effective machinery for appealing against a local authority decision to reject a planning application;
- that the approval to sub-divide land is not given unless unauthorised structures are first demolished, which discourages cooperatives and land-owning companies from applying for sub-division approval.

The team learnt that administrative difficulties -- in particular the establishment of a registry -- had impeded the application of the recently enacted Sectional Titles Act. As a result, sales of flats by HFIs were based on sub-leases and not on leases under that Act.

We recommend that technical assistance be given to the key local authorities and the Department of Lands in order to help them streamline procedures relating to planning approvals and land conveyancing. An important area on which technical assistance could focus is the development of computerised databases for use by planners and land administrators.

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[42] Saad Yahya and Associates et al. (1983)

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Annex 1

Terms of Reference
Overview and Analysis of the Kenyan Housing Finance Sector

Background

The housing finance sector in Kenya has experienced considerable change in recent years. As has the entire economy, it has been buffeted by a myriad of forces that have produced substantial strains and transformed its structure. After a period in which there was a proliferation of private building societies, a near collapse of the industry resulted in the demise of a dozen or more societies whose holdings were assumed by the Consolidated Bank of Kenya in 1992. Currently the sector is dominated by three active societies: the private East African Building Society; the Housing Finance Company of Kenya (HFCK) which made its first offering of public shares in 1993; and Savings and Loan, a subsidiary of the Kenya Commercial Bank.

The former USAID Regional Housing and Urban Development Office (RHUDO) for east and southern Africa was actively engaged with the housing finance in an ultimately frustrated effort to implement a private sector housing project. After substantial investments in project preparation through technical assistance, training and developmental studies, the effort was abandoned. Changing economic and financial circumstances in Kenya precluded a hard currency borrowing under the USAID Housing Guaranty (HG) Program and made a low-cost housing mortgage program unattractive to the building societies. The project preparation efforts were discontinued in 1991 with the deauthorization of the outstanding HG authority.

USAID remains interested in the potential for progress in the housing sector and, in particular, in housing finance as a vehicle for improving the ability of the country to produce low-cost shelter. The Urban and Infrastructure Division of REDSO/ESA, which is responsible for the former RHUDO portfolio, continues to support the work of the African Union of Housing Finance Institutions (AUHFI). Through the AUHFI, USAID has been able to maintain its involvement in the sector throughout the region, helping to influence government policy and to improve the capacity of the private institutions.

Although Kenya remains ineligible for new borrowing under the HG program, REDSO/UID continues to be involved with the government and private institutions in dialogue on shelter policy and in the funding of pilot projects, such as the Kariobangi upgrading scheme, all of which ultimately involve finance. Moreover, there is potential for a HG program that would provide for a guaranty of local currency rather than require a hard currency borrowing. With these interests in mind, and given the dramatic recent changes in the sector, REDSO/UID requires an analysis of the current state of housing finance in Kenya as a basis for contemplating future project activities. The analysis will also serve simultaneously as a form of support for the program of the AUHFI.

Article I -- Title

Overview and analysis of the Kenya Housing Finance Sector.

Article II -- Objective

The objective of this contract is to provide a current assessment of the state of the housing finance sector in Kenya, its ability to meet the housing demand of the country, and its potential to play a significant role in the achievement of the National Housing Strategy, in particular with respect to low-cost shelter.

Article III -- Statement of Work

To achieve the objective of this consultancy, as described above, the contractor will provide staff and support resources as required to accomplish the following tasks:

A. The contractor will prepare a comprehensive history of the housing finance sector in Kenya, covering both public sector involvement in the field and the history and growth of the private mortgage industry.

B. The contractor will analyze the growth of the industry and the proliferation of private building societies through the mid to late 1980s and the subsequent collapse of the societies, explaining as best as possible the broader economic and regulatory issues that produced the erratic patterns of growth and decline. This shall include analysis of the creation of the Consolidated Bank and the role it now plays in the finance sector to the degree that it affects housing finance. To the extent possible, this analysis shall be based on existing published material from the building societies, banks, government agencies, and donors.

C. The contractor will provide a comprehensive analysis of the current institutions in the sector, describing their sources of funds and cost of borrowing, the compositions of their mortgage portfolios, their organizational structures and operational procedures, and other such factors as are appropriate. This analysis will, to the extent possible, cover all financial institutions active in Kenya that engage in mortgage lending, plan to do so, or could be expected to do so under the right circumstances, including the Co-operative Bank of Kenya and commercial banks.

D. The contractor will analyze the current economic, regulatory and financial situation in the country insofar as they affect the viability of the housing finance institutions, their ability to compete for savings and investment, and their ability to lend profitably. This analysis will include an examination of various sources of funds going into the sector and potential sources that could be attracted to it under the right incentives.

E. Based on the above, the contractor will assess the future of the housing finance industry and its viability as a contributor to the achievement of the shelter sector objectives of the country. The contractor shall suggest alternative programmatic options for the sector and ways in which the donor community could intervene to support its ability to provide low-cost housing finance.

Article IV -- Reports

The contractor will prepare a final report of its work, which shall be a complete presentation of all the work completed under this contract. In addition, the contractor shall prepare a supplementary report,suitable in length and content, for presentation and distribution at the 1993 Annual Meeting of African Union of Housing Finance Agencies. Five (5) copies of the draft reports shall be submitted for review and discussion with USAID. Within five days of the receipt of USAID comments on the draft, ten (10) copies shall be submitted in final. The final version shall include an executive summary.

The contractor shall meet with USAID staff and other designated by the Project Officer at least three times during the course of the work: at its inception to receive an orientation briefing; at the midpoint to review the work; and for a final briefing at the completion of all work tasks.

Article V -- Relationships and Responsibilities

The contractor will work under the general supervision of REDSO/UID. The responsible USAID official shall be the Regional Housing and Urban Development Officer. The contractor shall collaborate and coordinate closely with Mr Walter Mukuria, Managing Director of the Housing Finance Company of Kenya and Chairman of the African Union of Housing Finance Institutions, and with the Kenya Union of Housing Finance Institutions during the execution of this work.

Article VI -- Terms of Reference

The assignment is expected to commence on or about August 15, 1993 and to complete not later than December 15, 1993. The special report presentation at the AUHFI Annual meeting shall be submitted in draft not later than September 30, 1993 and in revised form following receipt of comments from the Project Officer, not later than October 8, 1993.

Article VII -- Work Days Ordered

A total of 20 work days is ordered for this assignment for a senior housing finance specialist, who must be familiar with the Kenya housing finance system and who will serve as team leader. With the concurrence of USAID, the time may be split between two housing finance specialists. Up to 10 days of time may be performed by an urban economist working on the team. The work will also require 10 work days of research assistants to support data collection and basic analyses.

Annex 2

National Housing Corporation

(a) Establishment and Objectives

The National Housing Corporation was established in 1966 as the successor to the Central Housing Board, following a recommendation by a UN mission to Kenya.[1] In the terms of its governing legislation, the Housing Act (Cap.117), the NHC is empowered to lend or grant money to local authorities for purposes of housing development; to make loans to companies, societies and individual persons for the purpose of developing housing; and to construct dwellings, carry out approved schemes and lay out and provide services for approved housing schemes.

(b) Policy Framework

The NHC operates within a policy framework developed by the ministry responsible for housing -- presently the Ministry of Public Works and Housing. First set out in Sessional Paper No. 5 of 1966/7 housing policy is usually updated by in the various national development plans. Its essence is to require the NHC to give priority to housing for lower-income groups. In addition to its primary mission the NHC has found it necessary to support middle-income housing for sale via long-term mortgage loans made to individuals either by itself or by private HFIs.

(c) Project Financing

The Corporation has traditionally employed four methods to finance housing. Under the first method it makes a direct loan to a local authority, which in turn acts as the developer. The local authority is then responsible for collection of rents (in respect of rental housing) and loan repayments by tenant purchasers (in respect to tenant purchase housing) and remitting debt charges to the NHC. This financing method is commonly applied to the principal local authorities, primarily Nairobi and Mombasa.

Under the second method the NHC acts as the developer on behalf of a local authority. Upon project completion a loan equivalent to the project cost is made to the local authority. As in the previous case, the local authority is responsible for meeting debt charges. This method is generally applied to the smaller local authorities which do not have the requisite capacity for project planning and implementation.

The third method sees the Corporation acting as its own developer and is commonly employed to finance tenant purchase projects. The NHC enters into tenant purchase agreements with individual beneficiaries allowing it to collect debt charges. This

[1] See Bloomberg, L.N. and Abrams, C. (1965)

method has recently been applied to two tenant-purchase projects in Nairobi, Nyayo Estate in Kibera and another in Pumwani.

Under the fourth method the NHC acts as a developer but does not provide term finance to buyers, arranging instead for long-term mortgage loans from HFIs, usually the HFCK. Upon the conclusion of sales agreements the NHC recoups its development outlay which is then applied to other projects. There is no budgetary provision in the government's annual development estimates for this type of financing.

(d) Past Programmes

Between 1965 and 1989 the NHC financed over 42,000 dwellings, acting either directly or indirectly via local authorities. This number was made up of 12,060 rental dwellings (28.5%), 8,330 tenant purchase units (19.7%), 19,770 sites and services plots (46.6%) and 2,180 dwellings for sale on mortgage terms (5.2%). In all, total expenditure amounted to over K£67 million with about 26% going to rental projects, 17% to tenant purchase schemes, 30% to sites and services projects and 27% to dwellings for sale on mortgage terms.

(e) Sources and cost of funds

The Corporation depends almost entirely on the exchequer for loans to finance its projects. It has also benefitted from previous USAID Housing Guaranty programmes, in addition to acting as the conduit for World Bank shelter loans to local authorities.

Although official policy has recently advocated the adoption of market interest rates in public housing[2] this policy has not yet been reflected in government loans to the NHC nor in NHC loans to local authorities. Government loans are made at 6.5% interest per year and are repayable over 40 years (if for rental housing) and over 20-25 years if for tenant-purchase housing. The first loan contracted under the USAID HG programme was for 25 years at an interest rate of 8.7% while the second loan was made for 30 years. In each case there was a grace period of 10 years on principal payments.

Under Urban III, the World Bank supported project, shelter loans were generally made to the NHC at 11% for a period of 27 years including a four-year grace period during which interest charges were to be capitalised.[3]

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[2] RoK (1986)

[3] The exception was a joint-venture component in Eldoret for which loans were made to the NHC for 7 years.

(f) On-lending Terms

The NHC typically on-lends to local authorities at an interest rate 0.5-2.0% higher than its cost of funds; and for durations that correspond to those for government loans. However, terms of external loans are usually different and in the case Urban III were as follows:

- o NHC on-lent to local authorities at 11.25% interest for a period of 27 years including a four-year grace period.
- o Local authorities on-lent to beneficiaries at 12% interest for a period of 25 years including a two-year grace period.

(g) Loan Servicing and Arrears

Arrears on NHC loans to local authorities have climbed dramatically, rising from Ksh 89.6 million in 1983 to Ksh.775.1 million in 1992. The "knock-on" effect of this level of delinquency is that NHC arrears on government loans have risen rapidly, growing from Ksh 622.7 million in June,1990 to Ksh 887.1 in million in June, 1992. Nairobi City Council has remained the major defaulter. accounting for nearly 50% of total arrears; and Mombasa and Kisumu Municipalities for another 35%.

Recent difficulties in obtaining government funding have compelled the NHC to seek additional powers to ensure loan recovery. Accordingly, the Corporation had the Housing Act amended, enabling it to take over the management of local authority housing. So far, the NHC has been able to take possession of housing in Kisumu, Kakamega and Busia.

The amendment of the Housing Act, however, did not make provision for the settlement of arrears -- say, for instance, by giving the NHC the power to dispose of local authority assets. Still, the Corporation could institute legal proceedings to recover arrears as a civil debt. Another measure being considered but which has not been received favourably by local authorities, is the privatisation of the more "up-market" rental estates. The intention here is to use the proceeds of sale to reduce arrears.

(h) Future Strategy

In response to dwindling financial resources the NHC is planning to launch a finance subsidiary that would operate on a commercial basis, catering largely for middle-income home buyers. It is assumed that the subsidiary would be insulated from the administrative controls ordinarily imposed on parastatals. This strategy is appraised in the main report.

Annex 3

Failure of Financial Institutions

Year of Failure	Commercial Bank	Non-Bank Fin. Inst.	Building Society	Action Taken
1984		Rural Urban		Official Receiver
1986	Continental Bank	Continental Finance		Official Receiver
1987		Capital Finance Inter Africa	Pioneer Tropical Cosmopolitan Budget	Official Receiver Closed
1989/90	Union Bank	Jimba Credit Kenya Savings & Mortgages* Home Savings & Mortgages* Nationwide Finance Business Finance Estate Finance	Citizens Bld. Society* Estate Bld. Society*	Consolidated Bank Management " " " " "
1993	Postbank Credit Trade Bank Exchange Bank Pan Africa Bank	 Central Finance Trade Finance Diners Finance Allied Credit International Finance United Trustee Nairobi Finance Middle Africa Finance	 Pan African Bld Society	Liquidation " CBK Management " Closed Liquidation " " " CBK Management "

* Reconstituted as Mortgage Finance Company, a subsidiary of Consolidated Bank.

Annex 4

East African Building Society

Profile

Registered in October, 1958, the East African Building Society (EABS) is the largest and oldest private sector building society. It is licensed under the Building Societies Act and seeks to mobilise savings for home ownership. It has six branches in the country.

In 1992 the Society's mortgage assets stood at KSh. 1.1 billion while public deposits were KSh. 2.4 billion.

Statistical Highlights — Ksh. million

	1988	1989	1990	1991	1992
Mortgage assets	725.3	875.5	887.4	982.8	1065.6
Public deposits	1698.5	1829.8	1970.7	1912.9	2396.9

Source: EABS Annual Reports and Accounts

Cost of Funds

Percentages

	1988	1989	1990	1991	1992
Interest rate paid on savings deposits (Average)	11	12	12	13	14
Interest rate paid on fixed deposits	13	14	15-15.5	16-17	17.5-18.5
Interest rate paid on HDBs	12	12.5	12.75-13.25	15	1616.5

Sources of Funds

	Ksh. million				
	1988	1989	1990	1991	1992
Savings Deposits	502.4	549.6	577.7	342.4	614.2
NSSF Deposits	-	-	-	80.0	250.0
HDB's	145.4	147.6	146.0	139.9	145.0
Deposits by Insurance Cos.	-	-	-	115.0	150.7
Trust Funds	-	-	-	-	-
Other Deposits	1050.7	1132.6	1247.0	1235.6	1237.
	1698.5	1829.8	1970.7	1912.9	2397.

Source: EABS Internal Records Accounts

Maturity structure of Deposits: December 1992

Maturity	% of total	Main Source
Upto 1 year	91	Main Banks, Financial Institutions, including insurance companies and individuals
1 - 5 years	9	
6 - 10 years	-	
11 - 15 years	-	

Lending

a) Maximum mortgage loan made in 1992: n.a.*
b) Minimum mortgage loan made in 1992: KSh.200,000
c) Standard lending term: 15 years
d) Average life of mortgage loans in years: 10-15 years

e) Distribution of mortgage loans made in 1992 by size

Loan size (Shs.)	No. of Mortgage Loans
Upto 250,000	n.a*.
250,001 - 500,000	"
500,000 - 750,000	"
750,000 - 1,000,000	"
More than 1,000,000	

* n.a. = not available

f) Geographical Distribution of Mortgage Assets

	Ksh. million	
	1991	1992
Nairobi	911.9	956.7
Mombasa	58.7	83.4
Kisumu	12.1	25.5
Eldoret	-	-
Nakuru	-	-
Other towns	-	-
Total	982.7	1,065.6

Transaction Costs

Stamp duty	6% of the value of the property
Legal fees	5% of the value of the property
Insurance	2.5% of the sum insured
Other charges	2% mobilization fee

Operating Costs

	Ksh'000				
	1988	1989	1990	1991	1992
Staff emoluments	10,457	12,230	14,230	18,241	21,978
Administrative costs	19,557	22,718	30,272	55,799	60,094
Other	-	-	-	-	-

Source: EABS Internal Records

Annex 5

Prudential Building Society

PROFILE

Prudential Building Society (PBS) was established in 1986. It is licensed under the Building Societies Act and seeks to mobilise savings for home-ownership.

PBS's core business of financing home-ownership and mobilising savings grew steadily from 1988 to 1990 reaching its highest in 1991 but declined slightly in 1992 as shown in the statistical highlights below. The 1993 Annual Report and Accounts for the year ended 31 March 1993 (figures not included in this study) show a sharp increase in mortgage assets, advances and public deposits as follows: mortgage assets rose from KShs. 13.7 million in 1991/92 to KShs. 423.0 million in 1992/93, while advances during the year rose from KShs. 1.2 million in 1991/92 to KShs. 432.1 million in 1992/93; and public deposits rose from KShs. 214.4 to KShs. 337.9 million.

Statistical Highlights

Ksh. million

	1987/88	1988/89	1989/90	1990/91	1991/92
Mortgage assets	1.6	3.1	3.4	14.2	13.7
Mortgage advances during the year	1.6	1.5	0.5	12.3	1.2
Public deposits	106.2	162.1	193.5	241.6	214.4

Source: PBS Annual Reports and Accounts

Cost of Funds

Percentages

	1988	1989	1990	1991	1992
Interest rate per year paid on savings deposits	12.0	12.5	12.5	13.5	13.5
Interest rate per year paid on fixed deposits	14.0	14.0	15.0	16.5	18.0

Sources of Funds

Ksh. million

	1988	1989	1990	1991	1992
Savings deposits	11.3	15.6	22.7	25.3	34.8
NSSF deposits	-	-	-	-	20.0
HDBS	-	-	-	-	-
Deposits by Insurance Cos.	-	-	-	11.0	22.0
Trust funds	-	-	-	-	-
Customers/Companies & other financial institutions	94.9	146.5	170.8	205.3	137.6
	106.2	162.1	193.5	241.6	214.4

Source: PBS Internal Records

Maturity structure of Deposits: December 1992

Maturity	% of total	Main Source
upto 1 year	22.7	Not given
1 - 5 years	8.3	"
6 - 10 years	69.0	"
11 - 15 years	-	

Lending

a) Maximum mortgage loan made in 1992: KSh. 1,800,000
b) Minimum mortgage loan made in 1992: KSh. 800,000
c) Standard lending term: 15 years
d) Average life of mortgage loan in years: 15 years
e) Distribution of mortgage loans made in 1992/93 by size

Loan size (KSh.)	No. of Mortgage Loans
Upto 250,000	-
250,001 - 500,000	-
500,000 - 750,000	-
750,000 - 1,000,000	1
More than 1,000,000	244

f) Geographical Distribution of Mortgage Assets

	Ksh. million	
	1991/92	1992/93
Nairobi	19	245
Mombasa	-	-
Kisumu	-	-
Eldoret	-	-
Nakuru	-	-
Other towns	-	-
Total	19	245

g) Arrears

Percentage of accounts in arrears: 2%

Distribution of accounts in arrears by age;

1-3 months	100%
4-6 months	-
More than 6 months	-

Operating Costs (in KSh. million)

	1988	1989	1990	1991	1992
Staff emoluments	0.5	1.0	1.2	1.4	1.7
Admin. costs	2.1	3.9	4.9	4.1	5.0
Other costs	-	-	-	-	-

Source: PBS Internal Records

Portfolio Structure

	Ksh million				
	1988	1989	1990	1991	1992
Fixed assets	1.4	1.6	2.3	1.9	2.0
Mortgages	1.6	3.1	3.4	14.1	13.7
Investment in property	6.1	-	-	-	-
Other assets	4.2	5.8	6.4	8.5	5.6
Investments	-	-	-	23.3	34.4
Treasury bills	-	-	-	10.0	10.0
Short term deposits	85.5	118.0	101.0	156.5	108.5
	98.8	128.5	113.1	214.3	174.2

Performance (Profit & Loss)

Gross revenue	17.2	20.3	25.8	43.5	41.4
Profit before Tax	(3.9)	0.2	1.1	2.9	0.2
Taxation	-	-	-	-	-

Annex 6

Family Finance Building Society

PROFILE

Family Finance Building Society, a small institution, has concentrated on short-term loans -- up to 3 years at a maximum annual interest rate of 40% -- mainly for land purchase. Like other HFIs it has temporarily suspended lending.

As a result of aggressive marketing, especially among farmers and retirees, it has managed to attract over 15,000 account holders to its 5 branches.

The principal operational bottlenecks have been the lack of long-term funds as well as the very high cost of funds -- depositors are reportedly insisting on receiving interest rates as high as 50% per year.

Statistical Highlights

Cost of Funds

Percentages

	1988	1989	1990	1991	1992
Interest rate paid on savings deposits	10	10	12	12	12
Interest rate paid on fixed deposits	11	15	16	17	18

Sources of Funds

Ksh. million

	1988	1989	1990	1991	1992
Saving deposits	26.1	25.0	35.6	39.0	51.0
NSSF deposits	-	-	10.0	20.0	20.0
HDBs	-	-	-	-	-
Deposits by Ins. Companies	-	-	-	-	-
Trust funds	-	-	-	-	-
Other deposits	106.8	67.7	52.2	50.2	58.6
	132.9	92.7	97.8	109.2	129.6

Maturity structure of deposits: December 1992

Maturity	% of total	Main source
Upto 1 year	100%	parastatals/individuals
1 - 5 years	-	-
6 - 10 years	-	-
11 - 15 years	-	-

Lending

a) Maximum mortgage loan made in 1992: KSh.850,000

b) Minimum mortgage loan made in 1992: KSh. 20,000

c) Standard lending term: 3 years

d) Average life of mortgage loan: 3 years

e) Distribution of mortgage loans made in 1992 by size

Loans size KSh.			No. of Mortgage Loans
Upto 250,000			47
250,001	-	500,000	2
500,000	-	750,000	
750,000	-	1,000,000	1
More than 1,000,000			-

f) Geographical Distribution of Loans

	Ksh. million	
	1991	1992
Nairobi	2.5	15.0
Mombasa	-	-
Kisumu	-	-
Eldoret	-	-
Nakuru	-	-
Other towns	2.8	8.9
	5.3	23.9

g) Arrears

Percentage of accounts in arrears: 10%

Distribution of accounts in arrears by age:

1-3 months	20%
4-6 months	20%
more than 6 months	60%

Transaction Costs

Stamp duty	4% of property value
Legal Fees	1.5% of property value

Operating Costs (KSh. million)

	1988	1989	1990	1991	1992
Staff emoluments	1.1	1.3	1.7	1.6	2.2
Admin. costs	18.6	13.0	17.4	15.4	19.7

Annex 7

Housing Finance Company of Kenya Limited

PROFILE

The Housing Finance Company of Kenya (HFCK) was incorporated in 1965 as the national mortgage institution. It is licensed under the Banking Act and seeks to mobilise savings for home-ownership through provision of savings and deposit facilities as well as such other services as acceptance and administration of provident funds.

The company's equity was jointly owned by, and equally divided between, the Government of Kenya and the Commonwealth Development Corporation (CDC) until November 1992, when the company floated 18 million new ordinary shares on the Nairobi Stock Exchange. The issue was more than three times oversubscribed. In order to spread the ownership of the company to as many people as possible, individual allocations were limited to a maximum of 2,300 shares, thus allowing all 19,233 valid applicants to receive an allotment.

The public now holds 39.2 per cent of HFCK's share capital, while the Government of Kenya and CDC hold 30.4 per cent each. The injection of the new funds has increased the company's paid up capital to KSh. 230 million. This has considerably enhanced HFCK's capital base.

Until the recent suspension of lending, HFCK's core business of financing home ownership and mobilising deposits continued to grow in spite of difficult economic conditions. In 1992 the company advanced KSh. 614 million bringing its mortgage assets to KSh. 3.2 billion, while public deposits stood at KSh. 3.4 billion. Although housing finance for home ownership has continued to be its core activity, the company now offers finance on a limited range of commercial properties, including maisonettes and flats.

As part of a policy to mobilise additional savings and extend customer service, two new branches were opened in 1993, in Kisumu and Meru. This brings the total number of branches to seven. Other branches are in Nairobi, Mombasa, Nakuru, Nyeri and Eldoret. The new branches are on-line with the head office mainframe computer, as are the existing branches. This ensures both faster response to customers' needs and improves operating cost efficiency.

Subsidiaries

Kenya Building Society (KBS), a wholly-owned subsidiary of HFCK, acts as the property development arm. KBS has developed, among others, Buru Buru Estate Phases IV and V, and Koma Rock Estate on the outskirts of Nairobi. It is intended that KBS will be involved in housing development in all major urban centres in Kenya and suitable land for this purpose is being identified.

HFCK is also in the process of revitalising its other subsidiary, First Permanent (East Africa) Limited, to specialise in providing mortgages for lower-income housing which the rest of the mortgage sector does not cater for.

Statistical Highlights

Ksh. Million

	1988	1989	1990	1991	1992
Mortgage Assets	1876.8	2103.6	2496.5	2823.0	3197.7
Mortgage Advances during the year	276.1	370.4	563.6	549.5	614.0
Public Deposits	1934.4	2320.4	2603.0	2820.0	3406.0

Source: HFCK Annual Reports and Accounts

Cost of Funds

Percentages

	1988	1989	1990	1991	1992
Interest paid on savings & trust funds	11-12.5	10-12.5	13.5-14	13.5-14	13.5-14
Interest paid on fixed term deposits	13-15.5	12-15	14-16	14-16	15-18
Interest paid on HDBs	10.74-11.0	11.75-12.5	12.75-14.5	-	13.28-15.5

Source: HFCK Internal Records

Sources of Funds

Ksh million

	1988	1989	1990	1991	1992
Long-Term Funds					
Share Capital	20.0	20.0	20.0	140.0	230.0
Reserves	19.0	26.6	191.7	197.2	252.6
Long Term Loans	6.7	5.5	4.3	3.0	2.2
Shareholders' income notes and loans	236.2	389.8	365.6	263.8	255.6
	281.9	441.9	581.6	604.0	740.4
Public Deposits					
Passbook Savings & Trust Funds	414.4	465.4	520.2	619.7	688.6
Fixed Term Deposits	553.7	692.0	925.3	807.1	989.1
Long-Term Deposits	501.8	672.8	729.4	948.8	1266.4
HDBs	284.6	275.3	244.3	223.9	219.2
Trust Funds	110.9	128.4	96.5	109.2	117.5
Deposits by Insurance Cos.	-	-	-	-	-
	1865.4	2233.9	2515.7	2708.7	3280.8

Maturity Structure of Deposits as of December 1992

Maturity	% of total	Main Sources
Upto 1 year	54%	80% fixed deposits and HDBs plus 100% of savings and trust funds
1 - 5 years	10%	20% fixed deposits and HDBs

6 - 10 years	-	-
11 - 15 years	36%	Each long term deposit is governed by an agreement. Some have no maturity while others are repaid over a period of 10 to 15 years.

Lending

a) Maximum mortgage loan made in 1992: Ksh. 5 million

b) Minimum mortgage loan made in 1992: Ksh. 250,000

c) Standard lending term in years: 15 years

d) Average life of mortgage loans: 10 years

e) Distribution of mortgage loans made in 1992 by size:

Loan size	No. of Mortgage Loans
Upto 250,000	24
250,001 - 500,000	63
500,001 - 750,000	430
750,001 - 1,000,000	210
More than 1,000,000	60

f) Geographical distribution of loans:

	Ksh. million	
	1991	1992
Nairobi	498.7	544.9
Mombasa	19.6	13.9
Kisumu	2.0	3.3
Eldoret	-	4.5
Nakuru	14.5	12.0
Other towns	14.4	3.5

g) Arrears:

Percentage of accounts in arrears: 37.14%
Arrears as a percentage of mortgage assets in December 1992: 3.16%

Distribution of accounts in arrears by age:

1 - 3 months	68.1%
4 - 6 months	13.6%
More than 6 months	18.3%

Operating Costs

	Ksh. million				
	1988	1989	1990	1991	1992
Management expenses	61.0	72.2	87.6	104.0	132.6*

* Includes share issue expenses

Portfolio Structure

	Ksh. Million				
	1988	1989	1990	1991	1992
Fixed Assets	86.7	85.5	235.9	236.2	227.6
Mortgages	1876.8	2103.6	2496.5	2823.0	3197.7
Long Term Investment	9.7	9.7	9.7	9.7	9.7
Investment in Subsidiaries	5.0	5.0	5.0	5.0	55.0
	1978.2	2203.8	2747.1	3073.9	3490.0

Performance (Profit and Loss)

	Ksh. million				
	1988	1989	1990	1991	1992
Gross Revenue	322.7	439.4	841.8	874.4	n.a.
Profit before Tax	13.5	27.3	60.3	71.8	120.7
Taxation	(11.6)	(18.4)	(26.0)	(29.4)	(49.2)
Profit After Taxation	1.8	8.8	34.3	42.4	71.5
Dividends	-	4.0	4.0	28.0	37.0
Retained Profit for the Year	1.6	4.8	30.3	14.4	34.5

n.a = not available

Annex 8

Savings and Loan (Kenya) Limited

Profile

Prior to 1957 Savings and Loan Kenya Limited (S&L) was known as Savings and Loan Society Limited. It was a limited liability company incorporated in Tanganyika and registered under Part VIII of the Kenya Company's Ordinance. It was a wholly-owned subsidiary of Pearl Assurance Company. S&L's main objective was lending money on mortgages for purchase of residential houses.

In 1969 S&L was licensed under the 1968 Banking Act as a financial institution and in 1972 it was acquired by Kenya Commercial Finance Company (KCFC), a wholly owned subsidiary of Kenya Commercial Bank (KCB). Later, S&L became a wholly-owned subsidiary of KCB.

The company's core business of financing home ownership and mobilising savings has grown substantially over the years. In 1992 the company advanced KSh. 277 million bringing its mortgage assets to 1.6 billion, while public deposits stood at KShs 1.7 billion. Besides lending for housing, the company offers finance on a range of commercial properties.

As part of a policy to mobilise additional deposits and extend customer service, S&L recently opened its latest branch in Nakuru bringing the total number of branches to seven. Other branches are in Nairobi (two) and one each in Mombasa, Thika, Eldoret and Kisumu.

In order to give the company more borrowing capacity, the shareholders increased the company's paid up capital from KSh. 68 million to KSh. 108 million in 1992.

Statistical Highlights

	Ksh. million				
	1988	1989	1990	1991	1992
Mortgage Assets	1015	1118	1313	1480	1628
Mortgage Advances during the year	-	217	284	277	277
Public Deposits	1125	1277	1598	1646	1720

Source: S&L Annual Report Reports and Accounts

Cost of Funds

	Percentages				
	1988	1989	1990	1991	1992
Interest rate per year paid on savings deposits	11.5	12.0	12.5	13.0	13.5
Interest rate per year paid on fixed deposits	12.0	13.0	14.0	14.5	17.5
Interest rate per year paid on HDBs	10.5	13.5	14.25	14.5	16.05

Sources of Funds

	Ksh. million				
	1988	1989	1990	1991	1992
Long-Term Funds					
Share Capital	68	68	68	68	108
Reserves	7	7	7	34	42
Loans from GoK	17	14	13	12	11
	92	89	88	114	161
Public Deposits					
Savings Deposits	220	268	302	362	418
NSSF Deposits	234	234	284	284	274
HDBs	277	263	235	226	198
Deposits by Insurance Cos	120	210	230	244	264
Trust Funds	-	-	-	-	-
Other Deposits	274	302	547	530	566
	1125	1277	1598	1646	1720

Source: S&L Annual Reports and Accounts

Maturity Structure of Deposits: December 1992

Maturity	% of total	Main Sources
Upto 1 year	63 %	Individuals and Companies
1 - 5 years	37 %	NSSF
6 - 10 years	-	-
11 - 15 years	-	-

Lending - Residential

a) Maximum mortgage loan made in 1992 — KSh. 2,000,000

b) Minimum mortgage loan made in 1992 — KSh. 200,000

c) Standard lending term: — 15 years

d) Average life of mortgage loan in years — 20 years

e) Distribution of mortgage loans made in 1992 by size

Loan size (KSh.)	No. of Mortgage Loans
Upto 250,000	52
250,001 - 500,000	83
500,001 - 750,000	46
750,001 - 1,000,000	31
more than 1,000,000	127

f) Geographical Distribution of Mortgage Assets

	Ksh. million	
	1991	1992
Nairobi	1162	1273
Mombasa	80	81
Kisumu	85	97
Eldoret	70	83
Nakuru	44	53
Other towns	40	41
Total	1481	1628

g) Arrears: KShs. 159 million

Percentage of accounts in arrears: 55.0 %

Arrears as a percentage of mortgage assets: 9.2 %

Distribution of accounts in arrears by age:

1 - 3 months	45.5%
4 - 6 months	30.9%
more than 6 months	23.6%

Transaction Costs

Stamp duty	6 % of the value of the property
Legal fees	5 % of the value of the property
Insurance	2.5 % of the sum insured

Operating Costs (in Ksh. million)

	1988	1989	1990	1991	1992
Staff emoluments	11	14	17	21	25
Admin. costs	6	9	13	17	23
Others	2	2	2	2	2

Source: S & L Internal Records

Portfolio Structure

Ksh million

	1988	1989	1990	1991	1992
Fixed assets	15	17	19	45	47
Mortgages	1015	1118	1313	1480	1628
Investment in KCB	18	13	177	(23)	34
Investment in Treasury Bills	50	30	80	120	150
	1098	1178	1589	1622	1859

Performance (Profit & Loss)

KSh million

	1988	1989	1990	1991	1992
Gross Revenue	52	61	84	94	123
Profit before Tax	28	33	50	48	72
Taxation	(14)	(19)	(21)	(23)	(28)
Profit after Taxation	14	14	29	25	44
Retained Profit for the year	14	14	29	25	44

Annex 9

List of Building Societies: October, 1993

1. Kenya Building Society ***
2. First Permanent Building Society ***
3. East African Building Society *
4. United Kenya Building Society ***
5. Central Building Society ***
6. Kiambere Building Society ***
7. Pioneer Building Society **
8. Homeloans Building Society **
9. Country Building Society *
10. Cosmopolitan Building Society**
11. Kenyawide Building Society**
12. Equator Building Society*
13. Alliance Building Society**
14. Shelter Building Society**
15. Budget Building Society**
16. Gitanga Building Society**
17. Tropical Building Society **
18. Regional Loans Building Society**
19. The Family Shelter Building Society*
20. Equity Building Society*
21. Heritage Building Society*
22. Family Finance Building Society*
23. The Prudential Building Society*
24. Teachers Building Society*
25. Pan African Building Society**
26. Agrarian Building Society*

		No.
*	Active	10
**	Being wound up	11
***	Dormant	5
		26

Annex 10

Institutions and Persons Contacted

ALICO	Mr O. O. Wasonga
Capital Markets Authority	Mrs C. A Kola - Authority Secretary Mr F. W. Omollo - Financial Analysis Manager Dr D. G. Gunesekera - Adviser
Consolidated Bank of Kenya	Mr Ole Sunkuli - Public Relations Manager
Consolidated Mortgage Company	Mr Mbatia - Manager
Cooperative Bank of Kenya	Mr D. Nguchu - Chief Manager
Cooperative Finance Ltd	Mr S. Esiromo
East African Building Society	Mr R. Pandit - Executive Director Mr B. V. Dongre - Finance and Administration Manager
Family Finance Building Society	Mr Thangari - Financial Consultant
Housing Finance Company of Kenya	Mr W. B. Mukuria - Managing Director Mr J.K. Njenga - Advances Manager Mr H. Mwaniki - Chief Accountant Mr J. Kimemia - Banking Manager Mr Mugambi - Assistant Mortgage Manager
Kenya National Assurance	Mr E.G. Bunyassi - General Manager
Kenya Re-Insurance Corporation	Mr P. Bhoyyo - Administrative Manager
Manhattan Investment & Mortgage Brokers	Mr B. M. Kigano - Chief Executive
NACHU	Mr Kariuki Wagaiyu - General Manager
National Housing Corporation	Mr J. Laanoi - Managing Director Mr J. Njuguna - Finance Manager
Nairobi Stock Exchange	Mr J. Mbaru - Chairman
Prudential Building Society	Mr H.K. Bunei - Managing Director Mr M.S. Mutua - Chief Manager
Savings and Loan	Mrs Sheth - Marketing Manager