The Kenya Mortgage Refinancing Company, & Cytonn Weekly #14/2018

Focus of the Week

In a bid to support the Affordable Housing Initiative, Treasury Cabinet Secretary Hon. Henry Rotich announced plans of setting up a Mortgage Liquidity Facility (MLF) i.e. The Kenyan Mortgage Refinancing Company (KMRC), which is aimed at enhancing mortgage affordability and enabling long-term loans at attractive market rates in the country. KMRC is an initiative of National Treasury and the World Bank, and will be owned by the state, commercial banks and financial co-operatives as a Limited Liability Company and is expected to be licensed by CBK in February next year, with initial debt financing of USD 160 mn from the World Bank for lending on to financial institutions. It will be a newly created, non-bank financial institution, that is restricted to providing long-term funding and capital market access to mortgage lenders and issuing bonds to investors and will be under the CBK's supervision, while its bond issuance operations will be overseen by the Capital Markets Authority of Kenya. This week therefore, we look at the proposed mortgage liquidity facility, by looking at the following:

A. Introduction to Mortgage Liquidity Facilities
B. Mortgage Refinancing Companies in Africa; their Achievements, Challenges and Key Lessons for Kenya
C. The Current Kenyan Situation
D. The Conditions Necessary for KMRC to Thrive

A. Introduction to Mortgage Liquidity Facilities

As per the World Bank, a mortgage liquidity facility is a financial institution that is meant to support long-term lending activities by Primary Mortgage Lenders (PML) –such as banks, credit unions and mortgage brokers with the core function being to act as an intermediary between PMLs and the bond market. In Kenya, mortgage lenders are banks, with KCB and Standard Chartered being the leading banks in mortgage lending as per the Residential Mortgage Survey by Central Bank of Kenya, as well as one mortgage finance institution, I.e., Housing Finance. Mortgage refinancing works by:

i. Borrowers cede their property as security for a long-term mortgage loan,
ii. The mortgage liquidity facility will lend its funds to PMLs with the mortgages as collateral,
iii. The mortgage liquidity facility provides a bond to private institutions and investors, with the mortgages as collateral, and,
iv. Institutions with medium to long-term liabilities buy the bonds at a margin above the usual government securities. On bond issuance, investors are likely to buy into the long-term mortgage-backed bond for 13.9%-14.1%, assuming a 1.0% margin above the minimum of the risk-free rate for a 10-year bond, which currently stands at 12.9%, or 13.1% for a 15-year bond.

Refinancing facilities act as suitable intermediaries between primary mortgage lenders and capital markets. In this way, they enable countries with nascent mortgage markets to boost the supply of long-term capital and thus expand mortgage lending, through:

- Legislative reforms, especially to improve land titling and property registration are critically important for the expansion of mortgage lending. Refinancing facilities cannot expand their operations quickly in the absence of an adequate pool of mortgage loans;
- Refinancing facilities foster competition in the mortgage market by promoting the entry of new primary lenders;
- Refinancing facilities have the potential to offer lower interest rates than primary mortgage lenders.

B. Mortgage Refinancing Companies in Africa; their Achievements, Challenges and Key Lessons for Kenya

I. The Egyptian Mortgage Refinancing Company (EMRC)

The EMRC came about from structural reform programs by the Egyptian Government aimed at improving the investment climate and enhance economic growth in Egypt. This was given a boost by the World Bank, which funded the Egypt Mortgage Finance Project (EMFP) with USD 39.1 mn. While this helped in raising the liquidity, banks were still reluctant to write mortgages for two main reasons: (i) the maturity mismatch between their short-term deposits and long-term mortgage loans, and (ii) the lack of registered titles – partly due to the costly and time-consuming process to obtain good title. The government of Egypt in 2015 introduced the idea of contracting out a nation-wide streamlining and digitization of the existing property registration system in a bid to curb the informal and quasi-legal land processes. However, this has not yet come to effect and a paltry 7% -10% of property is formally registered in Egypt. The issues facing the growth of the mortgage market necessitated the government to step in and attempt to create a more enabling environment for lenders to provide home mortgages with attractive rates. For this reason, the Egypt Mortgage Refinance Company was formed under the EMFP in 2006. The EMRC's aim was to provide a low risk residential mortgage finance system in which mortgage lenders would be able compete on a market basis in order to make housing finance available on economically attractive terms and conditions.

Achievements:

i. The EMRC saw outstanding mortgage loans increase by a 5-year CAGR of 73.0% from USD 16.9 mn in 2006 to USD 265.8 mn in 2011,
ii. The number of primary mortgage lenders increased by a 5-year CAGR of 43.0% to 12 in 2011 from 2 in 2006,
iii. The average loan-to-maturity period for mortgages increased to 16-years 2011 from a 2006's average of 7-years, and,
iv. In 2016, EMRC received USD 28.2 mn from the Government of Egypt to re-invest into PMLs home loan reserves as part of the government's USD 1.4 bn mortgage initiative.

Challenges:

i. Lack of a buoyant and growing domestic institutional investor base,
ii. Poor macroeconomic environment worsened by the 2008 global crisis and Egypt's political instability that saw the fall of two governments in 2011 and 2013, and,
iii. Inefficient regulation of the mortgage industry players.

Lessons for Kenya from Egypt:

i. The government should call for the key participation of private institutions by offering them equity and significant governance in the entity, this will ensure that the MRC has the full cooperation of institutional investors,
ii. Formation of non-partisan group with representatives from all sectors to oversee the regulation of

the body will be crucial in ensuring it remain relevant and on track.

II. Tanzania Mortgage Refinancing Company (TMRC)

The Tanzania Mortgage Refinancing Company was formed after the Tanzanian Government, through the Ministry of Lands, Housing and Human Settlements, initiated the Housing Finance Project (HFP) to promote an active mortgage finance market. An agreement with the International Development Association was signed in 2011 with the main aim being to promote the housing mortgage finance market through the provision of medium and long-term mortgage lenders. For this purpose, the World Bank issued a debt of USD 30 mn and like the Egyptian Mortgage Refinancing Company, it was expected that the TMRC would begin issuing bonds in the capital markets to help fund its operations on a market sustainable basis.

Achievements:

- As at June 2017, the mortgage market registered a 7% growth from march 2017 with the outstanding loan value at USD 199 mn (Kshs 20.1bn),
- The number of mortgage accounts also stood at 3,915 with Kenya's Equity banks having the largest market share at 25.5%,
- The number of mortgage lenders has increased to 30 as at June 2017, from 2 in 2011,
- Mortgage loans' average duration also increased since the creation of the TMRC, from 5 to 10 years to 15 to 20 years.

Challenges:

- Government imposing new tax regimes on sale of properties, thus pushing home prices upwards
- Unfriendly land laws and lack of developer financing thus limiting housing supply,
- Due to unavailability of sufficient mortgage schemes, private developers have shied away from middle income housing opting rather for high end properties,
- Limited affordable housing coupled by high interest rates prevailing at 16-19%. To this end, Tanzania's national corporations such as National Housing Corporation and Watumishi Housing have been at the forefront of providing affordable Housing and currently, NHC accounts for 70% of residential homes in Dar es salaam and continues to unveil low cost housing projects aimed at low income earners. By this year, National Housing alone is expected to deliver over 2,000 homes for low to medium income earners through such projects as Kawe's 711, and Mwongozo Estate,
- In Tanzania, only 3.9% of housing units are provided by the private sector, with over 70% being individually owned homes. However, home construction and land purchase loans remain out of reach for most due to low income and the high interest rates.

Lessons for Kenya from Tanzania:

- With the housing deficit growing annually at approximately 200,000 units, and only 40% of urban dwellers and 7% of rural dwellers can afford a Kshs 1.7 mn mortgage loan, the government should channel its efforts towards provision of low cost homes as it has access to free land as well as infrastructure, compared to private developers who have to incur the extra costs,
- The government should also work towards improving lives by easing the rate of unemployment in Kenya which currently stands at 11.0% as at 2016, compared to a global average of 5.7%.

III. Nigeria Mortgage Refinancing Company (NMRC)

The Nigeria Mortgage Refinance Company Plc (NMRC) was incorporated in 2013 with the sole aim of providing affordability of good housing to Nigerians by enhancing increased liquidity in the mortgage market though mortgage and commercial banks. This was through a concessional USD 300 mn 40-year loan by the International Development Association (IDA) loan at 0.75% to the dollar. It was incorporated as part of the Nigeria Housing Finance Programme, by Federal Ministry of

Finance (FMOF), the Central Bank of Nigeria (CBN), Federal Ministry of Lands & Urban Development & Housing and the World Bank/international Finance Corporation as a public company registered with the Securities & Exchange Commission (SEC). Of key to note is that, the World Bank in a bid to avoid the same mistakes in Tanzania and Egypt of not tapping into the capital market, mandated for the International Development Association loan to the NMRC to be disbursed in phases as subordinate debt financing with the funds being invested in securities to cover the NMRCs operational costs and grow its capital base.

Achievements:

- In 2014, Financial Markets Dealers Association trading platform, Nigeria's Securities Exchange, listed the NMRC Naira 8bn Series 1, a 15-year 14.9% fixed rate bond. The 15-year bonds are meant to refinance existing mortgages that meet specified underwriting requirements,
- By 2015, NMRC refinanced approximately Naira 1 bn (Kshs 280.8 mn) of existing mortgages of Imperial Homes Nigeria,
- As at 2017, NMRC's liquidity stood at Naira 440 bn (Kshs 123.5 bn).

Challenges:

- The leading challenge for Nigeria's MRC remains the macroeconomic environment. As at 2017, the lending rates were still high at an average of 24-27% for mortgage borrowers and double-digit inflation rates,
- The volatility of the Naira against the US Dollar,
- Limited access to finance by the end users, and in addition,
- High costs of construction and infrastructure,
- Limited public understanding of its key role in the mortgage industry. To this end, NMRC last year announced partnership with Centre for Affordable Housing Finance in Africa, that will enable (i) data exchange towards the mutual development of the NMRC Mortgage Market Information Portal, (ii) building a Housing Economic Model for Nigeria, (iii) data analysis to assess mortgage access, performance and profitability in Nigeria.

Lessons for Kenya from Nigeria:

- Nigeria has ensured a sufficient regulatory system that has private, state and federal players thus ensuring transparency and effectiveness,
- The MRC should uphold innovation to enable it to address the problem as per Kenya market's special needs,
- Additionally, the government and the private sector should come up with institutions that will see a fair analysis of the mortgage market in Kenya, and the subsequent performance of KMRC.

Based on the case studies, the **key issues affecting** mortgage liquidity facilities include:

i. Inefficient regulation schemes over MLFs,
ii. Unestablished capital markets and institutional investors base,
iii. Unfavorable government policies affecting the real estate sector such as monetary policies that promote high interest rates as well as tax regimes,
iv. Poor macroeconomic environments,
v. Insufficient supply of affordable homes, and,
vi. Lack of an efficient land titling process.

C. The Current Kenyan Situation

In Kenya, mortgages declined by 1.5% as of December 2016 to 24,085 from 24,458 in December 2015 attributed to the interest rates cap law. As property prices rose, the value of mortgage loan assets outstanding increased to Kshs 219.9 bn in December 2016 from Kshs 203.3 bn in December

2015, an increase of 8.1%. However, following the interest rate cap law, average mortgage interest rates dropped to 10.5%-18.0%, from 11.9%-23.0% in 2015. As per the 2016 Kenya Mortgage Survey by Central Bank of Kenya, factors hindering the maturity of the Kenyan mortgage market despite its potential include: (i) high costs of houses against low incomes, (ii) high lending rates, (iii) difficulties with property registration and titling, (iv) undeveloped standardization of loan underwriting, documentation or servicing procedures, and (v) lack of access to long term financing. To address this; (i) the Ministry of lands is currently undertaking the land registration digitization process and effecting a computerized titling system and to enable multiple land titling, and (ii) According to Hon. Henry Rotich, the National Treasury is in the process of revising the interest rate cap law from the current 13.5% due to the negative effect it has had in the credit sector, such as the decline of private sector credit growth which dropped to 2.1% as at February 2018.

In our view, the **key conditions necessary** for the success of Kenya Mortgage Refinancing Company will be:

i. Transparent and effective regulation of KMRC by a regulatory body. To this end, the government announced that the MRC will be supervised by the Central Bank of Kenya and regulation by the Capital Markets Authority. Of key to note however, is that there is need for inclusion of the private sector in the oversight as they will make up the investor base,
ii. Governance rules designed to ensure its efficiency, especially now that the government is the biggest shareholder,
iii. A clear and efficient land titling process,
iv. Sufficient support from the private sector, especially in regards to bond issuance, and,
v. Provision of affordable homes (***we shall address affordable housing in a future focus note).***

With this in mind, we are of the view that for KMRC to have a meaningful impact, we need to address the cost of housing to make it more affordable. On bonds issuance, investors are likely to buy into the long-term mortgage-backed bond for 13.9% - 14.1%, assuming a 1.0% margin above the minimum of the risk-free rate for a 10-year bond, which currently stands at 12.9%, or 13.1% for a 15-year bond. In or view, this is still high for financing end user mortgages as it might mean high costs of debt thus locking out low income earners. The assumption is based on the typical corporate premium charged above the risk-free rate. This however, should be guided by the Capital Markets Authority's Policy Guidance Note (PGN) which is aimed at facilitating the issuance of Asset-Backed Securities (ABS). Kenya Mortgage Refinancing Company is a step in the right direction towards making the Government initiative of providing 500,000 homes per year till 2022 come to effect. We expect the body to result to a rise in (i) number of mortgage lenders, (ii) the number of mortgage undertakings, and thus (iii) increased uptake of homes by the low-income population.