

# **What Have African Urban Housing Policies Wrought: A Historical Perspective Of Housing And Housing Finance Issues In Africa**

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HISTORICAL PERSPECTIVE OF HOUSING AND HOUSING FINANCE ISSUES  
IN AFRICA**

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## **WHAT HAVE AFRICAN URBAN HOUSING POLICIES WROUGHT: A HISTORICAL PERSPECTIVE OF HOUSING AND HOUSING FINANCE ISSUES IN AFRICA**

### **Introduction:**

Given the important role of housing in all economies, developed and developing, the theme of this seminar “maintaining sustainable mortgage finance schemes in Africa” should come as no surprise. Moreover, the received wisdom among economists, financial experts, and policy makers is that what is good for the housing sector can in fact be good for the economy as whole. It is also clear that the development of mortgage finance system is strongly related to the general development and sophistication of a country’s financial markets, which in turn is closely related to overall economic development. I am delighted to note that there are very encouraging signs that several African countries have come to realize these important linkages among housing, mortgage finance and the economy, and the benefits that accrue to countries when these linkages are properly managed. Serious efforts are being made by several African countries to create enabling environments that will unleash the benefits of these linkages, even though progress is somewhat slow. We are witnessing major changes in the financial sectors of some countries on the continent. For example the financial sectors in Ghana, Uganda, Cote D’Ivoire, to name a few, are being completely overhauled with much greater emphasis being placed on accountability, sustainability, transparency and even the effects of instruments of public policy. These financial reforms in some cases are seeking to diversify the sources of funds for housing and to develop liquidity management facilities such as Home Finance Company in Ghana, whose brain child this important seminar is. Although programs of wide-ranging financial reforms are being implemented in some African countries, further steps need to be taken to develop viable mortgage finance systems, or more broadly to deepen the financial sector so as to attain sustainable long term growth. One of the key sectors that could lead the way to economic growth IF properly financed is housing.

My talk is loosely based upon a topic which I had suggested to the organizers of this conference. It is perhaps self evident that because the price of the average housing is several multiples of a typical household's income some form of intermediation is always necessary for transactions to take place in housing markets. The main part of my presentation deals with the strategic role of housing in the economy and the critical role of mortgage finance as an intermediation system in unleashing the powers of the housing sector as an engine of economic growth. Indeed, the evidence so far leads to the conclusion that a well-functioning market-based mortgage finance system can contribute very significantly to more robust real estate investment and therefore to more dynamic economic growth. Interestingly, the share of housing investment financed through the formal financial intermediaries is very small in virtually all African countries and other developing countries. To learn from our past financial sins of commission and omission, my presentation tries to place the performance of urban housing policy within an international context, by examining how several aspects of African housing policy, in particular housing intermediation systems, measure up against international norms. I define urban housing policy to include housing finance as an important component. Following this, I will dwell on issues and policies of mortgage finance which are particularly relevant to the development of sustainable mortgage finance systems in emerging African countries, or more broadly as African countries search for ways to develop more efficient financial markets. To succeed, mortgage finance, financial and macro-economic reforms must go hand in hand. I will conclude my remarks with a summary of the policy lessons which can be drawn from past experience and where African countries go from here in search of well functioning and sustainable mortgage finance systems. A **sustainable mortgage finance system** is one that is broadly accessible (ie, serves the needs of all consumers at market prices), funded by agents better able to bear the risk of a mortgage loan, profitable, that mitigates past distortions in the economy, and whose efficiency is not in doubt.

## **Housing investment and the economy**

To lend coherence to my presentation, I begin with a review of housing and the economy, and how housing markets work. Housing investment is typically the largest single form of fixed capital investment in most economies. In developing countries such as emerging economies of Africa, housing investment amounts to 3 percent to 8 percent of gross domestic product or GDP and 15 percent to 30 percent of gross capital formation. Other than human capital, housing and land have the widest ownership, typically accounting for between one-quarter and one-half of the capital stock in both developed and developing countries. The increasing importance of housing as a component of annual capital formation and total output is accepted by economists and non-economists alike. Lastly, the housing sector is an important part of a country's fiscal system, because it is an important source of revenue in the form of property tax, building materials and capital gains tax, and, on the other hand often attracts considerable subsidies.

To appreciate the backward and forward linkages between the housing sector and the rest of the economy, it will be helpful to sketch out how housing markets operate. Specifically, prices, and thus housing affordability by different income groups are determined in the market by supply and demand factors. Inputs such as land, labor, finance, materials and infrastructure are combined by supply side agents such as landlords and developers to produce housing services. Relative prices inform producers of housing services whether to provide more or less housing, and the input suppliers about providing more or fewer inputs. Similar to market economies elsewhere, the market for producing housing services in most African countries can be characterized as competitive. However, unlike markets in developed countries, the market for many inputs in many African countries is not competitive. The market for two inputs --- land and finance – deserve special mention. In the former market (land) owners do and can fix prices when transactions occur; and in many cases simple land transactions either fail to occur or become protracted because it is not clear who has the authority to sell or lease the land. In the latter market (finance), the main focus of this seminar, interest rate subsidies and other government regulations have restricted competitive allocation of capital which has retarded the

development of both viable mortgage finance systems and economic growth in many African countries.

Indeed, the problems of inflation and financial instability encountered in so many countries in the 1980s have shown that the structure and operations of housing markets and the mortgage finance systems can either support the development process or undermine it. They are never neutral. The structure of the housing market and the system of housing finance can have large positive or negative effects on urban development, financial development and fiscal stability, depending on the way they operate. Specifically, the efficiency of housing investment, which constitutes one-sixth to one-fourth of total annual aggregate investments, is directly influenced by the way mortgage finance systems operate. Sustainable mortgage finance is also important to financial development in three important respects. First, mortgage finance is important to financial resources mobilization because of the important role households play in domestic savings mobilization. Second, the high collateral safety of housing suggests that mortgage lending must be an explicit part of rethinking financial policies aimed at achieving greater financial stability in Africa. Lastly, but not the least, mortgage subsidies in the name of housing affordability can create a large fiscal overhang with disastrous consequences on macro-economic stability.

### **What African housing and mortgage finance policies have wrought**

A key characteristic of past housing and mortgage finance policies in Africa is that they frequently have side stepped markets and have instead emphasized planning and direct government intervention, even in instances where there are no signs of market breakdowns. It, therefore, comes as no surprise that traditional efforts by African governments to promote economic development by controlling interest rates and rents, directing credit to “priority” sectors, including funds for public sector activities, have often undermined the development of financial markets. More specifically, urban housing policies in Africa have intervened directly on the supply-side of the market by producing housing and by fixing prices through rent control and interest rate ceilings. I suppose one can label such activities as attempts by African governments to “intermediate” using legislative fiat instead of relying on private market discipline.

Unfortunately, ample evidence exists that direct public production policies adopted by many African countries have not been effective. For example, Nigeria's 1975-1980 Development Plan envisaged the construction of 202,000 housing units. However, by the end of the plan period only 14% of the planned units had been built, costing in excess of a billion of US dollars. In Cote D'Ivoire, housing production by public agencies was only slightly more than 2000 units per year over a period of 23 years.

Despite the tremendous investment in the housing sector through the policy of direct construction, or because of this policy, the housing sector in many African countries experienced severe inflation that exceeded that of the general economy. Many African countries responded by instituting price controls in the form of rent and interest rate controls. Since rent controls essentially reduced returns to housing investments, the financing of rental housing either through formal or informal means was curtailed. This in turn reduced both the quality and quantity of housing. Further, this form of price control was almost certainly one of the key factors stifling the development of a viable mortgage finance system in many African countries, because the potential debt servicing capacity of the rental unit was reduced. The general consensus is that these interventionist policies did very little to increase housing supply or decrease housing price. On the contrary, they made a bad situation worse.

While there are perhaps more important causes of inflation, the housing sector itself has been significantly involved in the process of inflation. Several studies show that inappropriate housing and housing finance policies of the type that I have just described, can cause the housing sector to receive a very large share of government transfer (subsidies), even though the sector itself may be relatively small. While some of these subsidies are off-budget they must be financed, which contributes to the level of inflation. Further, because the housing sector is strongly linked to real financial and fiscal sectors of the economy, these off-budget subsidies coupled with wrong housing finance policies and poorly supervised institutions, have caused distortions in resource allocation at great cost to the economy. For example, in the U.S. the so-called savings and loans debacle, a result of inadequate regulatory policies, has cost tax-payers in excess of \$300 billion to indemnify the depositors of failed institutions. In the UK, failed housing policies are blamed for a structural increase in unemployment, a major decrease in the

household savings rate, an increase in interest and inflation rates and a higher balance of payments deficit. Finally, in many African countries, the former socialist countries of Eastern Europe and the former Soviet Union, lower labor mobility resulting from constricted housing markets was a real drag on their economies, and is now the prime motivation for reforms in housing policy.

Indeed, the end result of these policies is that the *housing affordability problem* in many African countries became worse. To add clarity to the discussion, I should distinguish between “housing affordability problem” and “mortgage debt affordability” problem. Housing affordability problem arises because a house is a long-lived asset and its rental cost or price takes a significant share of annual income. In diversified markets of developed economies the price of a housing unit is about three times the annual income of the household. In African countries and other developing countries, this price-income ratio is often considerably higher and of the order of six times. While there is little that fiscal policy can do about this kind of housing affordability problem, instruments of urban policy such as mortgage finance, rapid and abundant provision of serviced land and well conceived planning and zoning laws can lower the housing price-income ratio by acting on the elasticity of housing. In many African countries ill-conceived urban policies in the areas of mortgage finance, infrastructure, building codes, land use regulation and zoning, often based on codes of former colonial powers, tended to exacerbate the problem of high housing price-income ratios. Relatively high housing price-income ratios coupled with factors such as inflation can make the financing of housing more problematic for households.

At this point, I should forcefully state that the purpose of mortgage finance is not to lower artificially the housing price-income ratio, for instance through unsustainable financial subsidies. The development of a sustainable mortgage finance system requires a clear understanding that its primary purpose is to make mortgage loans widely available at market prices. An efficiently designed mortgage finance system is concerned with mortgage instruments and institutional arrangements that can improve mortgage affordability and attenuate the impact of inflation and high interest rate on borrowers. To paraphrase Bertrand Renaud, the difference



between mortgage finance and other housing sector policy is the difference between addressing problems of mortgage affordability and problems of housing affordability.

So how have African countries addressed the mortgage affordability problem? Since housing is typically the largest asset in the household portfolio it has always been financed in the sense that virtually all owners of housing capital must pay for their units over several years. Even households who own their units “free and clear” finance the unit if one considers the fact that holding such a large asset has a financial opportunity cost. More to the point, as I stated at the beginning of this talk, some form of intermediation, i.e. attracting funds from people who have a surplus of financial assets and channeling these funds to those who wish to borrow, becomes essential for efficient operation of housing markets. The absence of a well-developed mortgage finance system means that, the only way to invest in housing is to save first or through financing between individuals, often referred to as informal financing. In such an environment home ownership is postponed until very late in life, if it occurs at all. At the same time access to mortgage credit is a strong incentive for people to save and invest. Savings in housing institutions while generally used to provide mortgages, can also become a source of financing for other non-housing projects. Moreover, when housing finance is operated as a system for true intermediation rather than as a subsidy system, it helps ensure that housing projects are repeated, as repaid loans and profits provide funds for new mortgages.

I have earlier alluded to the fact that housing investments have beneficial effects on the economy as a whole. Now the extent to which housing investments benefits the economy as whole derives from the linkage between mortgage finance and housing as a component of annual capital formation. However, in many African countries the share of housing investment financed through the formal financial sector is very small and mortgage securities accounts for a minute fraction of financial assets. The data show that in developing countries of Africa a much greater share of housing investment comes from internally generated funds or the informal sector. Consider the loan to value ratio as a measure of credit supplied by the formal sector. Using this measure, the average credit supplied by the formal sector to housing investment is about 11% in Kenya and 6% in Senegal. By comparison the ratios for the United Kingdom and United States are 58% and 126%, respectively. At first glance the percentage of house value financed by

formal sector mortgages for the US might seem odd. In point of fact it is indicative of the extent to which mortgage finance has become the instrument of choice for financing not only housing but consumption goods and other assets in the US, as well as the fact that mortgage finance is the principal method of financing the purchase of existing homes, not just new homes. Further more this outcome speaks of the high collateral strength of housing which makes mortgage lending one of safest financial assets and why the reorganization of mortgage finance system must form an integral part of any serious economic and financial reforms in any African country.

On a risk-adjusted basis, mortgage finance is a profitable banking activity and financial institutions must be induced through prudential regulation to diversify their portfolios into residential mortgage finance. Evidence from both industrialized countries such as US and UK, and emerged economies such as Argentina, Brazil, Malaysia and Korea, shows that the volatility of equities (stocks) is about three times that of housing assets. Housing's relatively low volatility implies that the price for bearing risk of mortgages should be lower than the price of bearing risk for more volatile assets such as stocks [REMEMBER MONDAY, OCTOBER 27, 1997]. So what has impeded voluntary diversification by financial institutions in African countries? There are at least three reasons. First, portfolio regulation in the past has required banks to hold government instruments. Second, interest rate regulations created situations where real lending rates were in effect negative. Third, high-yield low-risk government Treasuries meant that bank managers as rational agents prefer to hold short term government securities rather than long term mortgages. The latter situation has short-circuited the intermediary role of banks in gathering and processing information to select appropriate projects, mobilizing resources to finance these projects, providing vehicles for diversifying risk, and acting as agents for innovation and change.

The result is that the bulk of financing in African countries and other developing countries of the world is provided through informal methods. Lack of mortgage financing and the fact that informal financing is small and risky is the *raison d'être* for unproductive incremental housing construction, a trademark of African urban housing markets, where houses are completed only after many years, sometimes never. When added up, the large inventory of small uncompleted constructions prevalent in many African countries is quite large compared to

the size of the economy. Needless to say, the opportunity cost of the resources so *immobilized* is quite high. This resource *immobilization* is manifested in relatively high house prices in African countries which makes the housing affordability problem worse. Consider, the average house price to income ratio as a rough indicator of the performance of the housing sector and of the housing affordability problem. The data show that countries with less efficient or underdeveloped housing finance systems have higher house prices relative to incomes. As an example in the United States and the United Kingdom, countries with sophisticated mortgage finance systems, the price of a house is about three times the income of the household. At the other extreme, in Ghana, Nigeria, Kenya etc this ratio is considerably higher and often of the order of six times or higher. Certainly, housing finance is not the sole determinant of such differences. Other urban housing policies, such as inappropriate land use controls, zoning and building codes are also responsible for the high cost of housing. However, the pattern is clear. There is an obvious linkage between the twin urban problems of housing affordability and mortgage affordability. The vicious cycle of high house price-to-income ratios and limited access to mortgage finance mean that adequate shelter, both in terms of ownership and renting, is very difficult to acquire or impossible for many households in Africa.

In spite of the potential benefits of mortgage finance systems, no African country can be characterized as having a widespread and successful one at this point, although constructive efforts are being made in countries such as Ghana, Kenya, Uganda and South Africa. I will submit that even South Africa does not have a successful mortgage finance system. Although the share of the assets of the banking system in the form of mortgages in South Africa at 39%, is relatively high, only R6-8 billion of the roughly R52 billion mortgages in 1990, were allocated to mortgages in the black townships. Certainly, recent economic circumstances in African countries – inflation, shifting terms of trade and slow growth – have not been conducive to the development of mortgage finance institutions. However, a policy of interest rate controls to make housing more affordable only makes matters worse.

During the high inflationary periods of the 1970s and the 1980s this policy meant mortgage institutions in many African countries had to lend at negative real interest rates, which meant that savers and other investors earned negative rates of return on their savings and

investments. While the regulation of interest rates is often justified on the grounds of affordability, the simple correlation between house prices and interest rate policy suggests that artificially low interest rates are related to inelastic housing supply and higher house prices. There is also the tendency to treat housing more as a consumption good than as investment and the consequent failure to recognize either its potential for encouraging savings or the macro-economic linkages between it and other sectors of the economy. The consequences of such policies and attitude towards housing is that the viability of housing finance system in many African countries has often been compromised if not completely jeopardized. The negative effects of these policies are the lack of viable financial intermediaries, low savings and unproductive behavior in the form of currency hoarding, and other activities such as the piece meal purchasing of building materials and incremental housing construction. Incremental housing construction is inefficient and makes the urban landscape unattractive. Bertrand Renaud put it best: "Cities are built the way they are financed".

### **Toward Efficient and Sustainable Housing Finance Systems**

So where do African countries go from here?. Before attempting to answer this question it is instructive to first summarize the many lessons from the preceding analysis. First, economic realities in many African countries dictate that housing investment will continue to be an important component of annual capital formation. Second, the magnitude of the benefits of housing to the economy as whole is linked to the development of a sustainable mortgage finance system. Third, while informal financing provides the greatest share of financing it is small, irregular and risky and the resulting incremental housing construction has high opportunity cost of capital. Fourth, it bears repeating that direct intervention by governments either through interest rate regulation or housing production as an attempt to facilitate intermediation is counterproductive at best. It stunts the development of sustainable mortgage markets and makes housing markets inefficient. Fifth, cumbersome and costly zoning, inappropriate building regulations and land use controls, impede the housing production delivery systems and in turn exacerbate the twin problems of housing affordability and mortgage credit affordability prevalent in most African countries. Sixth, although at any given time there may be tasks such as land

market reforms, municipal reforms, better infrastructure finance and reorganization of real estate industry that might be more pressing than the development of the mortgage finance system, housing finance issues are always a critical part of economic and financial agendas. This is because the effects of an efficient mortgage finance system reach much beyond the housing sector. Seventh, because housing is the principal asset of the household, mortgage finance significantly determines the financial or non-financial form savings may take, and therefore the reorganization of the mortgage finance system must be a significant part of economic and financial reforms. Finally, the preceding discussion also provides a clear lesson for policy makers. Whereas in the past, housing finance policies have been shaped largely by political and social considerations, new and sustainable mortgage finance policies must be based on economic realism. Against this backdrop, I now proceed to outline what should and should not be done in developing sustainable mortgage finance systems in Africa.

In developing policies for sustainable mortgage finance systems, the goal of increasing savings must be distinguished from the goal of ensuring that savings are in financial assets rather than non-financial or hoarded assets. The former goal is part of the overall economic and financial policy. It is the latter goal that is more germane to the development of formal mortgage finance system. Earlier, I have mentioned the fact that households in many African countries and, for that matter in many other developing countries, frequently save in the form of non-financial assets (e.g. textiles, gold and silver trinkets, cattle, hoarded currency, incremental housing construction) rather than in the form of financial assets. This suggests a number of problems with the financial system including lack of confidence, inappropriate financial instruments, artificially low interest rates, lack of liquidity in the form of quick withdrawal, limited lending capabilities and unsuitable locations for financial institutions. The chief concern in the development of a sustainable mortgage finance system is the need to mobilize additional resources. This concern leads to consideration of a variety of options including the modification of traditional schemes and the institution of modern ones that seek to tap resources from other segments of financial markets. Some of the modern schemes can be quite complex and require appropriate expertise within the mortgage finance system that are not yet available in many African countries, although movements are afoot to provide the needed expertise.

Moreover, the development of some of these schemes is conditional on the modernization of the overall financial system.

- ***Attractive instrument design:*** On both the asset and the liability side the key to successful resource mobilization is instrument design with realistic pricing and distribution of risk. In the current macro-economic environment characterized by high inflation this entails indexation on both sides. On the liability side, indexing savings deposits and bonds enables financial institutions to mobilize funds domestically, increasing savings. Of course this is a general financial issue not just a mortgage finance issue. On the asset side, indexing permits financial institutions to lend funds and stay solvent. It is important to note that on both the asset and the liability side the exact details of indexation matter. Moreover indexation is not a substitute for stable macro-economic policy. With high and variable inflation where income fails to track inflation perfectly, there is no indexation system which can insulate the system completely.
- ***Retail deposits from Household Sector:*** The savings potential of the private sector in many African countries is relatively deep as suggested by the ratio of private to total savings and private savings to GNP. However, as I indicated earlier the banking sector has barely exploited this potential. There are several good reasons to look to the existing retail deposit system as a source of additional resources. First, the household sector is a net supplier of savings to the rest of the economy in many countries. Second, since housing is a large expenditure and wealth item, access to mortgage finance provides a strong incentive for people to save. Third, despite the globalization and integration of financial markets, there are difficulties, not to mention the intense competition, in accessing foreign capital. Fourth, the system and expertise in retail deposits already exists, where as some of the alternatives that I discuss below require new expertise and institutions. However, I do not want to exaggerate the former point. While the expertise exists, the banking sector in many African countries has not been innovative in the design of appropriate instruments to induce households to save more. So the real challenge here lies in the ability of the financial system to design appropriate and innovative instruments with characteristics that protects the saver against wealth erosion. To foster innovation and appropriate risk taking by financial institutions, governments must curb the appetite of these institutions for Treasury securities. This will

require a change in macro-economic policy that induces banks and other financial institutions to play the role of true financial intermediaries by channeling part of domestic savings into long-term mortgage finance.

- ***Mortgage Bonds:*** Another promising way of attracting capital into the housing sector is for non-bank institutions such as liquidity facilities to issue bonds which are sold to investors including long term institutional investors for the express purpose of financing housing. The bonds are backed by the full faith and credit of the lending institution, its assets and or in some cases the government. To the best of my knowledge very few financial institutions in Africa have utilized this option to raise funds for mortgage finance. In this context two institutions hosting this conference, Home Finance Company and the Ghana Stock Exchange, deserve special mention for their efforts to develop this segment of the financial markets. It is important that the option of issuing mortgage bonds to raise funds for housing financing is not viewed simply as a means of relief when funds to meet mortgage commitment are low. There are important reasons for developing and expanding the usage of these bonds as a source of new and reliable funding for housing finance. First, there is substantial interest within several African countries to expand the role of securities markets. Several African countries have established stock markets and are moving to expand the size of the market and introduce new financial instruments such as options, futures and other derivative products. These innovations are quite consistent and supportive of the efforts that need to be made to establish housing bonds as a sustainable source of mortgage finance. Second, there is real demand for quality long-term assets from institutional investors such as government pension funds, corporate pension plans and insurance companies. The liabilities of these institutional investors are long-term in nature and they require financial assets with similar duration or payment pattern to hedge their liabilities. Third, apart from the ones that are mature, pension plans have limited need for liquidity. Fourth, housing bonds backed implicitly or explicitly by long-term mortgages, appropriately designed and underwritten, are fundamentally safe. These are exactly the kind of assets needed by these institutional investors given their fiduciary responsibilities. The safety of these bonds derives from housing's high collateral strength alluded to earlier. Its returns are effectively indexed and therefore not adversely affected by unanticipated increases in the rate of inflation as are returns to many other investments. Finally, housing bonds may permit mortgage institutions to better withstand the increase in

competition from term risk and denomination transformation where housing is typically financed with long term mortgages which are in turn financed with smaller short-term deposits.

- ***Secondary Mortgage Market and Securitization:*** The globalization of financial intermediation relies on a wide range of new products such as securitization and other synthetic assets to allocate risks of financial instruments to those better able to handle them. An alternative way to increase resources available for housing finance is to securitize the originated mortgages and sell them to long term investors. While this option might be viewed as a special case of the funding through bonds, mortgage securitization requires substantial skills not required by the former. Securitization requires considerable expertise in structuring the instrument, the pricing of mortgages, the legal and mechanical aspects of ownership transfer and the marketing procedures needed to sell the mortgage backed securities (MBS). While it is dangerous to draw too many comparisons with the U.S. where MBS are now the backbone of mortgage markets, the rapid growth of the MBS market suggests that there are lessons to be learned for the long term future of mortgage markets in many African countries. Indeed there is evidence suggesting that it is actually cheaper to raise funds via MBS than with a deposit system. The level of expertise required for both the housing bond and MBS approaches to mobilizing funds suggest that various groups involved in capital market development would need to coordinate their activities and share knowledge and expertise. Again the activities of Home Finance Company of Ghana as a liquidity facility is noted as an important step in the right direction for the development of a viable and sustainable mortgage finance system. The development of a secondary market facility which allows mortgage lenders to manage their liquidity and interest rate risks acts as a potent force for the diffusion of mortgage lending among a variety of institutions. Moreover, the creation of secondary mortgage markets and securitization of mortgages will gradually integrate mortgage finance into the rest of the financial markets which leads to greater competition and innovation among the suppliers of long term credit for housing finance. Global financial intermediation and integration of financial markets have dramatically increased capital mobility and mortgage securitization is increasingly being used to attract capital from both domestic and international capital markets in both developed and emerging economies. While African countries should perhaps be no exception to these capital markets trends, the timing



of the development of secondary markets is an unresolved issue. It is not clear to me if African countries are ready to develop secondary mortgage markets at this point.

- ***Appropriate mortgage menu:*** Mortgage loans are contractual arrangements which commonly vary from as little as one year to as much as 35 years. Over the life of the loan financial conditions, in particular inflation and interest rates, can and do fluctuate. Such fluctuations create contractual problems for risk sharing between lenders and borrowers. Lenders must consider a menu of mortgage instruments; how to change the mix of mortgage instruments, terms and conditions as economic circumstances change; and how to evaluate the impact of alternative instruments on profitability, demand for credit, repayments, delinquencies and default.
- ***Alternative risk sharing arrangements:*** To the extent possible the mortgage finance system should include a full range of mortgage contracts that share risks between borrowers and lenders fairly and in a sustainable manner over the life of the loan. There are five broad classes of mortgages that have been implemented that attempt to solve the mortgage affordability problems in ways that meet the constraints of the lender and borrower. These are fixed rate mortgage (FRM), graduated payment mortgage (GPM), price-level adjusted mortgage (PLAM), adjustable rate mortgage (ARM), and more recently dual-index mortgage (DIM). Each of these mortgage types differ in terms of complexity, flexibility and sharing of risk between the lender and the borrower.
- ***Standardization in underwriting, mortgage instruments and mortgage servicing:*** The establishments of an efficient mortgage finance system also requires a proper system of mortgage underwriting to assess the amount of risk in a mortgage loan. For underwriting to be an effective system for pricing risk, some form of standardization in mortgage instruments is necessary. Excessive diversity in mortgage instruments makes mortgages more illiquid. Moreover, the development of an efficient secondary market and the securitization of mortgages requires a standardized underwriting framework (borrower loan application information, loan documentation, collateral, etc) to permit the isolation and assignment of risk to those best able to handle them. The lack of standardization in borrower and collateral information makes mortgage pricing difficult and ad-hoc. An important factor affecting the

optimal price of a mortgage is default risk. Default risk in turn varies according to loan-to-value ratios. Expertise in the valuation of houses and other real estate is essential in determining appropriate loan-to-value ratios, so as to more correctly measure the level of protection against default. Research shows that there is a direct relation between loan-to-value ratios and default risk.

- ***Mortgages must be appropriately priced:*** Equally important in the development of a sustainable mortgage finance system is that mortgage loans must be made at positive real interest rates, with the reasonable expectation that the loans will be repaid. This means that governments should deregulate the financial markets and allow lending institutions to price mortgage loans to reflect the underlying credit and default risks of the borrower. Appropriate mortgage pricing will require the selection of a benchmark index for measuring the degree of improvement in loan pricing. Indices such as Treasury rates or corporate bond rates will, in addition to facilitating the integration of mortgage finance into the rest of financial markets, allow mortgage loan pricing to respond more quickly to changes in financial market conditions.
- ***Modern asset-liability management:*** An effective resource mobilization scheme must be accompanied by modern-asset liability management as part of the overall financial policy. This means that the development of the financial system in Africa must move toward a market-determined term-structure of interest rates similar to those in industrialized countries with developed financial markets. Modern asset-liability management involves the coordination of the pattern of receipts from assets, i.e. mortgage payments, and the pattern of liability payments, i.e. interest rates. Failure to do so exposes the mortgage finance system to substantial interest rate or price risk when mortgage rates do not float freely. The asset-liability schemes require new and substantial financial management skills that are currently in short supply or non-existent in many African countries. Consequently, major efforts to increase expertise in financial management need to be undertaken by financial sector institutions in African countries.
- ***Allow equal access to mortgage credit:*** Once mortgages are properly priced, there should be no economic incentive for preferring financing of owner-occupied housing at the expense of rental housing. Equal access to institutional credit should be given to the private “informal”

and private formal sectors, at prices that reflect differences in risk and transaction costs, not administrative fiat. The realities of the housing markets in Africa, particularly in sub-Saharan Africa, is that the majority of the housing (both rental and owner-occupied) will be supplied by the private sector. The private sector also provides the inputs into housing production and the financing used to purchase the housing. Expanding appropriately priced housing credit through these sectors will help ensure that at least part of the housing needs of the poor are addressed. Adequate mortgage financing should be available to households to smooth housing consumption over time, and to enable producers to undertake efficient land development and construction of housing.

- ***Improve the operation of land market:*** The success of reforms in the mortgage market is closely linked with complementary reforms in property rights and land market operation. This is because problems in operations of housing markets typically spill over into mortgage markets and this retards the efficient operation of the market. It is often asserted that customary land tenure or common property regimes and the lack of private fee simple are to blame for many of the problems identified in African housing markets. In my view customary land tenure per se is not the culprit. After all the essence of property rights is that they aid in the formation of reasonable expectations by an entity in its dealings with other entities. Thus a good property rights policy is one that guarantees an entity's right to a benefit stream (security of tenure) whether the benefit derives from a fee simple or a usufructuary right. This guarantee falls in the domain of the government and is absolutely essential for the development of sustainable mortgage finance systems in Africa.
- ***Credible Contracts:*** As discussed earlier because house price is several multiples of a household's annual income the production of housing needs financing in order to be undertaken. Moreover it has been shown that access to mortgage financing can reduce the cost of housing. The absence of credible contracts is one reason, some will say the main reason, why very little mortgage credit is voluntarily provided by the formal sector. For mortgage financing to be most effective it should have a maturity similar to the asset life or the expected length of the owner's working life, that is the financing must be long term. Since the circumstances of either the lender or the borrow can change during the course of the contract this long-term contract must provide a set of rules for modifying contractual

obligations. The development of a sustainable mortgage finance system in African countries (for that matter in any country) is essentially tied to the development of contracts that can be enforced, no more no less. When lenders cannot foreclose on mortgage properties when borrowers default the cost of mortgage financing will be so high as to preclude the voluntary supply of mortgage finance. Indeed, with relatively small loans, unclear titles and high administrative cost of intermediation, as is the case in many African countries, lenders are not able to exploit the inherent high collateral safety of mortgage loans and the supply of mortgage finance will be very low.

- ***Role of the government:*** As part of overall financial system, the development of sound a mortgage finance system cannot progress far without a sound regulatory framework. The purpose of an efficient regulatory framework is to promote competition and free entry by new lenders. It is neither to protect existing lenders nor to guarantee outcomes to new lenders. Prudential regulation must define capital adequacy, specify asset classification, state rules for diversification as well as specify the accounting system, management, and control of management self-dealing. The whole objective here is to build confidence in the entire financial system. Another important role for the public sector in the development of sustainable mortgage finance systems is to bear the cost of financial innovation. In some cases private lenders may fail to innovate if they have to bear all the costs of innovation but must share the benefits with competing banks. Moreover, the foundation of a sustainable mortgage finance system rests on efficient tenure arrangements, effective land registration and expansion of adequately serviced land. These activities are the responsibilities of the government. Finally, what do we do with the informal finance sector? Clearly, outlawing informal lending will be a misguided policy. Informal lending is neither irrational nor predatory, although its scope is limited. It is also costly because of its inability to diversify risks and the lack of standardization which can come with economies of scale and of scope. Public policy should encourage the evolution of informal to formal finance where by formal institutions can capitalize on the comparative advantage of the informal sector.

### **Concluding Remarks:**

In most African countries, the desire to buy or upgrade a home is one of the most potent catalysts for household savings. However, in contrast to developed countries, African

housing markets lack the support of a well-developed and functioning mortgage finance system. This situation is critical since research shows that policies designed to expand institutional credit also increase housing consumption. There is evidence to show that the more sophisticated the mortgage finance system, the lower the proportion of household income allocated to housing. The data show that a viable mortgage finance system can speed up both financial and economic development of African countries. It can speed up the diffusion of banking services in the household sector, improve the efficiency of household savings, and directly influence the efficiency of housing investment, which constitutes a major proportion of total annual capital formation. In the final analysis the development of a viable mortgage finance system in African countries is an essential component of general financial development and stable macro-economic environments.

THANK YOU