Capital Markets Based Home Ownership Savings Plans, & Cytonn Weekly #03/2020

Focus of the Week

This week we revisit the Home Ownership Savings Plan, HOSP, topic in light of the Finance Act 2019, which expanded the scope of approved institutions that can hold savings towards HOSP to include Fund Managers and Investment Banks registered under the Capital Markets Act; the expansion was through the amendment of the Income Tax Act. Before the amendment, only banks savings qualified for HOSP. We review the prevailing housing market conditions that led up to the government's declaration of affordable housing as part of the Big 4 Agenda and the effect of recent government incentives in promoting affordability. We also look at features of the Cytonn Affordable Housing Investment Plan, an investment plan that will enable Kenyans to build a deposit towards their affordable housing ownership; CAHIP is a collaboration between Cytonn Investment, as the structuring agent, and Cytonn Asset Managers Limited, as the Fund Manager eligible to take HOSP savings.

As such, we shall look at the following:

i. Government's Affordable Housing Agenda,
ii. A Recap of Our Analysis of Home Ownership Savings Plans and Recent Developments,
iii. Benefits of Home Ownership Savings,
iv. Structural Impediments to Capital Markets Based Home Ownership Savings Programs, and,
v. The Cytonn Affordable Housing Investment Plan, CAHIP.

Section I: Government's Affordable Housing Agenda

Kenya's housing sector is largely characterized by deteriorating housing conditions countrywide arising from a demand that far outpaces supply, particularly in urban areas. According to the National Housing Corporation (NHC), Kenya has a cumulative housing deficit of 2.0 mn units growing by 200,000 units per year driven mainly by; i) rapid population growth of 2.2% p.a. compared to the global average of 0.9%, and ii) a high urbanization rate of 4.3% against global and Sub-Saharan averages of 2.1% and 4.1%, respectively. Supply, on the other hand, has been constrained mainly by the high construction costs, high costs of land in urban areas as well as high cost of capital, with the Ministry of Housing in Kenya estimating the total annual supply to be at 50,000 units.

Notably, the Ministry indicates that 83.0% of the existing housing supply is for the high income and upper-middle-income segments, with only 15.0% for the lower-middle and 2.0% for the low-income population. In short, while 74.4% of Kenya's working population requires affordable housing, only 17.0% of housing supply goes into serving the low to lower-middle-income segment. This shortage in housing has manifested itself through the proliferation of slums and informal settlements in urban areas and poor quality housing in rural areas.

It is in this regard that the President of Kenya declared the Affordable Housing Initiative under the Big Four Agenda in 2017 aiming to deliver 500,000 homes by 2022 with a price range of Kshs 0.6 mn and Kshs 3.0 mn.

Affordable Housing - Income Classes

Type of Housing	Income Range (Kshs)	% of Kenyan Population
Social Housing	0-19,999	2.6%
Low Cost Housing	20,000-49,999	71.8%
Mortgage Gap	50,000-149,999	22.6%
Middle to High Income	>150,000	2.9%

Source: Ministry of Housing

The target beneficiaries for the units are Kenyans who are unable to access long-term housing finance. This is as most local banks have products for households that earn above Kshs 150,000 per month.

As a low middle-income country, Kenya's largest challenge has been access to finance. As a result, previous government regimes had introduced some measures aimed at alleviating the housing finance crisis, namely:

a. **Mortgage Relief:** Introduced in the 1995 Income Tax Act cap 470, borrowers of mortgages from a registered financial institution to purchase a home or to improve a home guarantees them tax relief on interests paid to the registered financial institution of up to a maximum of Kshs 300,000 p.a.,
b. **Home Ownership Savings Plan:** Introduced in 1995 in the Income Tax Act and amended in 2018, savings with a Registered Home Ownership Savings Plan for a maximum of ten-years allows the subscribers tax exemption on income to a maximum of Kshs 8,000 per month or Kshs 96,000 annually and on interest income earned by a depositor on savings of up to a maximum of Kshs 3.0 mn.

However, since the declaration of Affordable Housing Agenda, the current regime has gone ahead and passed a host of more legislations meant to enable the affordable housing initiative. These include:

a. **Affordable Housing Relief:** The Income Tax Act was amended in 2018 to allow 15.0% tax relief up to a maximum of Kshs 108,000 p.a., or Kshs 9,000 p.m., to affordable home buyers,
b. **Stamp Duty Act:** Amended in 2018, the Act allows for the exemption of first-time homebuyers under the affordable housing scheme from paying the Stamp Duty Tax, which is normally set at 2.0% - 4.0% of the property value depending on location, and,
c. **Kenya Mortgage Refinancing Company:** The facility was set up with the intention of enhancing mortgage affordability in Kenya by enabling long-term loans at attractive market rates through the provision of affordable long-term funding and capital market access to primary mortgage lenders such as banks and financial co-operatives.

The government has over the past three years also introduced a host of other measures to help ease construction costs for developers of affordable housing, key among them being:

i. 50% corporate tax break from 30% to 15% for investors who put up 100 and above affordable housing units,
ii. Scrapping off, of the NEMA and NCA levies, which used to be 0.1% and 0.05% of the project costs, respectively,

iii. Exemption of VAT for supplies imported or purchased for direct and exclusive use in the construction of affordable houses by licensed Special Economic Zones (SEZ). Developers will also need (i) a recommendation from the Cabinet Secretary for Housing, and (ii) a minimum of 5,000 units to qualify,
iv. Exemption of companies implementing projects under the affordable housing scheme from the application of thin capitalization rules,
v. Exemption of the transfer of a house constructed under the affordable housing scheme from the developer to the National Housing Corporation from Stamp Duty,
vi. Reduction of Import Declaration Fee (IDF) on inputs for the construction of houses under the affordable housing scheme approved by the CS Finance from 2% to 1.5%, and,
vii. Under the Nairobi City County Sessional Paper Number 1 of 2018, waiving of building fees for all affordable housing projects in Nairobi.

The above measures are aimed at lowering construction costs by approximately 30.0%, from the average market rate of Kshs 44,754 per SQM to Kshs 31,328 per SQM, thereby fostering the development of affordable homes. The table below shows the anticipated impact of the above incentives in promoting affordability.

Affordable Housing Initiatives

Initiative	Expected Impact on Reducing Property Prices	Impact on Buyers
Reduction of Import Declaration Fee (IDF) from 2.0% to 1.5%	0.5%	Indirect
Zero rate VAT for affordable construction supplies	16.0%	Indirect
Corporate tax reduction from 30% to 15% for developers of over 100 units	8.0%	Indirect
The scrapping of 2.0% and 4.0% Stamp Duty for First-time Homebuyers	3.0%	Direct
Total Impact on Affordability	**27.5%**	

Source: Cytonn

We estimate that measures such as zero-rating VAT, reducing IDF Fee, and the 50.0% corporate tax reduction for developers will indirectly reduce home prices by at least 16.0%, 0.5%, and 8.0%, respectively, while the scrapped off stamp duty outright saves the homebuyer 2.0% or 4.0% of the home value. Thus, on average, the incentives will help increase affordability by up to 27.5%. Taking, for instance, an average two-bedroom unit priced at Kshs 7.0 mn in the prevailing market values; with the government incentives applied, the unit price, therefore, will cost Kshs 5.1 mn. We also expect that other measures such as the incorporation of The Kenya Mortgage Refinancing Company will also ease the cost of buying in the long run, particularly for mortgage borrowers. In our KMRC Topical, we estimated that the facility would help reduce monthly repayments for a mortgage by at least 14.0%, comparing a mortgage loan of 12 and 20 years offered at an interest rate of 13.6%.

Section II: A Recap of Our Analysis of Home Ownership Savings Plans (HOSP) and Recent Developments

It has been our view that linking housing finance systems to the capital market, which is capable of offering attractive rates to Kenyans saving for homeownership will enhance financial liberalization and assist low-income earners to efficiently save towards homeownership as part of the overall government’s development strategy.

To reiterate our Home Ownership Savings Plans (HOSP) topical pieces dated September 15, 2019, and December 22, 2019, the Income Tax Act cap 470 defines a Home Ownership Savings Plan (HOSP) as a savings plan established by an 'approved institution' and registered with the commissioner for Income Tax for receiving and holding funds in trust for depositors. It is a tax-sheltered savings plan whose main objective was to enable individual depositors to save for home acquisition or development and was introduced in Kenya in 1995. The regulation allows depositors tax rebates of Kshs 8,000 per month maximum or Kshs 96,000 per annum, effectively reducing an individual's taxable income by the amount of their monthly contribution) with the condition that it is with a Registered Home Ownership Savings Plan. As per the Income Tax Act, any interest earned on the deposits up to Kshs 3.0mn is also tax-exempt. It is also important to note that Registered Home Ownership Savings accounts in Kenya are restricted to first time home buyers. The accumulated funds are withdrawn tax-free to strictly purchase or construct a house. Thus, if the depositor utilizes the funds for any other purpose other than to acquire a house, they become taxable in the year of withdrawal.

In the topical, we also noted how Home Ownership Savings Plan in Kenya has not been very successful in its overall objective, which was to avail housing finance and promote a culture of savings for aspiring homeowners. This has been evidenced by the fact that only one institution, Housing Finance, explicitly offers the product to the public; the low homeownership rates in the country which as per the Kenya Integrated Household Budget Survey of 2016 stood at 26.5%; and the relatively low mortgage uptake with 26,504 mortgage accounts recorded as at 2018 against an adult population of 23.0 mn and the existing housing deficit estimated at 2.0 mn by the National Housing Corporation.

As at the time of our first topical, the Income Tax Act restricted the product to a few approved institutions, which were; banks or financial institutions registered under the Banking Act, insurance companies licensed under the Insurance Act or building societies registered under the Building Societies Act.

It is in this regard that real estate and capital market players lobbied for the passing of Registered Home Ownership Saving Plans to include Fund Managers and Investment Banks under the Capital Markets Act. This is also because, a well-developed capital market that is in sync with the housing finance system is a prerequisite for a sustainable, low-cost capital raising mechanism for affordable housing in Kenya for both developers and potential homeowners. As such, we lobbied stakeholders and recommended that Fund Managers and Investment Banks should qualify as HOSP approved institutions, under Section 22 C (8) Income Tax Act 2018.

We commend the government for heeding this call. The Finance Act of 2019, passed in November 2019, expanded the scope of approved Institutions which can hold deposits of a HOSP to include Fund Managers and Investment Banks registered under the Capital Markets Act.

Section III: Benefits of Home Ownership Savings

The current attractiveness of HOSP schemes to stakeholders stems in part from the financial and housing market conditions that prevail today in the Kenyan market characterized by lack of long-term savings, the huge housing shortage, affordability problems as evidenced by extremely high price-to-income ratios, relatively high and volatile inflation, as well as reduced wage incomes. For the government, HOSP schemes alleviate the housing problem by enabling homebuyers to have the required funding to acquire a home. As it is, there exists a direct correlation between the existing housing finance system and the level of informal settlements in the country, which the World Bank estimated to be 61.0% of urban dwellers as at 2017. For financial institutions, HOSP schemes can offer effective screening and monitoring as well as establishing the reputation of steady savers as future borrowers, thus lowering credit risks. Savers, on the other hand, stand to benefit in the following ways:

i. **Tax Rebates:** According to Income Tax Act, individuals in a Registered Home Ownership Savings Plan are guaranteed tax exemption on income of up to Kshs 8,000 per month or Kshs 96,000 per annum, while the interest income of up to Kshs 3.0 mn is tax-exempt upon withdrawal. With this, assuming a median income of Kshs 50,000, an individual depositing Kshs 8,000 per month with a registered HOSP account pays 28.1% less PAYE (Pay as You Earn) than one without a HOSP account, as shown below:

(All Values in Kshs Unless Stated Otherwise)

PAYE Remittances Scenario

	HOSP Subscriber	**Without HOSP**
Monthly Gross Salary (Kshs)	50,000	50,000
HOSP Remittance (Kshs)	8,000	-
PAYE (Kshs)	5,459	7,596
Taxable Income (Kshs)	**42,000**	**50,000**

ii. **Credit Profile:** In a country like Kenya, the provision of loans for private households is rather restricted, which also implies exorbitant interest rates and very short repayment timelines. This is mainly because lending institutions are not in a position to evaluate the creditworthiness of potential customers as the majority of people do not have bank accounts or have very irregular incomes with 83.4% of the working population being within the informal sector. Having an active HOSP sector can help customers establish their creditworthiness through their regular saving. Those who can save a small portion of their income regularly will be identified as reliable borrowers, and,
iii. **Household Savings:** Saving in a HOSP fund facilitates the accumulation of equity for households or the depositors by establishing a savings discipline, which can be non-existent in many emerging economies like Kenya. As such, the schemes provide a concrete goal for homebuyers and offer prospects of a well-priced loan, which ultimately makes it easier for an individual to acquire a home by efficiently raising a deposit for a future house loan. According to the World Bank, inability to raise deposits required to access mortgage has been proven as one of the reasons behind the small number of home loans, necessitating the need for tax incentives to boost savings for property acquisition.

Section IV: Structural Impediments to Capital Markets Based Home Ownership Savings Programs

While the government has done a lot to stimulate HOSP, we still have 3 key structural impediments to the Capital Markets Based Home Ownership Program that require urgent review, in any case, the biggest financier to sustainable affordable housing is going to capital markets funding. We request the government and the Capital Markets Authority, CMA, to look into these three issues with due speed since they are huge impediments to capital formation towards affordable housing:

i. **Allow Specialist Funds:** Our archaic capital market rules currently do not allow investors to form a specialized fund, such as an affordable housing real estate fund, because the Collective Investment Schemes regulations allow only 25% of a fund to be invested in one sector; so even if you form a real estate fund, only 25% can go into real estate, the rest has to go to other sectors,
ii. **Remove Conflict of Interest by Banks:** The regulations currently require that the overseer / Trustee of a collective investment scheme must be a bank, and indeed only 5 banks are registered as Trustees. Obviously, commercial banks are good in deposit gathering and lending, not capital markets instruments, but more importantly, they will be more comfortable with allocating investor savings back into the banking sector rather than into the housing sector,

iii. **Reduce the Minimums for Investors Wishing to Put Money Together to Invest in Affordable Housing:** Our CMA rules essentially require that an investor must have at least Kshs 1.0 mn in the case of a real estate high yield fund, or Kshs 5.0 mn in the case of Real Estate Investment Trust, in order to come together as investors to invest in real estate. These amounts are too high for a regular Kenyan and seem designed to lock out the regular Kenyan, leaving them with no option but to join informal schemes such as Ekeza, where they end up risking their savings.

Affordable housing agenda will not move fast or far without capital markets funding, and capital formation will not happen without reviewing the above structural impediments; it is crucial that we review the above 3 with a sense of urgency.

Section V: The Cytonn Affordable Housing Investment Plan (CAHIP)

Majority of Kenyans desire to own a home and this has seen many duped by unscrupulous organizations purporting to help them achieve that objective. Having been a key player in lobbying for expanding of HOSP to include Fund Managers, and in an effort to provide a credible home savings platform, Cytonn Investments will on Tuesday, 21st January 2020, launch the Cytonn Affordable Housing Investment Plan (CAHIP) with the main objective being to offer a solution to members of the public, the common *mwananchi*, who are keen on saving towards homeownership.

CAHIP will provide those saving towards home purchase an attractive investment proposition, compared to those currently available in the market. To achieve this, CAHIP, which is structured by Cytonn Investments, has partnered with the Cytonn Money Market Fund, which not only has tax advantages for those saving towards homeownership but provides high levels of returns while protecting investor's capital. The key features are as indicated below:

i. The minimum initial investments into the Fund shall be Kenya Shillings One Thousand (Kshs. 1,000), with individuals and then making monthly contributions to a minimum of Kshs 1,000,
ii. The savings made shall attract an attractive interest of approximately 10.0% - 11.0% p.a., in line with the target return of the Cytonn Market Money Fund,
iii. Unit holders will be entitled to a tax exemption on savings made under the Fund subject to a maximum of Kshs 8,000 per month or Kshs 96,000 per year for 10-years, in line with the Income Tax Act Section 22,
iv. Any interest income on savings, up to a maximum of Kshs 3.0 mn of savings, earned by the unit holder on investment into the Fund shall be exempt from tax. However, any excess amount of the withdrawal shall be subject to tax, and,
v. Individuals can save up for as long as they wish and/or until they have a property (residential house or land) into which they would like to direct the savings, upon which evidence must be provided. However, if the depositor utilizes the funds for any other purpose other than the above mentioned, the savings become taxable in the year of withdrawal.

Below we illustrate an individual savings plan through: (i) a HOSP scheme, which is likely to offer a 5.0% return per annum, based on the rates we received in the market, and (ii) a Fund Manager’s Unit Trust Fund such as the Cytonn Affordable Housing Investment Plan, offering a 11.0% yield per annum; the purpose of the example is to show how much a depositor would have after the ten-year period:

(All Values in Kshs Unless Stated Otherwise)

	CAHIP	HOSP (Current Market Rate)
Monthly Deposits	2,000	2,000
Rate of Return	11.0%	5.0%
Tenor (Years)	10	10
Future Value	**432,249**	**310,565**

• At the end of a ten-year savings period, a depositor in a unit trust fund would have Kshs 432,249, 39.2% more than an individual saving in a HOSP fund in the current market
• In the affordable housing programme, to make a purchase of a three-bedroom unit costing Kshs 3.0 mn, a 12.5% deposit is required. The unit trust investor will have 15.3% more than the required amount of Kshs 375,000, while persons saving through the existing HOSP scheme would be short by 17.2%

Assuming (i) an 11.0% yield on savings, (ii) goal is to build a 10% towards a house costing Kshs 4.0 mn, hence saving at least 400,000, this is how long it would take you (assuming an initial investment of Kshs 5,000). The below table also shows different levels of monthly savings needed to achieve the Kshs 400,000:

All values in Kshs unless stated otherwise

Monthly Investment after Initial 5000	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
1,000	17,139	31,716	47,890	65,835	85,746	107,837	132,347	159,542	189,715	223,192
2,000	28,730	57,277	88,951	124,094	163,085	206,346	254,346	307,602	366,690	432,249
3,000	40,321	82,838	130,012	182,352	240,424	304,856	376,344	455,661	543,665	641,306
4,000	51,912	108,399	171,073	240,610	317,763	403,365	498,342	603,721	720,640	850,363
5,000	63,503	133,960	212,134	298,868	395,102	501,874	620,340	751,780	897,615	1,059,420
6,000	75,094	159,521	253,194	357,127	472,441	600,384	742,339	899,840	1,074,590	1,268,477
7,000	86,685	185,082	294,255	415,385	549,780	698,893	864,337	1,047,899	1,251,564	1,477,534
8,000	98,276	210,643	335,316	473,643	627,119	797,403	986,335	1,195,959	1,428,539	1,686,591
9,000	109,867	236,204	376,377	531,901	704,458	895,912	1,108,333	1,344,018	1,605,514	1,895,648
10,000	121,458	261,765	417,438	590,159	781,797	994,421	1,230,332	1,492,078	1,782,489	2,104,705

In conclusion, being part of a risk-averse homeownership savings plans that offers an attractive return on your homeownership savings will enable savers to purchase a home more easily and more efficiently in comparison to other savings vehicles and for ardent savers; a high rate of return also means high-interest income and capital stability.

For more information on CAHIP, email us at housing@cytonn.com.