THE CAUSES OF NON-PERFORMING MORTGAGE LOANS IN KENYA'S RESIDENTIAL PROPERTY MARKET

CHEGE WAIGANJO

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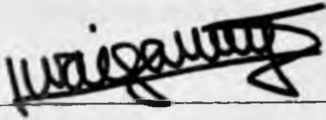
DECLARATION

I CHEGE WAIGANJO, hereby declare that this research project is my original work and has not been presented for the award of a degree in any other university.

Signature: 

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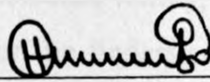
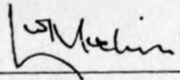
Dr. Ing. W.H.A Olima Signed: 

Mr. L. W. Muchiri Signed: 

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DEDICATION

The word *mortgage* comes from two Latin words. The first one is '*mortuus*', which means '*death*' and the second is '*gage*', which means '*grip*'

This research is dedicated to those, whose mortgages have become a '*death grip*'.

ABSTRACT

Mortgages have generally been understood to comprise the lending of money by mortgage financial institutions against the security of a fixed property that should hold a value greater than that of the value advanced. This view creates the impression that mortgage financing is generally low risk as the value of the property covers the loan and so the loan is adequately secured should there be a default in repayments. The reality however is that mortgage financial institutions experience bad debts similar to and in some cases of higher levels than found in the banking industry as whole.

Interest rates on mortgages in Kenya have fluctuated between 18 per cent and 30 per cent in the last 10 years. In addition to this, economic growth in the country has been slow, with some years registering negative growth. For example in year 2000, the country registered a growth rate of negative 0.3 per cent (IEA, 2002). This has led to economic woes in the productive sectors of the economy and such consequences as retrenchments as firms and industries were forced to shut down or reduce their operations. This not only led to reduced demand for new mortgages because of rising unemployment but also to a high number of mortgagees who have been unable to service their loans as per the mortgage contracts. Mortgage defaults have led to financial institutions experience high levels of non performing loans.

Unfortunately, lenders have not identified with the problems facing their customers. Instead of offering discounts on interest rates and more lenient repayment terms in order to recover their money, they levy additional payments as a punishment for a mortgagees incapacity to pay, equating incapacity with unwillingness to pay. They appear to be in a position of power and often face little or no competition as borrowers have experienced when their properties are auctioned.

This study has sought to identify the main causes of non performing mortgage loans from both the borrowers and mortgage finance companies. The main ones have been identified and expounded. The study has also sought to identify the solutions from the perspectives of borrowers and lenders as well as those advanced by Central Bank of Kenya, which is the regulator of financial systems and practices in the country.

Various recommendations which are aimed at reducing the current high level of non performing mortgage loans have been given as well as measures which would ensure that the mortgage finance system is equitable and sustainable.

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CHAPTER ONE

INTRODUCTION AND PROBLEM STATEMENT

1.0 Introduction

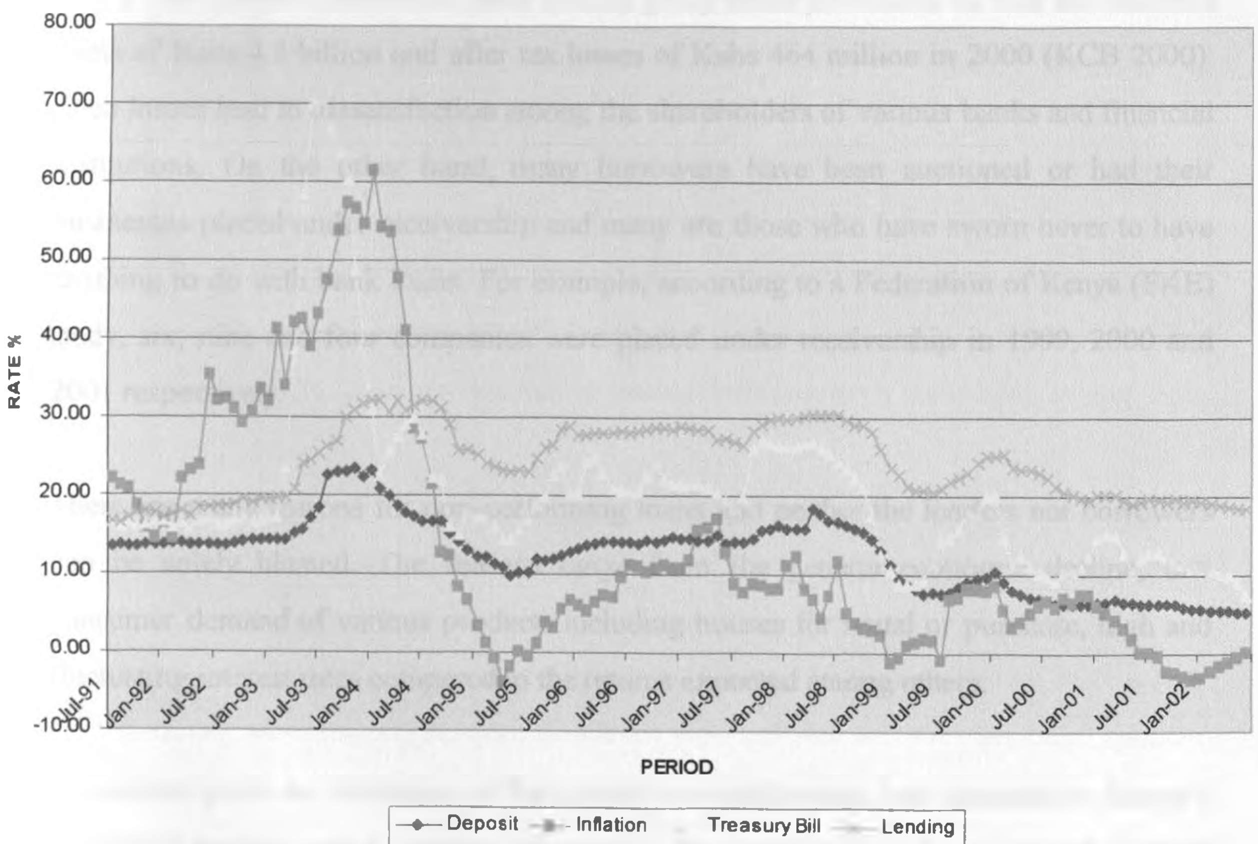
The access to and provision of reasonably priced credit to any business organization or individual to a large measure contributes to its growth. Credit refers to funds made available to an organization or individual from an external source, normally a bank or other financial institution, which is repayable together with accrued interest at a future agreed date and time. To be advanced credit borrowers must of necessity prove that they are able to meet the repayment conditions and requirements.

From the purchase of a family's modest first home to the multimillion commercial sale of a property, financing is the key to almost every successful real estate transaction. Financial institutions lend money because lending is profitable and much of the profitability being from the risk entailed. Lenders are exposed to various financial risks in their lending and investing activities. The main risks are credit risk, liquidity risk and interest rates risk. Behaving like rational investors, the financial institutions consider the returns and risks entailed in each investment before making the decision on whether to lend or not and how much to lend. A lender's risk is reduced when its loan is secured because when a particular real estate secures a debt, then the lender gains a right to sell the security and apply the proceeds against the debts if the borrower fails to pay or violates some other term of the loan agreement (Gibson and Karp et al, 1992)

In the last 10 years, Kenya has experienced rough economic times. One of the most negatively affected groups are those who had taken up loans and for various reasons were unable to service them. There have been many cases of loan defaults and consequent efforts by financiers or lenders to sell whatever property or item was used as security for the debts. For example, the leading mortgage finance company in Kenya, Housing Finance Limited opened an auction mart in 2000 with the aim of selling off, by public auction, the properties that they had lent against and had foreclosed.

Since 1992, the Kenya government embraced open market policies and deregulated many aspects of the economy including the banking sector (Ndung'u and Ngugi, 2000). Interest rates on loans were deregulated and the forces of demand and supply were left to set or determine the equilibrium rates. The immediate effect of the economic and financial liberalization was that the main economic indicators, namely lending interest rates, inflation rates, Treasury Bill rates and economic growth rates became unstable and unpredictable. One of the most dramatic changes was the treasury Bill rate, which rose from 18.6 per cent in January 1993 to 70 per cent in July 1993. The level of inflation also fluctuated dramatically as shown and this resulted to economic uncertainties and resultant loss of investment opportunities and reduced levels of economic growth. These fluctuations are shown in figure 1 below.

Figure 1. The percentage levels of deposits, inflation, treasury bills and lending rates.



Lending interest rates have fluctuated from 18% in 1991 to a high of 32% in 1994 and 21% in 2002. To the existing loans this resulted to increased mortgage installment amounts. The borrowers thereby found themselves caught up in a difficult situation where mortgage installments had almost doubled and their economic conditions had not changed. Servicing the loans therefore became difficult and defaults set in, thus the increase in non-performing loans. Decreasing returns in form of rentals attainable or expected sales prices compounded the situation.

Non-performing loans are those loans that are not being serviced as per loan contracts and expose the financial institutions to potential losses. Their occurrence have impacted negatively on both lenders and borrowers to a great extent. Lenders, both commercial banks and mortgage finance institutions have undergone losses, as they have had to write off some debts or make provisions for them in their accounts as bad and doubtful debts. For example, Housing Finance Limited made provisions for mortgage losses of Kshs 186.6 million and made an after tax loss of Kshs186.5 million in 2001 (Housing Finance, 2001). The Kenya Commercial Bank (KCB) group made provisions for bad and doubtful debts of Kshs 4.3 billion and after tax losses of Kshs 464 million in 2000 (KCB 2000). Such losses lead to dissatisfaction among the shareholders of various banks and financial institutions. On the other hand, many borrowers have been auctioned or had their businesses placed under receivership and many are those who have sworn never to have anything to do with bank loans. For example, according to a Federation of Kenya (FKE) study, six, nine and four companies were placed under receivership in 1999, 2000 and 2001 respectively.

There are many reasons for non-performing loans and neither the lenders nor borrowers can be solely blamed. The reasons range from the general economic decline, low consumer demand of various products including houses for rental or purchase, high and fluctuating interest rates compared to the returns expected among others.

The above gives an indication of the current non-performing loan situation in Kenya's residential market, which problem is immense. The reasons given from either the supply side or the demand side (lenders and borrowers) calls for a study to determine which are

the main ones, as this would help in focusing on the best solutions to the problems faced. The solutions would point on the way forward for the mortgage industry in Kenya.

1.1 Problem Statement

There are two Mortgage Finance Companies in Kenya. These are Housing Finance Limited and Savings and Loan (K) Limited. These two institutions combined command a market share of 67 per cent of residential property lending (CBK, 2000). Other institutions that provide finance for house purchase or construction include Building Societies such as East African Building Society, Equity Building Society and Family Finance Building Society. The government, through the National Housing Corporation is involved in construction of residential houses, mainly to the low income group and avails loans mainly on Tenant Purchase at comparatively low interest rates compared to the market rates. The National Social Security Fund (NSSF) is also an active participant in the industry though it is a recent entrant in providing end finance, through tenant purchase, for the houses it has constructed. Others include various commercial banks, which mainly lend to their staff for house purchase at low 'staff' interest rates and insurance companies.

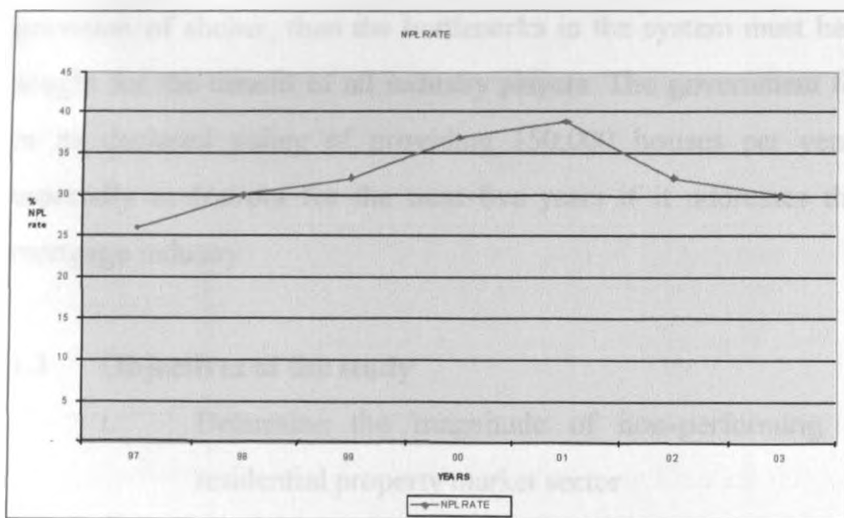
Most homebuyers enter into mortgage arrangements intending to pay the amounts borrowed together with interest. This is, however, not always possible due to variations in loan terms, for example, rising interest rates, resulting in higher monthly payments being required, changes in borrowers' financial conditions due to loss of income among others. Consequently, a rising number of borrowers have been defaulting in their loan repayments.

Non-performing loans are a problem to many banks and not just in the property market sector. In Kenya, as at December 2001 an estimated 42.1 per cent of all loans were non-performing (CBK 2001). The average annual rate since 1997 is as shown in Figure 1. This rate is evidently high and threatens the survival of the banking industry. Furthermore, this has translated into higher cost of bank credit, slowed economic growth and employment opportunities (CBK, 2000). High cost of bank credit and reduced consumer demand for various products including real estate worsens an already bad situation especially for those struggling to pay often pushing them to bankruptcy. In the

property market sector, the level of non-performing loans as a percentage of total loans in Housing Finance Limited was 52 per cent in 2000 and 58 per cent in 2001 (CBK, 2000; Housing Finance, 2001) while in Savings and Loan (K) Limited was 32.7 per cent in 2000 (CBK, 2000). These rates are evidently high and unsustainable. They threaten the survival of the affected institutions and calls for concerted efforts by all players to arrest the situation before it gets out of hand.

Figure 2:

Annual Percentage Rate of Non-Performing Loans in the banking sector since 1997.



Source: Central Bank of Kenya

NB. The rate for year 2003 is at February

Both lenders and borrowers have advanced various reasons for the problem of non-performing loans. Both have at times traded accusations to each other with borrowers accusing lenders (mainly banks) of greed and practising usury at the expense of Kenyans facing harsh economic conditions including reduced rental incomes from their property investments. On the other hand, the banks have defended themselves against such accusations by stating that they are also faced by the poor economic conditions and being in business are answerable to shareholders who demand profits like in any other profit making organization (East African Standard, April 2002).

Non-performing loans impact negatively on the borrowers, lenders and the economy as a whole. To the borrowers, they lead to stress and its related consequences, loss of faith in the credit system but the worst consequence is when the borrowers' home is auctioned

after paying for many years and the amounts outstanding keep on increasing. To the lenders there is loss of income and can even lead to bankruptcy when income does not match the expenditure. The whole economy suffers when there is loss of confidence in the banking or credit industry. Local as well as foreign investors keep away when the cost of money is too high and when prospects of making profits are bleak.

The problem is critical as any industry or business that exhibits a failure rate of 40 – 50 percent indicates that there are serious problems that require short term and long-term remedial measures if it is to be sustained. Since the mortgage industry is crucial to the provision of shelter, then the bottlenecks in the system must be identified and solutions sought for the benefit of all industry players. The government for example, can succeed in its declared policy of providing 150,000 houses per year to the urban markets especially in Nairobi for the next five years if it addresses the constraints facing the mortgage industry.

1.2 Objectives of the study

i. Determine the magnitude of non-performing mortgage loans in the residential property market sector.

ii. Identify the main factors that have contributed to the high level of non-performing mortgage loans in Kenya.

iii. Identify possible solutions to the problem of non-performing mortgage loans and suggest measures to be taken by the main players in the industry to reduce their occurrence.

1.3 Hypothesis

Non performance of mortgage loans in the residential property market is mainly caused by poor credit assessment of borrowers by lenders.

1.4 Methodology

This study was investigative and analytical. It was primarily based on primary and secondary data. The study relied on interactive review of both quantitative and qualitative analysis of primary information and data.

The study focuses on the residential property market since 80 – 90 percent of all applicants financed by the two mortgage finance companies are for purchase or construction of residential houses while National Housing Corporation only finances, develops or sells residential properties.

The three estates were developed at different periods. Phase I of Kibera Highrise estate, comprising 982 units was developed by National Housing Co-operation (NHC) from 1989 to 1994 while phase II was constructed from 1994 to 2001 with funds from the central government as well as loans from the World Bank and other donor agencies. Once completed, some units were sold to various public bodies, notably, Kenya Power and Lighting Company and National Social Security Fund. Most of the units were however sold to individuals through a Tenant Purchase Scheme (TPS). Each purchaser required to pay only 10 per cent of the purchase price and the rest advanced through long term loans of up to 18 years with fixed rates of 12 per cent and 10 per cent for phase II and I respectively.

Komarock estate was developed progressively from 1989 up to 2003. The developer was Kenya Building Society, a subsidiary of Housing Finance (HF). Housing Finance either sold the units to outright purchasers or gave loans at market and variable rates of interest. The loan to value ratio was 90 per cent of the market price as determined by Housing Finance Ltd. Loans were granted up to a maximum term of 15 years.

Funguo Estate was developed in 1998-99 by ICDC for sale as an investment. About 50 per cent of the houses were purchased by employees of ICDC, which offered soft lending terms, with interest rates of 11 per cent while the rest were financed mainly by Savings & Loan Ltd with interest rates 21per cent per annum for a period of up to 15 years. The loan to value ratio was 70 per cent.

Primary data collection was done through structured questionnaires to mortgage payers or borrowers. The questions required the respondent to state among others the ages, whether employed, self employed or unemployed, name of lender, interest rates charged at the time of borrowing and the current interest rate, the main reasons of loan default and what they think would solve the problem of non-performing loans.

From the borrower's viewpoint, selected borrowers, whether their loans are non-performing or not were interviewed. These borrowers were sampled from three residential estates, each with a fairly uniform character in terms of age and values. The three estates are Funguo residential estate along Mbagathi road, Komarock residential estate off Kangundo road and Kibera Highrise estate along Mbagathi road, all in Nairobi. The three estates were selected on the basis of the estimated values of the properties therein, which correlates with the income groups of the borrowers and also on the basis of the main end financiers involved in each.

Kibera Highrise estate is a low income, high density estate with property values at current prices ranging between Kshs 600,000/ up to Kshs 1,000,000 for one and two bedroom flats respectively. The estate was developed and sold by National Housing Corporation through a Tenant Purchase Scheme. Komarock estate is a low – middle income, high density estate developed by Kenya Building Society, a subsidiary of Housing Finance Limited. The houses in the estate are in the value range of between Kshs 1,000,000/- and Kshs 3,000,000/-. The main end financier was Housing Finance Limited, the largest mortgage finance company in Kenya. Funguo estate is a middle

income, high density estate, developed by Industrial and Commercial Development Corporation (ICDC). Most purchasers were financed by ICDC and Savings and Loans (K) Limited. National Housing Corporation is the dominant player in the low income housing in Kenya while Housing Finance Limited and Savings and Loan are the only mortgage finance companies in Kenya, both with a market share of 67% (CBK, 2000).

Since the mortgage institutions are prevented by rules of confidentiality to disclose to third parties' borrowers whose loans are non-performing, the borrowers were interviewed, regardless of their loan performance.

The borrowers were randomly sampled in Funguo estate to attain 28 respondents from a total of 146 residents within the estate. Kibera highrise has 30 blocks of flats sold by NHC, each with 36 – 40 units or flats per block. 10 blocks were selected by stratified sampling, selecting every third block, after selecting the first one randomly. From the 10

blocks, 3 residents were randomly selected to make a total of 30 respondents. Komarock estate has four main phases each with about 600 up to 1000 houses. The phases were developed at different periods, phase 1 in 1989 and progressively with phase 4 in 1999. It was therefore important to get respondents from each phase and from these, 10 respondents were randomly selected from each to make 40 respondents. The total sample size from the questionnaires was 98.

Primary data and information from Housing Finance Limited, Savings & Loan Ltd and National Housing Corporation was obtained through both structured questionnaires and interviews with the staff in each organization involved in loan disbursement and administration as well as credit risk management. The questionnaires addressed specific questions. The information and data sought included the level of non-performing loans over the years, their lending rates of interest, distribution of loans by size, their methods of credit assessment before the decision to lend, the causes of non-performing loans and strategies adopted in addressing the problem of non-performing loans. These were administered to officers in each institution involved in the actual lending process, the loan administration and in debt recovery.

Secondary information and data was obtained through library research including text books, journals, reports, dailies and Acts of Parliament. Information was also obtained from brochures, letters of offer, terms and conditions of lending, debt recovery manuals and annual reports and accounts of the studied institutions. Other information and data was sought from other research bodies like Institute of Policy Analysis and Research, Credit Research Bureau, literature from the selected financial institutions and data from Central Bank of Kenya financial and statistical reports.

The data is analysed principally using descriptive statistics in terms of mainly percentages and tabulations. Qualitative data is analysed through descriptive text.

1.5 Study Assumptions

The following assumptions were made in the course of the study:

i. That mortgage financing is aimed to be equitable, sustainable and beneficial to both borrower and lender.

ii. Borrowers in residential real estate sector do so with the intention of repaying their debts in full and therefore benefit from the financing.
iii. The main limitation of the research study was that the institutions studied had not kept data on their levels of non-performing loans prior to 1999.

1.6 Significance of the study

Few studies have been undertaken on the whole subject of property finance in Kenya. Most literature on the subject addresses the developed world, notably the United States of America and Britain where the property market is more vibrant and developed. Wight (2001) in his study on the property finance business in South Africa gives an insight to the whole process of the internal operations of the property finance business and the links between the property industry and finance industry in South Africa. Ndung'u (2001) in his study on an investigation of mortgage financing strategies applied by various institutions in Kenya concludes that the financiers of residential investments need to be more innovative and develop appropriate financing options and menus for financing residential property buyers in Kenya. Matu (2001) in his study on the applicability of financial crisis predictive model to bank failures in Kenya concludes that external influence by shareholders, directors and government, high interest rates and poor bank management, partly due to lack of effective supervision by Central bank have been central to bank failures in Kenya.

No empirical study has been carried out on the causes of non-performing loans in Kenya (CBK, 2000). When Central Bank released the first Bank Supervision Report in 1999; it required all banks and financial institutions to henceforth report on their levels on nonperforming loans and provisions for the same in their reports and accounts annually or semi annually. Prior to that, this kind of reporting was not mandatory. Bad loans data was treated in confidence and this may partly explain why the subject remained 'unstudied' although the institutions were experiencing difficulties of non-performing loans.

This research project has attempted, with the available data, to document the main causes of non-performing mortgage loans and their percentage contribution to the problem. The study is significant in that it will bring out the main causes of non-performing loans and this will be useful to any lender or borrower who would hence be more aware of the risks to loans. This study shall act as a source of information to property professionals as various investors who intend to develop or purchase property through loans often approach them for advice.

Lenders would also find the study useful because it explores ways of minimising the occurrence of non-performing loans as well as various options which can be applied when loans are non-performing since the only alternative currently appears to be foreclosure, which is not only extremely unpopular but also discourages new borrowing.

1.7 Scope and Organization of the study

This study is limited to non-performing loans in the residential property market sector, loans that were given to various borrowers by mortgage finance companies for the purchase of residential houses for either rental or for owner occupation.

The study time is restricted to the period 1995-2002, as this is the period the non-performing loans were very high Kenya, averaging-30 – 42 per cent of gross loans.

This study is organized into four chapters. Chapter one introduces the study area and presents the introduction, problem statement, objectives of the study, research questions, hypothesis, and research methodology, significance of the study and scope and organization of the study.

Chapter two is a review of the literature related to residential mortgage financing. It commences with the property development process, which is the starting point of the need to finance, discusses the history and theories of mortgages as well as highlighting the contents of a mortgage/charge document, noting also the remedies available to the lender in the event of default by the borrower in the terms and conditions of the mortgage.

The mortgage lending process from the application, analysis, commitment up to the loan disbursement stage as given by the mortgage finance companies as well as the requirements of a sustainable mortgage finance system and the limitations are also discussed. These limitations and the risks to mortgage finance are discussed towards end of the chapter to show their relationship to non-performing loans.

Chapter three starts by focusing on brief profiles of the institutions under study i.e. Housing Finance Limited and Savings and Loan Limited and National Housing Corporation. A brief background and ownership structures and their mortgage financing strategies are discussed. The data collected from the borrowers from each of the selected estates is then statistically analysed and presented in percentages, focusing mainly on what they perceive as the main causes of non-performing loans. Similarly, information from the financial institutions is analysed and presented and descriptive text.

The chapter also discuses the solutions to the non-performing loans as suggested by both borrowers and lenders. Data collected from the borrowers and lenders on the solutions is similarly analysed as that of the causes. The chapter also introduces other solutions suggested by Central Bank of Kenya and applied successfully in other countries and which may be applicable in the local environment.

Chapter four gives the conclusions and recommendations on the way forward not only to reduce the current level of non-performing mortgage loans in Kenya but also on what should be implemented to ensure the situation does not re occur and that the mortgage finance system is vibrant and sustainable. The chapter ends with suggested areas for further research.

CHAPTER TWO

LITERATURE REVIEW AND CONCEPTUAL FRAMEWORK

2.0 Introduction

Adequate shelter along with food and clothing is a basic human right. With increasing urbanization levels in Kenya, currently estimated at 34 percent of the total population, housing is a major concern to various local authorities, individuals and government. Urban population grew at 5 percent per annum between 1980 and 1990 and further 5.6 percent per annum between 1990 and 2000 (GOK, 2000). This growth, coupled with a general economic decline has continued to exert great pressure on central and local government, as well as the private sector in the urban areas for the provision of basic infrastructural services and especially housing.

2.1 The Nature of Property Development

Over time the demand for land resources changes. This change is brought about by variations in the size, income and tastes of the population, the rate of growth of economic activity, methods of transport and techniques of production and distribution. On the supply side, the existing buildings wear out or become less suitable to present uses and the cost of constructing new buildings or adapting old buildings changes. Development is the response to such changes (Harvey, 1996).

The nature of development may take various forms. Existing buildings may be modified through conversion, for example, houses, divided into flats or refurbished. Secondly, through redevelopment where existing buildings are demolished and replaced by new ones, and thirdly, by new development through outward expansion of undeveloped land for example, suburban housing.

The Physical Planning Act 1996 defines 'development' as

(i) The making of any material change in the use or density of any building or land or the sub-division of any land for the purposes of development and use of land.

(ii) The erection of buildings, works and the carrying out of such building operations as the minister responsible may determine. This may include subdivision of land, extension and /or change of user to a higher density

Property development is a process that involves changing or intensifying the use of land. It is an industry in itself that produces buildings for occupation by bringing together various inputs, which include land, building materials, labour, finances and professional skills and expertise. Property development employs substantial resources of capital and labour to provide a product, which is relatively indivisible (Cadman and Topping, 2001).

Residential development especially in urban areas in Kenya is carried out by individuals, building for owner occupation or for rental, by specialist developers who develop houses for sale or rental and institutional developers including banks and other financial institutions, insurance and re-insurance companies, local authorities, and government bodies such as the National Housing Corporation. Irrespective of who is carrying out the development, the same basic calculations and decisions have to be made in the property development process.

2.2 The Property Development Process

The process of development commences at the initiation stage when either a parcel of land or site is considered suitable for more intensive use. The initiative may come from any of the actors of the property development process such as the landowners, developers, financial institutions, planners and central or local government. The parcel is then evaluated in terms of its suitability for the proposed development including a market research for the completed buildings as well as a financial appraisal to ensure the financial feasibility for the project. If the site of the project is found feasible the parcel may be acquired and relevant designs and drawings drawn for the proposed project (Cadman and Topping, 2001). Relevant planning permissions are then sought from the local authority upon submission of the required drawings.

When the necessary planning works are carried out satisfactorily, then funds are committed to the project and raw materials brought to site. Implementation follows with the main aim of completing the project within the set budget and time.

The last phase is when the property is to be let, managed or disposed. The developments' success depends on the ability to secure a willing occupier or purchaser at the expected rent or price within the period originally forecast in the evaluation. Many residential developments set up by developers or financial institutions are for sale purposes. The developers are therefore keen to have their projects completed on time and on whether the market will absorb the developments. Since real estate normally requires a large capital outlay then financing of the purchasers is very critical to the success of the whole development process.

2.3 Residential Property Financing Options

Several economic characteristics of real property, principally the long term nature of real estate investment and the consequent need for large amounts of money over a long period of time, make mortgage credit both necessary for most purchasers and attractive to many lenders (Floyd and Allen, 1997). This has given rise to the real estate finance industry.

Real estate has various advantages that enable it to be preferred as security for debts. It is immovable, has capacity to gain value over time and often has financial returns by way of rent. Because of this, many lenders are willing to provide debt capital for real estate purchase as long as their assets seem as adequate collateral for the loan. A legal framework for real estate financing exists whereby real estate can be pledged as security for a debt and if the borrower should default on the loan, the value of the property can be used to satisfy the debt.

There are various sources of funds for development of residential properties. These include owner's equity, cooperative loans, short-term bank loans and medium to long-term mortgages. In most urban areas especially Nairobi with the greatest concentration

of residential houses in Kenya, the main source of funds is owners equity combined with medium to long term loans in form of mortgages.

The use of equity funds alone is hardly adequate due to the heavy capital expenditure required to purchase a residential property. It is therefore not often to come across outright house purchases without some form of loan arrangement from various sources. Co-operative Societies or Savings and Credit Cooperative Organizations (SACCO's) are a significant source of funds especially to the low income groups which do not have access to credit from conventional institutions. They are able to extend 'conventional' terms of credit to their members (UNHCS, 1992). Interest rates for normal short-term loans are 1 percent per month on the declining balance. Security is often based on a common bond -the fact that members of the SACCO know each other well and have some binding ties such as common workplace. Many SACCOs based on the workplace bond use a 'check off' system operated by the employer for savings and loan repayments.

Co-operative loans are often short term, with repayment normally ranging from 24-36 months. These loans are used for various purposes including personal consumption and business development. For investment in house construction or purchase, these loans are often inadequate and long-term loans are found necessary. However, due to the unavailability of long-term loans to low-income groups, they have devised various strategies in their use of short term SACCO loans. (UNHCS, 1992) For example, many will build a house incrementally and take another SACCO loan when the first has been repaid. The principal reason for the emphasis of the 'common bond' is that the social pressure of the group is considered very important as security for loans. It is a form of collateral that is not available in conventional finance.

Whereas most co-operative loans are mainly used for construction especially in low income areas, the majority of house purchases in middle and high income areas use mortgage financing. This is a more formal financing arrangement where a financial institution provides the finances required to pay off the property owner and creates a debt, which is paid by the purchaser over an agreed time with interest. In addition, the financier creates a legal interest in the property that secures the money loaned in the

event of default in the repayment. Most mortgages in Kenya run for a period of between five to fifteen years depending on the financier and other terms of the mortgage.

2.4 The Mortgage Concept

2.4.1 History of Mortgage Concept

A mortgage is a pledge of property to secure a debt. The concept dates back to the early Egyptian, Greek and Roman times. Under early Roman law, non-payment of a mortgage loan entitled the lender to make the borrower the lenders slave. Eventually, Roman law was changed to permit the unpaid debt to be satisfied by the sale of the mortgaged property (Floyd and Marcus, 1997).

Although the concept of pledging property to secure a debt was widespread in England by the 11th Century, the Christian beliefs against usury prohibited the charging of interest on loans. Instead, Christian lenders simply took over debtor's property and collected rents until the debt was paid. Jewish lenders, not bound by Christian precepts, charged interest and left borrowers in possession of their property. These early mortgages provided that if the borrower met all the terms of the loan and completely repaid the debt, the mortgage was then terminated, and the title was returned to the borrower. If any condition was not met, however, the borrower lost all rights to the property including all money previously paid and the property was sold to repay the debt. By the 14th Century, however, the charging of interest to borrowers left in possession of their property, known as hypothecation became universal (Floyd and Marcus, 1997).

The Law of Property Act 1925 of England fundamentally changed this legal basis of a mortgage. Together with the law of equity, many equitable principles of mortgage were made statutory. For example, instead of the temporary transfer of the property to the lender, the ownership remains with the borrower and the lender receives an interest in the property as security for the loan. Also allowances were made for early and late repayments of the loan. So the mortgage was seen as a means of providing security for a loan, rather than a temporary exchange of property (Vaughan, 1987). Thereafter a system was developed to more equitably protect the rights of the parties to a loan secured by real estate. Many of these concepts serve as the basis for the modern mortgage laws in Kenya.

2.4.1 Theories of Mortgages

Three theories exist regarding who has legal title to a mortgaged property. Under the *title theory*, title to the security interest rests with the mortgagee. This implies that upon the registration of a mortgage, the title to the mortgaged property is conveyed to the mortgagee (lender).

Under the *lien theory*, the legal title remains with the mortgagor unless there is foreclosure. The mortgagee in this case has an interest in the property, but not title. Title would only pass to him if the mortgager fails to pay the debt or fails to honour the mortgage provisions.

The *intermediate theory* applies the lien theory until there is a default on the mortgage whereupon title theory applies.

Mortgage law and practice in Kenya applies the lien theory. Title only passes to the mortgagee after the due process of law. The Mortgages (Special Provisions) Act Cap 304 of the Laws of Kenya outlines the procedure to be followed to enable the Housing Finance Company of Kenya to obtain possession of property in respect of which it is able as mortgagee to exercise its power of sale or appoint a receiver.

2.4.2 Mortgages and Charges

The term mortgage and charge are often used interchangeably and indeed there is little practical difference between them. Both are encumbrances on land, which until discharged enable one person to exercise control over the property of another. At common law however, the two instruments are regarded differently (Waiganjo, 2001). For example, mortgages created under land registered under the Registration of Titles Act (RTA) are governed by the provisions of the Indian Transfer of Property Act (ITPA) while those created under the Registered Land Act are governed by that Act (Wanjala 1990). Both laws have many provisions defining, describing and regulating the rights and duties of the mortgagors/chargers and mortgagees/chargees.

A mortgage has been described as a conveyance of land or an assignment of chattels as security for the payment of a debt or the discharge of some other obligation for which it is given. The mortgage transaction consists of a transfer of the legal or equitable title to the property from the borrower, to the lender to be held by the lender until all his claims under the mortgage are satisfied. The borrower's right is to have the title restored to him on fulfilment of his obligation to the lender even if he does not do so until after the contractual date for that fulfilment (Cousins, 1989).

Fisher and Lockwoods in the "law of mortgage" defines mortgage as a form of security created by contract conferring an interest in property, defeasible upon performing the condition of paying a given sum of money with or without interest or of performing some other condition (Vaughan, 1987).

Under the Registered Land Act a charge is defined as an interest in land securing the payment of money or money's worth or the fulfillment of any condition and includes a sub charge and the instrument creating a charge. A charge is completed by its registration as an encumbrance and the registration of the person in whose favour it is created as its proprietor but does not operate as a transfer. It has effect as security only (RLA Cap 300).

From these definitions, three characteristics of a mortgage or charge emerge, namely, the conveyance of title, the re-conveyance upon repayment on the contractual date and the mortgagors/chargers right to redeem the property after the contractual right has expired. This right is jealously guarded in equity and cannot be taken away by express covenant or by conveyance trick (Waiganjo, 2001)

2.4.3 Contents of a Mortgage/Charge

The mortgage contract is usually a lengthy document that sets forth the various obligations of the borrower, with respect to the loan and to the real estate that acts as security. The major elements include the parties ie the lender and the borrower, the loan amount and the manner in which it will be repaid as well as the interest rate to be

charged on the loan. The contract also covers the description of the property (legal and physical description) including the condition of property. In this clause the borrower is obligated to maintain the property in good condition of repair and maintenance, not to demolish any improvements without the consent of the lender and not to permit the occurrence of waste on the property, which may be detrimental to the lender. A default clause is also included which normally specifies the number of events of default, which right include failure to pay interest and principal when due, failure to pay taxes and insurance premiums and failure to keep the property in good repair.

The mortgage document must in addition be signed by both parties and executed at the lands registry at the district or area in which the property is located. Most mortgages contain substantially more information than the above minimal requirement. This is mainly because the parties, especially the mortgagee insert many provisions designed to protect their interests.

Because historically the mortgage was a conveyance, the mortgage often has many provisions similar to those of a transfer instrument. A mortgage contract generally has the following information to be effective.

- Names of the parties
- Legal description of the premises
- Language indicating that the instrument is given as security for a debt
- Statement of the debt secured
- Terms for repaying the debt.

Some of the provisions in a mortgage contract include the following:

- Prepayment: The borrower in this clause has the right to prepay any or the entire principal any time before it is due without penalty.

- Overdue payments: These attract a late payment charge or default charge. Continued default permits the lender to accelerate the full amount of principal that has not been paid and any interest owed on that amount.

- Liability for the debt: All those who sign the contract are jointly and severally liable for the debt, i.e. the lender can demand payment from one or all of the borrowers at its option.

- Due on sale: In the event the borrower sells or transfers all or any part of the property secured by the mortgage, the lender may at its option require immediate payments for all amounts owed.

- The promise to repay the debt is secured by a pledge of property as secured in the mortgage document, which typically contains the names of the mortgagor and the mortgagee, description of the property, etc.

2.4.4 Mortgage Default

Default is a failure to fulfil a contract, agreement, or duty especially in a financial obligation. Mortgage default therefore can result from breach of any of the mortgage covenants. The most common default however is the failure to meet monthly installments of the interest and principal. Other defaults include failure to pay taxes (eg rates to the local authority), insurance premiums etc, failure to keep the property in a good state of repair and maintenance, abandonment of property among others.

The risk that the borrower will default in making the monthly instalment payments of principal and interest is often the most important risk to the lender (Brueggeman and Fischer, 1997). This risk associated with mortgage loans depends in part on the rights of the lender if and when such default occurs. Lenders have the right of foreclosure on the property, which involves the sale of the secured property to satisfy the unpaid debt.

There are, however, alternatives to foreclosure which can be considered depending on the property type ie whether income producing or not, amount of loan outstanding, the

attitude of lenders and borrowers towards servicing the debt etc. The outstanding debt can be restructured, which involves applying a lower interest rate or extending the maturity date; or can be transferred to a new owner who assumes the debt, thereby transforming a non-performing loan to performing one.

2.4.5 Remedies for breach of mortgage covenants

There are a number of basic remedies by the lender against a defaulting borrower. Default means a breach of covenant not only of failure to pay the monthly instalment but also includes any other breach (RLA Cap 300 sect. 74). These remedies include the following :

i. *Foreclosure and sale of the charged property:* Foreclosure refers to the process of seizing control of the collateral for a loan and using the proceeds from its sale to satisfy a defaulted debt. It is the most common remedy applied when borrowers start defaulting on their mortgage payments. Usually however, the mortgage holder will try to work out some type of alternative payment programme to avoid the sale of the collateral. Not only is this practice much better for the lenders public relations efforts, it also avoids the time consuming, expensive and generally unprofitable foreclosure process. Foreclosure is, for the most part, an avenue of last resort. (Floyd and Allen, 1997).

ii. *Appointment of a receiver:* This remedy is often applied to ongoing businesses which run into financial difficulties and are unable to service their debts. A receiver exercises control over and administers the operations of the company in a bid to bring it back to sound financial footing.

iii. *Taking of possession and leasing:* This remedy is also available and applicable to such properties as can be leased and the proceeds or profits taken to service the outstanding debt. It would be useful remedy in properties which have a rental value high enough to service the debt over a reasonable time.

2.5 The Mortgage Lending Process

The lending policy of mortgage providers is the starting point for the assessment of every proposition. The policy addresses two fundamental issues/questions. The first is whether the security offered is adequate and secondly whether the borrower can afford to repay the loan. These two issues are normally influenced by the Loan to Value ratio and the net income of the borrower. In relation to the income, many lenders set down an income multiple in their lending policy. The general yardstick is the gross annual salary for employed persons or net profit for self-employed persons.

Different financial companies have their individual processes when lending for house purchase. Although each mortgage loan is different, there are some basic steps or stages in the mortgage loan process that are common to all. The stages as follows:

1. *Application Stage*: During the application stage of the mortgage lending process, the borrower submits a formal application for monies to the selected lender. Both Housing Finance and Savings and Loan (K) Limited have a schedule of requirements that are needed at the application stage. For individual or employed borrowers who are the majority, the requirements include bank statements for the last six months, letters from the employer confirming salary, allowances and terms of service and opening a mortgage related Savings Account as well as a sale agreement or letter of offer. Monies that require to be paid at this stage include loan processing fees, valuation fees and legal fees.

2. *Analysis Stage:* A thorough analysis of the mortgage loan application is done by the lender and concentrates on two areas: The property and the borrower. The analysis of the borrower concentrates on the financial strength or on the ability to repay the loan. If the borrowers' own funds from either being employed or self-employed are pledged, the lender carefully analyses the debt service coverage ratio ie the adequacy of the cash flows (net operating income) to meet the monthly instalments of the mortgage (Sirmans and Jaffe, 1986). The process of mortgage assessment i.e. evaluating the risk of an applicant and a property to make a decision on the loan

application, referred to as mortgage underwriting, considers various criteria such as employment, income sources, net worth and previous credit history where available. The actual amount to be given is based on the loan to value ratios, the down payment and income ratios (Floyd and Allen, 1997).

Since 2002 Housing Finance has developed a relatively more thorough assessment of ability to pay than was the case in the past. Its conditions include that to qualify for a loan, the maximum monthly repayments of a mortgage, when calculated should not exceed 35 percent of the borrowers gross income. In addition to this the borrower provides the average of his living expenses. To qualify or determine the maximum amount which can be given, at least 20 percent of the gross income must be retained after loan repayments and living expenses (Housing Finance, 2002).

The analysis of the property involves the review of the valuation report and the title search. The goal of this review is to assess the adequacy of the property as security for the loan ie debt coverage ability. A valuation report also indicates the nature of the property, materials of construction, rental value, tenure and the registered owners.

The value ascribed also determines the adequacy of the property as a source of repayment. One method of measuring the adequacy is the loan-to-value (LTV) ratio. Each lending institution sets guidelines on the LTV depending on the type of property and the current market conditions for that type of property. In Kenya the LTV ratio ranges from 50 percent to 80 percent for most institutions mainly depending on the type of property, its age, whether residential or commercial, its location ie whether urban or rural etc.

In the developed countries, for example, the USA the analysis of borrowers focuses to a large extent on the integrity of the borrower and experience in similar projects. Lenders carefully analyse the integrity and experience of their borrowers prior to financing any real estate project. They perform a background search to determine how the borrower has repaid obligations in the past. Lenders often require up to date credit reports which indicate the credit records, debt situation as well as how well the borrower has met obligations in the past. (http://www.gehomenow.com/homebuyer on 23/5/2003)

3. *Commitment Stage*: During the commitment stage the lender sends the borrower a commitment letter that outlines the terms under which the lender would make the loan. This sets the guidelines for expected performance of the terms of the loan.

   The lender at this stage outlines the amount of loan that has been approved and the repayment terms including the interest rates, the actual amounts payable per month and the dates it should be paid, any late payment charges, the default rate and the security for the loan.

4. *Final stage*: The final stage of the mortgage lending process focuses on the legal aspect of the loan. All payments including life and fire insurance premiums, legal fees, stamp duty fees currently a 4% of sale price payable to the government, any outstanding rates to the local authority etc are made. The sale agreement is signed by both the buyer and seller of the property releases his title to the financial institution after being given an undertaking that they will be paid the full amount of the purchase price as agreed.

   The transfer of the property is registered at the Lands Registry of the area where the property is situated and the loan amount is recorded in the properties title as an encumbrance in favour of the lender as at that date. Once all the documents are recorded or registered at either the lands registry or at the Financial Institution, the lender enters the mortgage in the loan tracking system and waits for the monthly repayment instalments as agreed with the borrower.

2.5.1 Determinants of Mortgage Interest Rates

(Brueggeman and Fisher (1997) identify four main determinants of mortgage interest rates. These are the following:

i) *The demand and supply of mortgage funds*. Most mortgage lenders are institutions that link the flow of funds form savers to borrowers. Borrowers

use the savings in the form of mortgage credit. The market rate of interest on mortgage loans is established by what borrowers are willing to pay for the use of funds over a specified period of time and what lenders are willing to accept in the way of compensation for the use of such funds.

ii) *The lenders costs of managing the funds* i.e. from the cost of attracting funds from savers, the cost of originating and managing the loans, losses from loan defaulters and foreclosures and when interest rates are fixed, potential losses due to unexpected changes in interest rates after a loan is made.

iii) *The returns and the associated risk of loss of alternative investments* in relation to returns available on mortgages. The mortgage market is a part of a larger capital market where lenders and investors evaluate returns available on mortgages and all competing forms of investment and the relative risk associated with each.

iv) *The risks associated with mortgage.* Mortgages are long term loans and general interest rates as well as levels of inflation change in an economy over time. Furthermore other risks specific to mortgages such as default risk, prepayments risk, liquidity risks and legislative risks are taken into consideration when determining the price of a mortgage loan.

This relationship of various factors taken into consideration when mortgage pricing can be summarized as follows: (Brueggeman and Fisher, 1997).

$$\mathbf{i = r + p + f}$$

where,

i Rate of interest on a mortgage loan.

r Real rate of interest (must be competitive with real returns available on other investment opportunities in the economy).

p Premium to compensate for default and other risks.

f Premium that anticipates expected inflation.

Pricing of mortgage loans by lenders are however rendered complex because mortgage loans are made at fixed rates are also affected by other macro economic factors in the country (Brueggeman and Fisher, 1997).

2.5.2 Requirements of a sustainable mortgage finance system

There are various important criteria for designing a mortgage. These criteria are based on the premise that for an efficient mortgage system, stability of the mortgage finance system is essential. In addition, mortgage risks should be shared between lenders and borrowers in a fair and sustainable manner over the life of the loan.

Both the government and private sector have a role to play in ensuring that the mortgage system is vibrant, equitable and sustainable. Ways and means must be sought to ensure that funds are made available for mortgage finance, risks to lenders are reduced and innovative mortgage systems created so as to encourage borrowers to borrow for housing. Jay Sa-Aadu, (1997) recommends that lenders should do the following:

- They must design appropriate mortgage repayment schedules. Mortgage loans are contractual arrangements that vary from one year to as long as 20-25 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. For example, between 1991 and 1995 lending rates for Housing Finance fluctuated between 18 percent and 26 percent while those for Savings & Loan fluctuated between 18 percent and 30 percent (Ndung'u 2001). Lenders must therefore consider a menu of mortgage instruments, how to change their mix, terms and conditions as economic circumstances change. They should also evaluate the impact of alternative instruments on profitability, demand for credit, repayments, delinquencies and default.

- Lenders must devise alternative risk sharing arrangements for equitable mortgages. To the extent possible the mortgage finance system should include a full range of mortgage contracts that share risk between borrowers and lenders in a sustainable

manner over the life of the loan other than the Fixed Rate Mortgage (FRM). Various alternative mortgage instruments exist. These include Variable Rate Mortgages (VRM) whereby the interest charged is not fixed throughout the term of the loan but is tied to a market index such as the rate on government bonds. This enables the rate on a VRM to rise and fall over the loan term in response to the market index (Wurtzebach and Miles, 1995). Variable Rate Mortgages encourage or allow continued borrowing during high interest rates periods since the rates are not tied to the high rate but fall depending on the index.

Adjustable Rate Mortgages (ARMs), also fluctuate depending on an index but have interest rate caps meaning their level of fluctuation is more controlled and cannot exceed set limits. Other mortgage alternatives include the Graduated Payment Mortgages (GPM), which allow low payments in the early years when the borrowers income low; Price Level Adjusted Mortgage (PLAM), Dual Index Mortgage (DIM) and Growing Equity Mortgage (GEM). Each of these mortgage types differ in terms of complexity, flexibility and sharing of risk between lender and borrower.

- There is a need to standardise the loan analysis (underwriting) of mortgage instruments and mortgage servicing requirements by various lenders. The establishment of an efficient mortgage finance system requires a proper system of mortgage underwriting to assess the amount of risk in mortgage loan. For underwriting to be an effective system of pricing risk, some form of standardisation in mortgage instruments is necessary. Excessive diversity in mortgage instruments makes mortgages more illiquid. If a Secondary Mortgage Market (SMM) as well as mortgage securitization is to be developed, then it is mandatory to have standardised underwriting framework (borrower loan application information, loan documentation, collateral etc). This will permit the isolation and assignment of risk to those best able to handle them. The lack of standardisation 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, which in turn varies according to loan to value ratios.

- There should be equal access to mortgage credit to both owner occupied houses and rental housing. Equal access to institutional credit should, be given to both the 'informal' and 'formal' private sectors at prices that reflect differences in risk and transaction costs. Expanding appropriately priced housing credit through the private 'informal' sector helps ensure that the housing needs of the poor who are the majority in our urban centres are addressed.

- Other requirements include improvements in operation of the land market since the success of reform in the mortgage market is closely linked to the complementary reforms in property rights and land market operation. This is because problems in operation of housing markets typically spill over into the mortgage markets and retards the efficient operation of the market. Government must ensure property rights' policies that guarantee an entity's right to a stream of benefits. At the same time the government should ensure a sound regulatory framework, which promotes competition by lenders as well as build confidence (not control) of the financial system.

Diamond (1997) identifies several criteria for designing a mortgage:
These include the following:

(i) The risk to the borrower ie whether the borrower be able to meet the mortgage terms. It is important that from the outset the borrower is confident about meeting payment terms and conditions. Lenders are never keen to foreclose and evict defaulters and would rather not lend if the risks were evident from the beginning.

(ii) The risks to the lender/investor: will the cash flows from the borrower allow the lender to meet lenders repayments requirements? The ultimate investor, whose funds are being invested by the lender, should receive a competitive return on his investment.

(iii) Affordability; when the risks to both the borrower and the lender have been minimised it is essential that the mortgage terms so constructed allow the borrower to borrow. The loan must also be affordable to attract customers into the system.

(iv) Simplicity: This is the degree to which the borrower and lender fully understand the deal that they are making.

The above four criteria should guide the design of a mortgage. These should however take consideration of the fact that within the loan period, interest rates, inflation rates, exchange rates, wage rates or household incomes change. Both Housing Finance and Savings & Loan (K) Limited have a Variable Rate Mortgage (VRM), which means repayments can vary greatly over a short time. This has many risks to borrowers most of who have stable or declining incomes or rentals. The level of defaulters is therefore high and related to the upward movement of the interest rates.

To reduce the risks in mortgage finance and make loans generally available to a wide array of borrowers ways must be sought to develop mortgage financing strategies that fit the above criteria. As Jay Sa – Aadu, (1997) observes, a sustainable mortgage finance system is one that is broadly accessible, (ie serves the need of all consumers at market prices), funded by agents better able to bear the risk of a mortgage loan, is profitable, that mitigates past distortions in the economy and whose efficiency is not in doubt.

Managing credit risk is therefore vital in the success of a mortgage system. Housing Finance systems must therefore develop methods for managing and pricing the risk that borrowers will become delinquent or default on their loans. Megbolugbe, (1997) argues that credit risk can be managed by the following:

i. Restricting borrowers to those who have demonstrated capacity and willingness to repay the debts.

ii. Collateralizing the loan either with the home itself or other valuable asset. This however requires a clear title and a legal system that supports cost effective repossession of property from defaulted properties.

iii. If the above two are in place, credit risk can be further managed by demanding a large down payment from borrowers to cushion the lender against the probability of default even if house values decline or borrowers loose their capacity to service their debt.

iv. Diversifying it across many areas and borrowers. This reduces the chance that economic or structural problems that affect particular types of borrowers or areas will result in catastrophic losses to a single funding source. For example Housing Finance appear to concentrated their lending to houses in Komarock estate, developed by their subsidiary, Kenya Building Society, which market declined greatly in the years 2000-2002 leading to massive losses in that market.

v. Risk can also be reduced in the case of variable rate loans by capping interest rate adjustments.

2.5.3 The limitations to the current mortgage system

The housing mortgage system at present faces various limitations, which constrain its growth and efficiency. This is mainly because both Housing Finance and Savings and Loan are the institutions, which originate the loans and retain them in their portfolio of assets thereby accepting the credit risk associated with the loan including collecting the payments and taking legal action if payments are not made. They are also the ones who obtain funds from the public with which to finance their assets. These multiple roles involve various problems such as funding inadequacies, interest rate and credit risks.

Funding limitations arise from the fact that the supply of mortgage funds to the markets depends on the ability of depository institutions such as banks and the mortgage institutions to raise funds. Funds must be available first before they are lent to borrowers. Most deposits are on short term as opposed to mortgages, which have a longer term. There is therefore a mismatch between borrowing short and lending long (Mensah, 1997).

Other limitations especially those associated with interest rates fluctuations arise. When interest rates of deposits are rising, the lender is forced to pay higher interest rates but can only earn the contractual rate on the loans advanced especially on fixed rate mortgages. This can cause problems to the lender similar to funding limitations associated with borrowing short and lending long. Lenders also take credit risk that

borrowers will default. This risk is very high especially in a period of high and fluctuating interest rates.

One of ways of solving the deposit to loan mismatch, is increasing funds for mortgage development by creating a Secondary Mortgage Market (SMM). A secondary market is a highly organized exchange with a large number of buyers and sellers, where performance is well publicized, similar to the stock market (Wurtzebach et al, 1995). In a secondary mortgage market, lenders originate the mortgage according to their standardized processes and procedures. This origination is a primary mortgage market. Instead of holding these mortgages until the homebuyers have repaid the last cent over the period or term of the mortgage, the lenders package the loans together and sell the packages to other investors who wish to have a stream of income offered by these large mortgage pools. The purchasers buy the mortgages at a lower rate of interest than what the lenders had negotiated with the borrowers and the difference in the two rates is the pool's profits. The income comes from the repayments of the mortgage instalments by the borrowers. Thus instead of the lenders originating the mortgages to hold, they sell most of the mortgages to the secondary mortgage market and profit by being loan originators more than as long term lenders. They are also able to receive back cash by selling what would have been illiquid portions of their portfolios thereby gaining flexibility and freedom to be loan originators (Wurtzebach et al, 1995).

How can this be achieved in Kenya? The Kenya Institute of Public Policy Research and Analysis (KIPPRA) says this can be achieved by encouraging the start up of an investment company with the main objective of developing the mortgage market. Such a company could purchase part of a portfolio of a mortgage finance company for use as security in raising long-term funds through the bonds market, which in turn would be invested back into the mortgage market to purchase additional assets.

The investment company would use the mortgage repayments to repay the bonds. The mortgage finance companies would be able to mobilize long-term funds by selling the existing portfolio to the investment company while earning extra transaction fees and charges and also spreading risk. Homeowners could benefit from increased mortgage duration periods and reduced interest rates, further enabling many potential homeowners

to qualify for mortgages. This would increase the demand for mortgage finance, improving the quality and quantity of housing, and finally stimulating the construction industry

Potential investors like pension funds and life insurance companies would get an opportunity to invest in long-term financial instruments that match their long term resources. Development of a secondary mortgage market would be beneficial to investors, borrowers, financial institutions, homeowners and society in general. (KIPPRA, 2000)

2.5.4 Classification of non-performing Loans

The central Bank of Kenya (CBK) has defined and classified advances into various categories (CBK, 2000). Provisioning guidelines are also made to guide the banks and financial institutions at every stage of a loan. These are as follows:

1. Normal: These are well-documented facilities to financially sound customers where no weaknesses exist. Such advances must not have been rescheduled.

2. Watch: These are good accounts, which normally would be classified under (1) above but have exhibited some specific weaknesses and hence warrant management attention.

3. Substandard: These are facilities, which though still operative involve some degree of risk, and there exists a possibility of some future loss unless close supervision is given and corrective action is taken to strengthen the position. For instance, an account being in three months installment arrears.

4. Doubtful debts: These are advances where major weaknesses exist. The recovery of the full amount outstanding might need to be extended or is doubtful and that loss, as yet uncertain will occur. For instance, an overdraft whose turnover has dried up.

5. Loss: These are all those facilities with outstanding arrears which are regarded as being uncollectable and where security is worthless or has been disposed off, the

proceeds of which have not covered the total debt and the balance remaining is unlikely to be recovered

2.5.5 Costs of Non-performing Loans

Non-performing loans have various costs, which not only worsen an already bad scenario but also push up the cost of credit. These include the following:

1. Legal Fees:- The higher the level of NPL's the greater will be the direct legal costs as well as indirect legal costs of beefing up legal departments, internal consultations and customer consultations.
2. Valuation Fees: These costs raise the cost of non-performing loans since valuations are carried out by private valuers. The Auctioneers Act prescribes that for the purposes of an auction sale, a property must have been valued within one year of the auction. This is aimed at establishing a reserve price below which a property may not be sold and has the effect of protecting the property owner from underselling of their properties.
3. Auctioneers Fees: Private auctioneers who charge a fee mainly based on a percentage of the sale price and their direct costs carry out auctions.
4. Management Time: Substantial amount spent on endless consultation with customers, rescheduling with customers, communication with lawyers etc.
5. Increased administrative costs: Hidden costs such as telephone bills, stationery etc borne by customers.
6. Lost or misdirected focus: Rather than focusing on productive activities beneficial to customers, the pre-occupation is on debt collection, not stated business objectives.

From the foregoing it is evident that non-performing loans have a substantial amount of not so obvious costs, which ultimately push up the cost of credit. In order for banks to remain in business, these costs, alongside other costs have to be financed as well as give shareholders value for their investment.

2.6 Property Finance Risk and Non-performing Loans

Risk is the chance of failing to meet the investors' objectives for retention and flow (Rowland, 1994). Most investors are mainly concerned with two aspects of risk: what is the likelihood that their return will be significantly less than expected and is there a real possibility that they will not break even? Various investment options including Treasury bills, corporate bonds, common stock and real estate face different levels of risks and returns. The major investment risk characteristics that investors consider when deciding among alternative investments include business risk, financial risk, liquidity risk, inflation risk, management risk, interest rate risk, legislative risk and environmental risk (Breuggeman and Fisher 1997). All these risks affect real estate but at different levels.

Of the above risks, some have had a more direct and profound effect on the performance of real estate as an investment and especially when it has been acquired through a mortgage. For example, changes in interest rates affect the prices of real estate investments. When interest rates are raised, the demand for real estate, which is often acquired through mortgage loans is reduced. Fewer people are able to afford high loan installments occasioned by high interest rates especially when rental incomes or the rate of return is constant. At the same time upward adjustments in interest rates for existing loans increases the monthly installments payable to redeem the debt. When rental incomes or other income used to pay for the mortgage installments remain constant, difficulties in meeting the obligations arise and defaults set in.

Non-performing loans are one of the greatest threats to bank profitability (CBK 2000). They generally arise because clients are facing financial distress. Insufficiency can arise when interest rates are raised, which consequently raises the monthly loan installments payable by borrowers or when rentals or personal incomes decline. For example, at a mortgage interest rate of 16 percent per annum for 10 years, the monthly installment for Kshs. 1,000,000/- borrowed from Housing Finance Limited is Kshs 16,530/-. When the interest rate is raised to 21 percent, all other factors remaining constant, the monthly repayment rises to Kshs. 19,645/- (Housing Finance, 2002). This increment of Kshs 3,115/- due to the raised interest rate creates difficulties to mortgage payers and often

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leads to defaults in monthly installments payable. Upon default, the mortgage finance companies levy a default charge of 1.5 per cent on the amount payable, which aggravates an already bad situation. The effect of this is raising the real interest rate charged on mortgages. Insufficiency also arises when operating cash flows generated by a building are not sufficient to meet the loan repayment obligations (Wight, 2001). In a situation like in the last four years (since 1999) when rentals especially in upper income areas of Nairobi have been declining (from an average rental of between Kshs. 90,000/- to Kshs 100,000/- for a 4-5 bedroom house in Runda residential estate in 1999 to the current average rental of between Kshs 60,000 - 70,000/- for the same property currently) the mortgage situation is dealt a double blow of increased repayments and reduced earnings. The situation is compounded when the property value declines due to other economic and social factors such as reduced demand, changes in tastes, etc.

Mortgage administration becomes increasingly difficult as a result of rising interest rates. When loan repayments are adjusted to take account of higher rates of interest, a significant number of borrowers are not able to pay the new installments. This leads to increases in levels of arrears. Moreover high inflation has put pressure on household budgets and therefore contributed to rising arrears even in those instances where interests rates have not been substantially revised (Mutero, 1993).

When lending, one major concern of financial institutions is the risk that borrowers will default on obligations to repay interest and principal. This risk, referred to as default risk, varies with the nature of the loan and the creditworthiness of individual borrowers. Default risk relates to the likelihood that borrowers' income may fall after a loan is made, thereby jeopardizing the receipt of future mortgage payments. The possibility that default may occur means that lenders must charge a premium, or a higher rate of interest, to offset possible loan losses. (Brueggeman and Fischer, 1997). Unfortunately the high interest rates contribute to the level of defaults, as the mortgage installments are high when interest rates are high and vice versa.

2.7 Conclusion

Issues of affordable mortgage interest rates as well as sustainable mortgages have been a subject of debate and study by various economists and real estate professionals as a long time. The Institute of Policy Analysis and Research (IPAR) has documented the key factors which sustain the high and distorted interest rates in Kenya. These include the governments' role in the money market through debt instruments such as Treasury Bills, inefficiency and uncompetitiveness of the banking system, poor lending especially by political banks (which has added to non-performing loans) and high implicit tax on bank deposits due to high cash ratio requirements of the CBK (IPAR, 2000).

Whereas reduced interest rates might reduce the default rates due to lesser mortgage installments, Ndungu (2001) in his study on mortgage financing strategies in Kenya concludes that, 'it is not the availability of cheap debt financing that is really import but it is the gains available to creative lenders who know how to structure debt and equity financing packages to solve problems'. The study proposes an introduction of a Secondary Mortgage Market (SMM), which would introduce different players in the mortgage industry and thereby increase the funds available for lending for housing.

To address the problem of risks on borrowers, adequate credit assessment which would ensure that only those who are able and willing to pay debts are availed credit. Good credit assessment and loan administration is likely to reduce risks on loans.

CHAPTER 3

CAUSES OF NON-PERFORMING MORTGAGE LOANS IN KENYA'S RESIDENTIAL PROPERTY MARKET

3.0 Introduction

The study sought to establish the levels of non-performing mortgage loans of the different institutions. This was done through the use of such data collection instruments as questionnaires and oral interviews. Data was also obtained from the annual reports and accounts of the institutions. Credit management staff of the two institutions namely, Housing Finance Limited and Savings & Loan (K) Limited who are the only Mortgage Finance Companies (MFC's) in Kenya were interviewed. Senior management staff of the National Housing Corporation (NHC) involved in the Tenant Purchase Scheme (TPS) were also interviewed. Although NHC is not a mortgage finance company, it has Tenant Purchase Scheme with house purchasers who are given credit terms similar to those in the mortgage finance companies but are comparatively more affordable and customer friendly in terms of interest rates and entry requirements. The study also sought to establish the main reasons for the non-performing loans from both borrowers and lenders point of view and perspective by use of interviews and questionnaires.

3.1 Overview of mortgage finance companies

The Banking Act Cap 488 of the Laws of Kenya defines a mortgage finance company (MFC) as a 'company other than a financial institution which accepts from members of the public, money on deposit repayable on demand, and is established for the purpose of the acquisition, construction, improvement, development or alteration of land and for no other purpose'. Similarly a mortgage finance company must lend only for purchase, construction, improvement, development or alteration of land. The loans should only be secured by a first mortgage or charge over the land. The maximum loan amount allowed is 90% of the value of the property mortgaged or charged.

The following are the legal provisions that the Banking Act requires mortgage finance companies to observe:

- The institutions must place at least 75 percent of their loan portfolio in residential property.
- The institutions must use only security allowed by Central Bank in deciding the amount that may be lent.
- The institutions can take other types of security but cannot use these to increase the amount lent.
- The minimum period of a loan may be prescribed by Central Bank.
- The Central Bank of Kenya can specify the maximum interest rate per annum (which must include all fees, charges, additions etc) that a mortgage finance company can charge.

It is with these and other similar controls that mortgage finance companies conduct their businesses. There are only two mortgage finance companies in Kenya. These are Housing Finance Limited and Savings and Loan (K) Limited. Their profiles and brief histories are discussed here below:

3.2 Profiles of lending institutions

3.2.1 Housing Finance Limited

3.2.1.1 Background and Ownership

Housing Finance Limited, formerly Housing Finance Company of Kenya (HFCK) is the largest Mortgage Company in Kenya. It was established to promote thrift and home-ownership for Kenyans. The company was incorporated in 1965 as a 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 and administration of provident funds (Mutero, 1993). The company was initially a joint venture between the government of Kenya and Commonwealth Development Corporation (CDC), each holding 60 per cent and 40 per cent of the shares respectively. In 1970 the government's shareholding increased to 50 per cent. The company's shareholders as at 31st December 2002 were Commonwealth Development Corporation (CDC) Capital Partners at 30.43 per cent, NSSF held 11.27 per cent, 7.32 per cent by the government and the rest, 51 per cent by individuals and various institutions (Housing Finance, 2002).

3.2.1.2 Financing strategies

The source of funds for lending purposes is mainly short term deposits from individuals and institutions. The company finances individuals, whether employed or self employed, and limited companies for the purposes of purchasing either residential or commercial properties. Various requirements are needed when one is being considered for a loan. For individuals, the main requirements are sale agreement of the property being purchased, letter from employer showing employment terms and monthly salary, pay slips and bank statements for previous six months, income tax returns and copies of title of the property being purchased.

The company finances the following:

i. Purchase of undeveloped plots for development, between 0.5 acres to 2.5 acres.
ii. Construction or repair of individual homes.
iii. Purchase of houses developed by private house builders, its subsidiary Kenya Building Society (KBS) or the National Housing Corporation.

The company gives loans subject to the mortgage value as determined by the company valuers. For undeveloped plots, the maximum loan advanced is Kshs 1,500,000 or 50 percent of the mortgage value of the property. For already completed houses the maximum loan advanced is 80 percent of the mortgage value. The company finances up to 30 percent construction cost where the borrower has done 70 percent of the work. The maximum loan term is 15 years, subject to the loan being fully paid by age 60 or by retirement age of the borrower, whichever comes earlier.

The interest rates as at September 2003 were 18.5 percent for residential properties and 21.5 percent for commercial properties.

In dealing with loan defaults, the institution is mainly governed by the provisions of the mortgage deed. The same is reinforced by the Mortgages (Special Provisions) Act Cap 304 of the Laws of Kenya, which is aptly titled as 'an Act of parliament to enable the Housing Finance Company of Kenya Limited to obtain possession more easily of property in respect of which it is able to as mortgagee to exercise its power of sale or

appoint a receiver'. Provisions of the Registered Land Act (RLA) Cap 300 of the laws of Kenya are also applied when the charged land is under RLA and those of Indian Transfer of Property Act applied when the property is registered under Registration of Titles Act Cap 281 of the Laws of Kenya.

3.2.2 Savings and Loan Kenya Ltd

3.2.2.1 Background and ownership

Savings & Loan Kenya Limited was prior to 1957 known as Savings & Loan Society Limited and was incorporated in Tanganyika now Tanzania. It was a subsidiary of Pearl Assurance Company. Savings and Loan was licensed as a financial institution in 1969 under the 1968 Banking Act Cap 488. It was acquired as a subsidiary of Kenya Commercial Finance Company (KCFC) which in turn was a wholly owned subsidiary of Kenya Commercial Bank (KCB). It was to become later on a fully owned subsidiary of KCB and has remained so to date (Mutero, 1993).

3.2.2.2 Financing strategies

The source of funds for lending purposes is mainly short term deposits from individuals and institutions. The institution offers a range of services. However the principal objective is to encourage savings as much as possible from individuals, institutions and organised groups and to provide loans to assist people buy or build their own houses anywhere in the country.

Savings and Loan Limited offers different financing packages to assist people save and eventually own houses. These are Deposit Accounts, Housing Development Bonds, House Deposit Accounts (HDA), Home Ownership Saving Plan, Staff House-Loan Schemes, Financing Estate Development, End Finance Commitments and Market Support for Estate Developers.

The company gives loans subject to the mortgage value as determined by private valuers appointed by the company. For already completed houses the maximum loan advanced is 70 percent of the mortgage value for properties less than 10 years old and 60 percent for properties over 10 years old. The company finances up to 60 percent construction

cost where the borrower has done 40 percent of the work. Commercial properties are financed up to 50 percent of the mortgage value. The maximum loan term is 10 years, subject to the loan being fully paid age 60 or by retirement age of the borrower, whichever comes earlier. The current lending interest rates are 19 percent for residential properties and 21 percent for commercial properties.

As far as dealing with loan defaults is concerned, the institution is governed by the provisions of the mortgage deed, which specify the rights available to the chargee upon default. The Registered Land Act, for example outlines he chargees' remedies and the procedures to be followed upon default (RLA Cap 300, Sect. 74).

3.2.3 National Housing Corporation

3.2.3.1 Background and Ownership

The National Housing Corporation was established in 1966 as the successor to the government Central Housing Board. In the terms of its governing legislation, the Housing Act (Cap 117), the institution 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.

National Housing Corporation operates within a policy framework developed by the ministry responsible for housing, presently the Ministry of Roads, Public Works and Housing. First set out in Sessional Paper No. 5 of 1966/7 the housing policy is usually updated 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 housing finance institutions.

3.2.3.2 Financing strategies

The Corporation depends almost entirely on the exchequer for loans to finance its operations including undertaking projects. It has also benefited from previous USAID Housing Guaranty programs, in addition to acting as the conduit for World Bank shelter loans to local authorities. Government loans are given at 6.5 percent interest per year and are repayable over 40 years (if for rental housing) and over 20-25 years in the case of tenant purchase housing schemes.

The National Housing 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. On 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 applied to finance tenant purchase projects. The corporation enters into tenant purchase agreements with individual beneficiaries allowing it to collect debt charges. This method has recently been applied to Kibera Highrise estate along Mbagathi road and Jonathan Nge'no estate in Langata, both in Nairobi. The tenant purchase agreements require the tenant purchaser to pay a down payment of 10 percent of the sale price and the balance 90 percent is paid over a period of 15 to 18 years at an interest rate of either 10 percent or 12 percent, depending on each particular scheme.

Under the fourth method the corporation acts as the developer but does not provide end finance to buyers, arranging instead for long term mortgage loans from housing finance

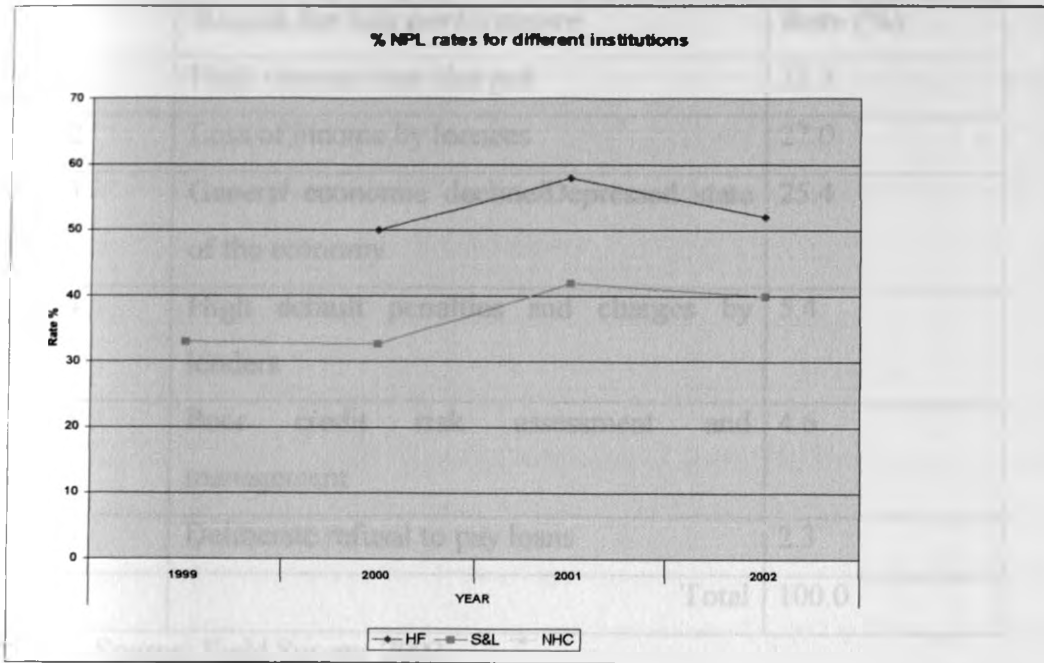
institutions, usually Housing Finance Ltd. Upon the conclusion of the sale agreements, the NHC recoups its development outlay which is then applied to other projects. There is no budgetary provision in the government's annual development estimates for this type of financing. This method is currently being applied in the ongoing residential development in Kiambu town.

In dealing with loan defaults, the Corporation enforces the Tenant Purchase Agreement, which requires it to issue a 21-day notice to the defaulting tenant purchaser to pay up. When this notice expires, a further notice of 7 days is issued for payment to be made. Failure to comply within a period of 28 days, a formal notice of 90 days is issued, stating the Corporations' intention to acquire the property at the end of that period. If no payment is made at the end of the 90 days, the Corporation demands vacant possession of the property. The corporation then sells outrightly the property at its market value. No refund is made of the monthly installments previously made and the same is treated as rent for the property for the period occupied. The initial deposit amount paid may be refunded if the property fetches an amount at least equal to the outstanding loan balance.

3.3 Levels of Non-performing Mortgage loans.

The study sought to determine the magnitude of non-performing mortgage loans in Kenya. The analysis of the data revealed that the different institutions have varying levels of non-performing loans. Housing Finance Limited exhibited the highest levels of non-performing loans above 50 percent while Savings and Loan Limited had levels of non-performing loans above 30 percent. National Housing Corporation had the lowest levels, standing below 7 percent. Figure 2 below shows the percentage levels of non-performing loans for the different studied institutions.

Figure 3: Percentage levels of non-performing mortgage loans for the different institutions.



Source: Field Survey, 2003

3.3.1 Causes of non-performing mortgage loans

The second objective of the study was to determine the main causes of non-performing loans in the property market sector. Both borrowers and lenders were interviewed separately so as to get their points of view and perspectives. The analysis from both borrowers and lenders revealed that there are various causes of non-performing mortgage loans.

Table 1 below shows the causes of non-performing mortgage loans according to the borrowers.

Table 1: Main causes of non-performing mortgage loans according to borrowers.

	Reason for non performance	Rate (%)
1	High interest rates charged	35.3
2	Loss of income by loanees	27.0
3	General economic decline/Depressed state of the economy	25.4
4	High default penalties and charges by lenders	5.4
5	Poor credit risk assessment and management	4.6
6	Deliberate refusal to pay loans	2.3
	Total	100.0

Source: Field Survey, 2003

The three institutions studied also revealed various causes of non-performing mortgage loans. Housing Finance Limited and Savings and Loan cited the following to be the main causes of non-performing mortgage loans in their institutions in the order of importance.

1. High interest rates charged
2. Depressed state of the economy/general economic decline
3. Loss of income by loanees.
4. Inadequate credit risk assessment and management
5. Delays through the judicial system

National Housing Corporation cites the poor state of the economy and loss of income by loanees as the major causes of non-performing loans.

The Central Bank of Kenya, Bank Supervision Annual Report 2000, had similar views to the above and in addition cited external pressure from dominant shareholders as the main causes of non-performing loans in the banking sector.

According to the borrowers the main causes of non-performing loans in Kenya are high interest rates charged by banks, loss of income and the economic decline the country has been experiencing, representing about 87.7 percent of the responses. Lenders have similar views but in addition, they cite delays through the judicial system and poor credit risk assessment and management as the main causes of non-performing mortgage loans. The main causes can be explained as follows:

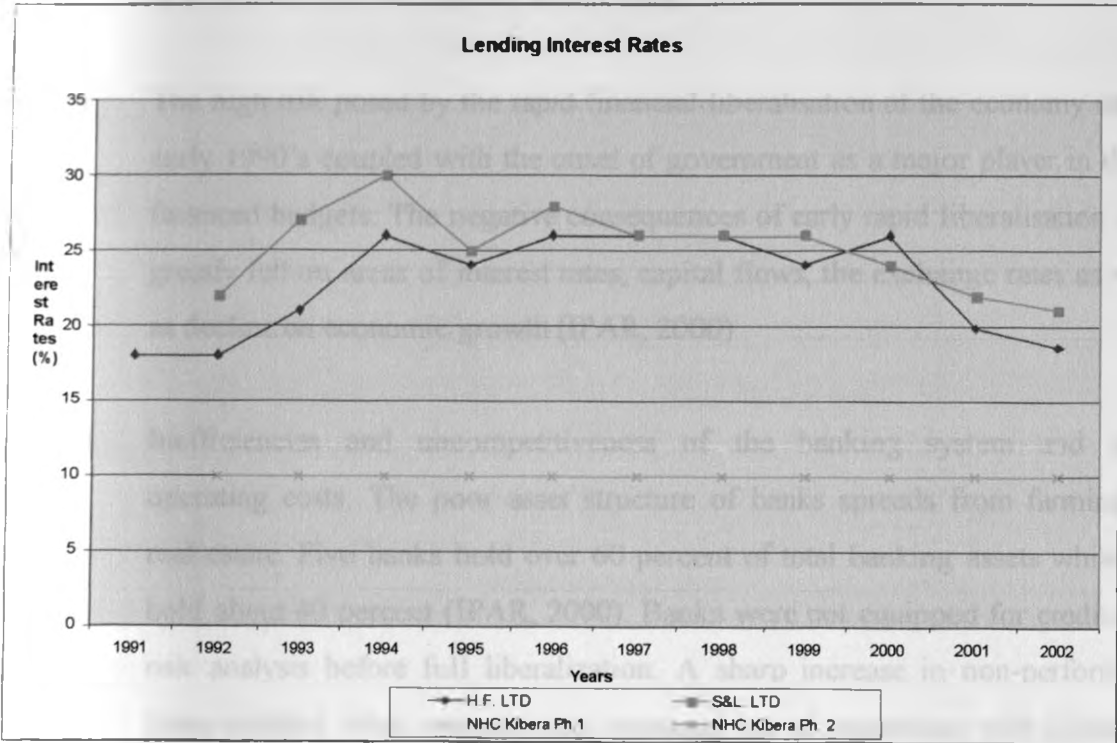
i) High interest rates

The high and fluctuating interest rates lead many borrowers to experience difficulties in servicing their debts. Most financial institutions including mortgage institutions use Adjustable Rate Mortgages (ARM), which leads to variations (often increases) in the monthly instalments payable for loans. Increases in mortgage instalments with static or declining incomes coupled with rising costs of living leads to mortgage defaults and consequent non-performance of the loans. High or sky rocketing interest rates lead to a decline in asset prices, increased bankruptcy, and insolvency, leading to substantial drops in the stock of money in circulation, a breakdown in allocation mechanism of financial capital leading to financial crisis (Minsky, 1977; Kindleberger, 1998). Increased lending rates increase the interest burden on loans leading to defaulting by borrowers. This in turn leads to an increase in non-performing loans, straining bank liquidity, and increasing their probability of failure (Matu, 2001).

Whereas banks price their levels of interest rates by considering various factors including risk levels, the high rates are counterproductive in that they perpetuate economic recession in vicious cycles. They lead to a contraction in credit availability particularly for the productive sectors in the private sector and thereby reducing their net worth. High rates also provoke bankruptcies in companies leading to unemployment and loss of incomes and disrupt court systems even where bankruptcy laws are in place (IPAR, 2000).

In the period between 1991 and 2002, mortgage lending rates for the different institutions fluctuated as shown in figure 3 below.

Figure 4. Lending interest rates for the three institutions



Source: Field survey, 2003 and IPAR 2002.

The two mortgage finance companies exhibited relatively high and varying rates of interest over time. National Housing Corporation applied two rates of interest for different Tenant Purchase schemes, 10 percent and 12 percent, for NHC Kibera Phase 2 NHC Kibera Phase 1 respectively and which are fixed for the term of the loan.

For the two mortgage finance companies, the lending interest rates were high compared to the average return on property investments, which average 8 percent (Ndung'u, 2001). The fluctuations in interest rates lead to varying monthly instalments repayable. The scenario becomes worse when effects of inflation reduce the effective income available to pay loans.

The high rates of interest in Kenya have been a subject of study and analysis by various bodies and interest groups. One of these is a study done by the Institute of Policy

Analysis and Research (IPAR) in 2000, which cited the following as the major causes of high interest rates in Kenya.

i) High government borrowing of funds from the market through debt instruments such as Treasury Bills (TBs).

ii) The high risk posed by the rapid financial liberalisation of the economy in the early 1990's coupled with the onset of government as a major player in debt-financed budgets. The negative consequences of early rapid liberalisation was greatly felt on areas of interest rates, capital flows, the exchange rates as well as decline on economic growth (IPAR, 2000)

iii) Inefficiencies and uncompetitiveness of the banking system and high operating costs. The poor asset structure of banks spreads from farming to real estate. Five banks hold over 60 percent of total banking assets while 44 hold about 40 percent (IPAR, 2000). Banks were not equipped for credit and risk analysis before full liberalization. A sharp increase in non-performing loans resulted when interest rates increased out of population with collateral (property) values.

iv) High implicit tax on bank deposits due to high cash ratio requirements of Central Bank of Kenya (CBK) without compensation. Banking regulations require commercial banks to maintain a cash ratio of up to 8 percent of their total deposits with the CBK. This cash ratio requirement means that while banks must pay interest on the deposits, they only keep 92 percent of the deposits for their operations because Central Bank does not pay any interest on the 8 percent deposited with it. This requires the banking institutions to make up for the interest that they have to pay to depositors. This high cash ratio requirement adds to the cost of operation for bankers if they must pay interest to all depositors and reduces the revenue earning assets available to banking institutions.

v) Deposit and Loan Mismatch. There are inadequate funds for lending on long term basis. This mismatch between the period of deposits available for lending and the lending period of the mortgage finance companies in Kenya is because the source of deposits used for lending is short term in nature while most mortgages are usually long term in nature. As shown in Table 3 below, no deposits had a maturity period of over 5 years while loans maturing in over 5 years accounted for over 90%. These institutions overwhelmingly rely on public deposits, which are predominantly short term in nature.

Table 2: Maturity profile of deposits and loans for mortgage finance companies

Maturity in years	1996 Kshs. (Billions)	%	1997 Kshs. Billions	%
		Deposits		
Up to 2 years	7.7	74.0	8.3	72.3
2-5 years	2.7	26.0	3.2	27.7
Over 5 years	0.0	0.0	0.0	0.0
Total Deposits	*10.4*	*100.0*	*11.5*	*100.0*
		Loans and advances		
Up to 2years	0.1	1.0	0.1	1.2
2-5 years	0.6	7.5	0.8	7.8
over 5 years	7.3	91.5	9.0	91.0
Total loans	*8.0*	*100.0*	*9.9*	*100.0*

Source: Kippra survey results 2001

The above Statistics from Central Bank on the maturity profile of deposits and loans in mortgage finance companies clearly show the threatening problem of deposit-to-loan mismatch and creates the problem of 'borrowing short' and 'lending long' for the mortgage finance companies, which contributes to the level of high interest rates.

Whereas the problem of interest rates is of major concern to borrowers, the two mortgage finance companies and Central Bank of Kenya, National Housing Corporation does not cite as a major cause of non-performing loans in its portfolio. The institution had relatively low rates of interest which are constant over the term of the tenant purchase agreement. The rate of interest applied, 10 per cent and 12 per cent compares well with the rate of interest in the cooperative movement, which is 12 per cent and appears affordable to many and is indeed the lowest in the housing market.

ii) Loss of income by loanees

Loss of income, occasioned mainly by loss of jobs through retrenchments was cited by all players in the mortgage industry as a major cause of defaults in loan repayments, leading to non-performing loans. The period from 1990 onwards saw the government as well as private companies including financial institutions commence to restructure their operations. The most significant effect was the laying off of employees not only in private organizations but also in the civil service. For example, 34, 41 and 27 companies were closed down in 1999, 2000 and 2001 respectively. As a result of this, 4988 people lost their jobs (East African standard, February 2002). At the same time economic liberalization had negative effects including opening up of markets such that the country was flooded with cheap imports of various goods and commodities. Consequently, locally produced goods could not compete in the market and the reduced demand of products inevitably led to companies retrenching their staff and some closed down. Affected employees who had mortgages and no other sources of income started defaulting on their financial obligations.

iii) Depressed state of the economy

This was a factor cited by all the players in the mortgage industry. The performance of Kenyan economy has been dismal over the last ten years (CBK, 2000). The growth rate for the whole economy has been on the decline. For example, since 1995, there has been consistent decline in the growth rate of the economy. The economy actually registered its worst performance since independence in 2000 at negative 0.3 percent (IEA, 2002). This led to many economic challenges key of which is unemployment, loss of income and loss of effective demand for goods and services including mortgages.

iv) Inadequate credit risk assessment

The level of credit assessment applied by the mortgage finance companies was until recently inadequate for it to be useful in ascertaining a borrower's ability to repay a loan. Before 2001, Housing Finance Limited was more liberal or had less stringent credit assessment measures in making advances to customers as compared to Savings and Loan Limited. However, when the level of non-performing loans reached an all time high of 58 percent, stringent measures were put in place before one could qualify for a loan.

Both Housing Finance Limited and Savings and Loan currently require a potential borrower to give specific evidence on the sources of funds to repay a loan. For example, both institutions appraise the customers' ability to pay depending on their net disposable income, after deductions on estimated or actual living expenses.

The institutions use the following information to help in the credit assessment:

- Amount of net income
- Other commitments as a percentage of net salary.
- Debt service coverage ratio i.e. adequacy of stated cash flows or income to meet monthly mortgage installments.
- Job status – whether temporary, contractual or permanent.
- Loan to value ratio.

For potential borrowers residing in Nairobi, Savings and Loan estimates that the minimum monthly expenditure of a borrower is Kshs. 40,000/-. This amount is deducted from the stated net earnings (from salary, emoluments, rental income etc). The balance must then be adequate to meet the expected loan repayments. Housing Finance introduced an underwriting criteria in 2000 which require all applicants to demonstrate that they have sufficient sustainable disposable income to meet their obligations after a proposed loan, as well as continuing to have sufficient money to maintain their established lifestyle (Housing Finance, 2000).

National Housing Corporation does not cite inadequate credit assessment as a high contributor to their non-performing loans. The institution does not in practice have a thorough approach in the determination of the ability and willingness to pay by a potential tenant purchaser. This is probably because majority of tenant purchasers financed by NHC are at the low-income bracket. 85 percent of tenant purchasers have purchased houses valued between Kshs 250,000 and Kshs 1 million. Since the corporations' main motive is not profit making but the implementation of the government housing policy, a thorough credit analysis and assessment may lock out most of the people it is supposed to benefit. However, the low interest rates, which are fixed for the term of the loan coupled with the long loan periods, averaging 18 years,

ensure the monthly loan repayments are relatively low and affordable to most tenant purchasers.

In 1999, NHC developed Jonathan Nge'no Estate, off Lang'ata road, a middle income estate and sold through tenant purchase agreements. The value of these houses was pegged at between Kshs. 3 million and 4.5 million. Currently, these account for about 10 percent of all the houses it has sold through TPS in the last 10 years. During the sale, the institution required that prospective purchasers furnish it with the following documents, which show the ability to pay the loan.

- Letter from employer stating the job status and remuneration.
- Pay slips for the last three months.

v) Delays through the Judicial System

Housing Finance Limited and Savings and Loan cite delays through the judicial system as a major cause of non-performing mortgage loans. The litigation system in Kenya is slow and open to abuse especially by borrowers who wish to cause delays through court injunctions and other delaying tactics (Wagacha, 2000). The fact that lending in Kenya is largely security-based makes the need for speedy resolution of commercial disputes in courts vitally important. While there were securities worth Kshs. 40 billion to cover non-performing loans as at December 2000, it takes not less than five years to realise securities even when they are properly charged (CBK, 2001).

NHC does not cite this as a problem because it does not have a mortgage system like the two mortgage finance companies. Rather, it enters in to a Tenant Purchase Agreement with a borrower, which is governed by the Housing Act Cap 117 of the Laws of Kenya, and which allows speedier taking of possession by the lender upon default.

In accordance with the best banking and accounting principles, institutions continue to reflect and report non-performing loans in their books so long as security has not been realised. International Accounting Standard No. 39 (IAS, 39) requires that non-performing loans be written-off the books only after exhausting all efforts of debt recovery. Hence, banks continue to hold non-performing loans in their books because of ineffectiveness of the court process. Although the establishment of commercial courts

has slightly alleviated the problem, there is still a huge back-log of pending cases which need to be resolved.

Analysis of the views of the borrowers and lenders indicated that poor credit assessment as hypothesised is not the main cause of non-performance of mortgage loans in Kenya's residential property market sector. According to the borrowers credit assessment contributes only 4.6 per cent to the problem of non-performing mortgage loans. The main factors are the high interest rates charged, contributing 35.3 per cent, loss of income by loanees, 27.0 per cent and the depressed state of the economy, 25.4 per cent. According to the lenders, poor credit risk assessment is ranked fourth after high interest rates charged, depressed state of the economy and delays through the judicial system.

The study therefore rejects the hypothesis as there are other main factors that led to non performance of mortgage loans.

3.4 Solutions to non-performing loans

The study also sought to establish the solutions to non-performing loans from the point of view and perspective of the borrowers and lenders. This was done through the use of questionnaires to the borrowers and also to credit management staff of the two mortgage finance companies and to the National Housing Corporation. Data and information in regard to non-performing mortgage loans was also obtained from the Central Bank of Kenya, being the control authority on the financial affairs of all banks and financial institutions in Kenya.

The analysis revealed that there are various solutions to the problem of non-performing loans. The contribution of each solution is shown in Table 3.

Table 3: Solutions to non-performing mortgage loans according to borrowers.

	Solution to non-performing loans	% Rate
1	Reduction of interest rates charged	41.5
2	Fixed interest rates over loan term	20.0
3	Rescheduling of loan terms to borrowers in difficulties	11.5
4	Improved credit risk assessment	9.2
5	Increased loan repayment periods	8.5
6	Reduced cost of houses	5.5
7	Others: Reduced loan default charges, improved credit management etc	3.8
	Total	100.0

Source: Field Survey, 2003

According to the borrowers, a reduction of the current interest rates charged and fixing the lower rates over the life of the loan (Fixed Rate Mortgages) would have a big impact on the non-performing loans problem. These two factors account for 61.5 per cent of the responses according to the borrowers. Other notable solutions include rescheduling of loans to borrowers facing difficulties in loan repayments, improved credit risk assessment and reduction in the cost of houses, accounting for 29.2 per cent of the responses.

The three institutions studied also revealed various solutions to the problem of non-performing loans. Both Housing Finance Limited and Savings and Loan Limited cited the following to be the main solutions to non-performing mortgage loans in the order of importance.

1. Reduction of interest rates charged
2. Improvement of the economy
3. Improved credit risk assessment
4. Improvement of the judicial system
5. Creation of a non-performing loans agency to take over non-performing loans
6. Loan rescheduling to borrowers facing difficulties

National Housing Corporation, on the other hand, cites the improvement of the economy and enhancement of the credit rating system as the main solutions that would reduce its non-performing loans. The institution appears not to have addressed itself to non-performing loans. It experiences low levels as compared to the mortgage finance companies. This may be because it has relatively low interest rates, which are constant over the term of the loan and the loan terms, averaging 15 up to 20 years ensure that the repayment amounts are generally low and affordable by most borrowers or tenant purchasers.

The Central Bank of Kenya, Bank Supervision Annual Report 2000, made the following suggestions on the resolution to non-performing loans (CBK, 2000).

- Creation of a non-performing loans agency.
- Strict supervision of banks and financial institutions to ensure compliance to set guidelines and adherence to the Banking Act.
- Formation of a loan buying company.
- Instituting economic recovery measures.
- Remodeling the Deposit Protection Fund Board (DPFB) to take over non-performing loans.

The solutions can be explained as follows:

i. Reduction of interest rates on loans.

From the above, it can be observed that both lenders and borrowers strongly believe that a reduction in the current interest rates charged would impact positively on the performance of loans. Reduced interest rates would translate to reduced loan payment installments thereby increasingly the affordability of mortgage to Kenyans. For example, the current interest rate of 19 per cent levied by Savings and Loan Limited on residential properties translates to a monthly repayment of Kshs 25,950/- for a loan of one million shillings borrowed for five years. If the interest rate was reduced to 14 percent, the monthly repayment would reduce to Kshs 23,000/-, representing an 11.4 per cent

decrease in the loan amount payable per month. Thus reduced rates would make loans more affordable and consequently reduce the levels of defaults.

Compared to the other countries, commercial banks and other financial institutions in Kenya operate on very wide interest rate margins of up to 10 percent (CBK, 1999). This is largely due to lack of effective competition, use of outdated systems and procedures, poor risk assessment and weak corporate governance. (CBK, 1999). The banks must therefore address these issues seriously in order to contribute to the reduction of the lending interest rates in the country.

ii. Fixed interest rates

This is a solution favoured by most of the borrowers. Application of fixed rate mortgages, though with risks to the lender has certain beneficial attributes to borrowers. One is that they are certain of the loan repayment amounts, which are constant, over the life of the loan and avoids interest rates adjustments and surprises that are common with Variable Rate Mortgages. This aids in financial planning as borrowers are aware of their financial obligations over the whole life of the loan and plan appropriately. This may partly explain why National Housing Corporation, with fixed rates of interest has notably lower levels of non-performing loans than the mortgage finance companies, which have variable rate mortgages. Both Housing Finance and savings and Loan are however averse to fixed rate mortgages due to the risks entailed.

iii. Improved credit risk assessment

Credit risk assessment aims at determining a borrower's ability to repay a proposed loan from a financial institution. All the institutions studied recognised this as an important starting point in the loan process and a major determinant on the success or failure of any loan. Accurate credit assessment of borrowers will identify those who have ability to pay the proposed mortgage loan depending on the amount and certainty of incomes and expenditure over the term of the loan. Credit assessment can be done by trained bank loan officers who can also use credit reference bureaus (CRB) to enable lending institutions share or exchange information on borrowers. If such information is made available to lenders and is shared, it would avoid the many instances of borrowers who move from bank to bank and are perpetual defaulters (CBK, 2000).

iv. Reduced loan default charges.

This is a solution suggested mostly by borrowers from the mortgage finance companies. When mortgage accounts fall in arrears, mortgage finance companies impose default charges, penalty interest and interest on arrears. These charges are added to the outstanding principal and interest due. The default charge is 1.5 percent of the monthly installment payable (Housing Finance 2000). These charges are compounded and the compounded interest raises the outstanding amount over time to very high levels. The magnitude of the problem is immense as Housing Finance Limited acknowledged having Kshs. 2.5 billion in an interest suspense account arising from these charges (Housing Finance, 2001). This is a significant amount given that the company had total assets of Kshs 11.6 billion as at December 2002 (Housing finance, 2002). Borrowers have taken Housing Finance Limited to court and courts have outlawed the charging of some punitive levies on mortgages, specifically penalty and default charges and interest on the charges (HCCC No. 589 of 2000). Charging of these levies which are not specifically provided for in the mortgage agreement has led to a number of borrowers seeking interest recalculation and some have obtained refunds from the mortgage institution.

v. Improvement in the court system.

The mortgage finance companies indicated that to resolve the current stock of non-performing loans, there needs to be an improvement in the Kenyan judicial system. This is because of the long time it takes to resolve a commercial dispute in court. Wagacha, (2000) argues that there is a logjam in the judicial system vis-à-vis the financial system. Furthermore, he argues that the judicial system suffers from low credibility especially in civil matters. If the legal framework is transparent and there is a tradition of honouring contracts, disputes are not likely to be tied up in court for years. The loopholes within the judicial system provide the immoral borrowers with ammunition to refuse servicing their loans. The success of this would be possible if the judicial and court systems are operating efficiently. This can commence with appointment of more judges and magistrates and provision of more physical facilities. Amendment of relevant laws as well as enactment of receivership and bankruptcy laws would also assist the judicial process.

vi. Improvement of the economy

All players in the mortgage industry stated that their level of non-performing loans would be lesser if the economy improved since they have all been negatively affected by the slow growth especially over the last five years. Economic recovery measures would enable borrowers to engage in viable business ventures that generate sufficient income to service the acquired loans. Economic recovery measures would not only raise the level of employment but also enhance security of employment thus reducing the risk of loss of income by loanees, which is a major cause of defaults in loans.

vii. Creation of a Non-Performing Loans Agency.

The creation of a non-performing loans agency was proposed by both Housing Finance Limited and Central Bank of Kenya. This involves the government issuing bonds to replace non-performing loans in the balance sheets of financial institutions and establishment of tribunals to expedite recovery of loans which are normally not well secured and documented. The concept of forming such an agency is based on experiences of countries like Ghana, Uganda and Tanzania where such agencies were formed to hive off non-performing loans from government –owned banks in preparation for their privatisation (CBK, 2000). This model may however only be applicable to government owned banks as government funding would not be appropriate for privately owned institutions.

viii. Formation of a Loan buying Company.

This was cited by the Central Bank of Kenya aimed at reducing the current stock of non-performing loans. This would be a private sector driven and funded company which would purchase the non-performing loans from the banking sector at a discount. The company would then enter in to agreements with the loanees to start repaying their debts with newly negotiated terms and conditions. This model works best where the loans are well documented and secured like mortgage loans and would require amendments to the existing legislation or enactment of new legislation to govern its operations as a mortgage purchaser.

ix. Strict supervision of mortgage finance companies

This solution was cited by Central Bank of Kenya and is aimed at ensuring that financial institutions comply with banking rules under the Banking Act as well guidelines under the Central Bank. This is mainly in the area of corporate governance especially to ensure separation of the roles of shareholders and management. Influence of major share holders, politicians and even government has been a major cause of bank failures or poor performance (Matu, 2001). Due to this influence for example, loan proposals of major shareholders are not always subjected to the normal critical credit assessment. As a result, most loans given under this influence have become delinquent and their follow-up and recovery has been hampered. Since 1984, fourty banking institutions have collapsed mainly due to problems caused by non-performing insider loans and external influence on management (CBK, 2000). Poor regulation has led also led to situations where the value of the security is eroded (due to mis-classification) and this causes a delay in taking corrective actions. Identifying problem areas early enough ensures timely action and this averts growth of non-performing loans. Regulation of bank charges should also be strict to ensure customers are not fleeced through such charges as high account maintenance fees, ledger fees, default charges, late penalty charges and interest on these charges.

3.5 Conclusion

As can be observed, there are a myriad of causes of non-performing loans. However the main contributor is the high interest rates and the general decline of the economy over the last 10 years. The mortgage finance companies have unsustainably high levels of non-performing loans, which threaten their economic performance and act as a disincentive to offer more loans to prospective borrowers. Notably, other important reasons for non performance is the loss of incomes by loanees due to retrenchments by various organizations including financial institutions and the government, poor credit risk assessment and management and delays through the judicial system in the determination of commercial disputes.

On the other hand, most of the solutions given by each of the players in the mortgage industry directly emanated from the causes of nonperforming loans. These include a

reduction in the level of interest rates, better credit risk assessment and a reversal in the economic decline of the country. The implementation of the strategies could cause a reduction of the level of nonperforming loans and also improve on the loan repayment. For example, whereas a reduction of interest rates charged to between 10 percent and 15 percent fixed over the term of the loan by the mortgage finance companies would have a strong positive effect on loans performance, other measures need to be taken to ensure loans perform. Whereas it is important to deal with the existing stock of non-performing loans, it is also important to institute measures to arrest their further increase (CBK 2000).

All players in the mortgage industry have a role to play in ensuring a reduction of the levels of non-performing loans as well as maintain the levels to the lowest possible level, which would be beneficial to the whole economy.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

4.0 Conclusions

Bad debt is inevitable not only in mortgage loans but also in other businesses which involve credit. While the inevitability of bad debt is not an issue, the reduction in the occurrence and quantum of bad debt is (Wight, 2001). The rates of non-performing loans observed by mortgage finance companies in Kenya in the last few years indicate a serious problem which needs urgent short term as well as medium and long term measures to correct the existing situation and ensure it does not reoccur. Bad debts are indeed endemic to the business of banking and should be analyzed as an integral part of bank behaviour and interest rate determination.

The whole economy and more specifically the property market industry has in the last few years been operating in a very volatile environment. For example mortgage lending rates fluctuated by between 8 and 10 percent within 1992 – 1994. Added to this were rising prices of various goods and services. This caused serious cash flow problems to most borrowers. In many situations cash flows were compromised to the extent that customers were unable to meet their repayment obligations. Marginally profitable property investments quickly became loss situations. Unfortunately, mortgage finance companies by and large failed to come up with innovative methods to create mutually acceptable compromises to loan repayment conditions such as soft rates, rescheduled capital redemption requirements and extension of loan periods to reduce repayment amounts. The institutions preferred adherence to 'legality of chargees' rights under the mortgage deed'.

From the analysis of the solutions to the problem of non-performing loans, the main solutions that emerge are a reduction of interest rates, improvement of the economy, and improvement of the judicial system, enhancement of credit risk assessment and management and creation of a secondary mortgage market, which would increase the actors in the mortgage market. It is noteworthy that mortgage finance companies have within the last two years made far reaching changes in their practice of credit risk

assessment. There seems to be a shift from 'collateral lending' to 'character lending' by putting more emphasis on a potential borrowers ability to pay before considering the security offered as collateral. This involves determining who has the capacity to borrow and repay loans and this can only be done through a systematic way of credit assessment. It is a way of rationing credit to only those who can prove they have capability and willingness to pay. In the developed countries, for example a borrower's credit rating plays a bigger role in determining the creditworthiness than the value of collateral being pledged as security for the debt. It is the proposition of this study that if credit was rationed to only those who can demonstrate capacity to pay, the level of non-performing loans would be low and consequently the level of interest rates, since banks charge higher interest rates to compensate for the income that is likely to be lost through non-performing loans. It is important to note that the government is moving in the direction of credit referencing. During the 2003/2004 budget speech the Minister for Finance proposed the amendment of the Banking Act to provide for the creation of a Credit Reference Bureau (CRB). (Budget speech 2003). The CRB would collect credit information on customers in the banking industry for use by its members. This is intended to help the banks share information on credit risk on customers and thus enhance their credit risk assessment.

Mortgage finance companies have lending guidelines and credit risk management measures, but these measures appear not to have been strictly followed, to the detriment of borrowers, who suffered the high interest rates brought about by the institutions perceived risk of loss due to non-performing loans. Now that the government and the institutions appear to be waking up to the reality of the magnitude of the problem, it is imperative that post mortems be carried out to thoroughly analyze all the factors that have contributed to the loss situation. Only by understanding the real issues shall the institutions add to their body of knowledge and thereby incorporate the findings in to their policies and procedures, providing prudent and timely guidelines.

5.1 Recommendations

A study of the challenges in the housing finance sector such as non-performing loans would be incomplete without recommending a way forward not only to reduce the

current level of non-performing loans but also to ensure the problem does not reoccur. Most of the solutions to non-performing loans are suggested in chapter four and the recommendations given arise from these solutions as well as the experiences of other countries, which have successful mortgage financing strategies and low levels of non-performing loans. The recommendations are as follows:

Reduction of levels of interest rates. Financial institutions must reduce their lending rates to attract borrowers in bigger volumes than strangle the few existing ones and perpetuate economic recession. To help reduce the levels of interest rates charged by banks, the government should lower the cash ratio currently at 8 percent. At the same time it should desist from borrowing short term loans from the domestic money market through the issuance of Treasury Bills. A lower cash ratio requirement would ensure banks have more funds at their disposal to lend since less money would be tied up at the Central Bank. By the government desisting from borrowing short term loans from the money market, the interest rates of short term treasury bills would decline thereby forcing banks to look for alternative investment options, especially lending. Banks then would have to lower the lending interest rates to encourage borrowers and also institute thorough credit assessment and management measures so as to minimize losses.

At the same time financial institutions must increase their efficiency through computerisation and restructuring to reduce on operational costs and inefficiencies. Lower operational costs could then be passed on to customer in form of lower lending rates.

Develop appropriate mortgage menus. Mortgage loans are contractual agreements whose terms vary from as little as one year to as much as 25 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, repayment delinquencies and default (Jay Sa Aadu, 1997). It is encouraging that Housing Finance Limited announced a shift in mortgage pricing effective October, 2003.

In the new plan, mortgage interest rates will be priced differently depending on the loan period with loans up to 5 years attracting an interest rate of 14 per cent, loans up to 10 years a rate of 15 per cent and up to 15 years a rate of 16 per cent. In each case there shall be a rebate of 1 per cent interest rate for timely payments of a continuous period of 6 months and a 1 per cent penalty for default (Housing Finance, 2003).

vii. Creation of a secondary mortgage market

One of the problems faced by mortgage finance institutions is lack of long term deposits to lend to borrowers, which creates a deposit to loan mismatch as they have to borrow short term deposits and lend long term loans. At the same time, the institutions operate the whole mortgage process from loan origination, credit assessment, loan administration up to when the outstanding amount is paid in full. A solution to this as mentioned in chapter two is the creation of a Secondary Mortgage Market (SMM) The role of a SMM is to purchase mortgages from the primary market or from the originators. Experiences from the United States of America (USA) show that secondary mortgage markets stabilise mortgage interest rates and increase the availability and affordability of home mortgages (Ball, 1990).

A Secondary Mortgage Market should be set up with the main aim of providing, through the securitization process, liquidity to the financial institutions, which grant long-term housing loans, which are illiquid long term assets. If a secondary mortgage market was established, house financing would be more accessible and affordable because there would be more long term funds available to lend to home buyers. Pension Fund schemes would, for example, more readily invest in a more efficient mortgage market as the returns would be more certain. This would however call for an amendment to the Retirement Benefits Act. Due to the longer term nature of the funds available for lending it would be possible to extend mortgage repayment periods from the current maximum of 15 years to 25 or even 30 years. This would encourage the demand for housing as a longer repayment period makes housing more pay to service and therefore more affordable.

The National Housing Corporation should also diversify its source of funds as it currently relies on the government and other multi lateral donors or lenders. Since these

sources are inadequate in providing enough funds, the institution should create a 'privatised' lending arm as a finance subsidiary that would operate on a commercial basis, catering largely for middle-income home buyers. The subsidiary would be insulated from the administrative controls ordinarily imposed on parastatals and therefore be able to mobilize funds for house construction and sale.

Standardization of the loan application process. The processing of mortgage loan applications by the mortgage financial companies and NHC is different. Each institution has its own policies and procedures, which they use to gauge the risks inherent in each loan. Thus the requirements needed to qualify from each institution require to be harmonised if some of the other recommendations are to succeed.

Standardization of most of these requirements and procedures is strongly recommended so that the institutions can together understand the dynamics of their portfolio and define systems with which to manage them. The challenge is for these institutions to produce standards and systems, which enable them to understand the attributes of their portfolios such as maturity profiles, profitability margins geographical spread and arrears. This allows them to manage their portfolios effectively and gives them the opportunity to utilize products such as securitisation (Wight, 2001). The Central Bank as a regulatory and control authority should produce guidelines that will enable the institutions to formulate suitable standardized loan application and management procedures.

New legislation or amendments to existing legislation. Mortgage finance companies are governed mainly under the Banking Act while National Housing Corporation operates under the Housing Act. Since the two mortgage finance companies are only allowed to lend for property development, it is recommended that a new legislation should be enacted which would deal with all the operations of mortgage financing including credit assessment, loans administration and dealing with bad debt. Currently, the institutions use/apply various statutes including the Company's Act, the Registered Land Act, Indian Transfer of Property Act, the Banking Act, and the Law of contract, depending on the Act under which the charged property is registered and the terms of the mortgage deed.

There is also a need for new legislation on bankruptcy and to govern the practice of receivership or taking over the incomes of non-performing investments property.

Financial institutions should also be encouraged to use other dispute resolution (Alternative Dispute Resolution) mechanisms such as negotiation, adjudication and arbitration, which are often faster and cheaper than litigation. These other dispute resolution measures are less adversarial than litigation as the main aim is to seek dispute settlement where the two parties in conflict arrive at a consensus, rather than a 'win – loose' situation prevalent in the court system.

Staff training on risk assessment and credit management.
All the lenders studied recognized the importance of well trained loan officers or credit management staff. To avoid giving loans to uncreditworthy borrowers, even when they have adequate security to be used as collateral, credit officers should be continually trained in assessment of creditworthiness, for example through inspection and verification of cash flow projections and feasibility studies given by borrowers. They should also be trained in timely loan approvals, adequate financing of development projects, constant visits to ongoing projects etc. Banks should also formulate, document and ensure implementation of appropriate policies and procedures that minimize credit risk. Training should also be done on customer relations so that they don't perceive defaulters as wrongdoers to be treated with contempt. They should identify with borrowers in distress and offer sound financial advice rather than run to lawyers and auctioneers immediately upon default. Borrowers should be made aware of the risks and costs of defaulting and on how to negotiate with lenders when in financial difficulties. Once a loan is approved, risk management staff should take time to impress upon the borrowers on the advantages of keeping the loan terms and especially on scheduled payments. The culture of paying debts should be enhanced as well as training on financial management forecasting so as to reduce over commitment.

Study of Real Estate Finance. The study of real estate finance is critical especially at graduate and postgraduate level in Kenya. For example, most often than not all participants in loan transactions especially the bankers, valuers, investors or other borrowers act in studied ignorance of each other and often in conflict of ideas and

intentions. The received wisdom among economists, financial experts and policy makers is that what is good for the housing sector can infact be good for the economy as a whole (Jay Sa Aadu, 1997). Since financing of real estate to a large extent determines its success and the success of the economy as whole, the study of real estate finance should be integrated in the broad subject of economics and taught in various fields. As Jay Sa Aadu (1997), argues, the development of the 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 the overall economic development. This can be better appreciated if well studied not only by students and practitioners in Land Economics but also in the fields of Finance and Development.

Property Finance Forum. Various African countries are facing similar economic challenges as they are in various stages of development. In the real estate sector, the development of successful mortgage poses a serious challenge due mainly to the various risks inherent in the property market in Africa. There needs to be a forum for these countries to share their experiences so that they can benefit by avoiding flawed strategies and policies and adopting proven and successful practices. As Wight (2001) concludes in his study of property finance business in South Africa, there needs to be created an African property finance forum with similar objectives to that of the African Real Estate Society (AfRES). The forum would meet on a regular basis to present and discuss papers or related topics. The 1997 regional seminar on maintaining Sustainable Mortgage Finance Schemes in Africa held in Accra, Ghana which brought together middle level managers of different property related institutions, policy makers especially on housing development is a case in point and such should be held regularly.

5.2 Areas for further research.

This research project has been undertaken with time constraints and therefore it has been limited in terms of quantity of data on non-performing mortgage loans. Mortgage finance companies have only recently started keeping data on loan delinquencies as required to do so by Central Bank. Be that as it may, the research is a starting point in

the studies of what ails the mortgage and housing sector in Kenya. There is however need for further study in the following areas:

- The practice of credit rating and assessment as a risk management measure in housing finance institutions.

- The nature and effects of non-performing loans in the entire banking industry.

- The linkages between a successful mortgage finance system and the financial sector and with the whole economy.

- The ways and means of mobilizing finance to benefit the housing sector of the economy.

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Appendix 1

QUESTIONNAIRE TO MORTGAGE PAYERS

Introduction

In the last few years there has been a hue and cry over the high number of defaults and consequent non-performing loans in the banking industry and particularly in the mortgage finance institutions. This study aims at identifying the main causes of non-performing loans in Kenya from the perspective of both lenders and borrowers. Borrowers targeted need not have non-performing loans but their experience with mortgages can shed light into the difficulties facing the industry. The reasons identified would provide the players in the mortgage industry be they borrowers, lenders or control authorities including the government with various options to be addressed in a bid to avert crisis in the banking/mortgage industry.

Kindly take a few minutes to answer the questions here below by ticking the correct option. **The study is for academic purposes only and any information shall be treated in strict confidence.**

1. NAME (OPTIONAL)____
2. AGE in years ☐ 20-30 ☐ 31-40 ☐ 41-50 ☐ 51-60 ☐ Over 60
3. Are you ☐ Employed ☐ Self Employed ☐ Unemployed
4. Estate____
5. Residential status: ☐ OWNER ☐ TENANT
6. Do you have experience with mortgages? ☐ YES ☐ NO
7. Name Of Lender ☐ Housing Finance ☐ S&L (K) ☐ NHC
   Other_____________________________
8. Date Loan Advanced (Year) ______________________________
9. Interest rate at time of borrowing__________________________%
10. Current interest rate ______________________________%

11. Loan repayment period in Years ______________________

12. Monthly instalment at start of borrowing in Kshs ______________

13. Monthly instalment today in Kshs ______________________

14. Is this your ☐ 1st mortgage ☐ 2nd mortgage ☐ 3rd mortgage

15. Have you rescheduled your mortgage payment ☐ YES ☐ NO

16. If YES, by how many Years _________ or what amount: Kshs ___________

17. Why was the rescheduling your loan repayment necessary?

☐ Difficulties in loan repayment

☐ To increase repayment period

☐ To decrease repayment amount

Other ______________________________

18. In your opinion, what are the main causes of defaults in mortgage loan repayments? Please number in the order of importance giving the **most important as No. 1 and the least as No. 6.** or other.

☐ High interest rates

☐ Loss of income

☐ General economic decline

☐ Poor credit assessment and management by lenders

☐ Deliberate refusal to pay loans

☐ High default and late payment charges and penalties banks

☐ Others: Please specify and rank

☐ ______________________________

☐ ______________________________

☐ ______________________________

19. Would you consider taking another loan if

i) Interest rates were frozen at current rate ☐ YES ☐ NO

ii) Economic conditions improved ☐ YES ☐ NO

20. What do you think would solve the problem of non-performing loans in the property market today? Please list in the order of importance awarding the most **important as No. 1 and the least important as No. 6** or other.

☐ Reduction of interest rates

☐ Use of constant/fixed interest rates over the period of the loan

☐ Improved credit assessment of applicants by lenders

☐ Reduced loan default charges

☐ Rescheduling of loan terms to borrowers facing difficulties

☐ Increased repayment period

Others (Please specify and rank)

☐ ________________________________

☐ ________________________________

☐ ________________________________

21. What do you think should be done by the government to increase access to housing?

____

____

____

____

____

Appendix 2

QUESTIONNAIRE TO MORTGAGE FINANCE COMPANIES

Introduction

Financing of real estate is mainly by way of mortgages, which often use the property as security for the lo: In the recent past, the numbers of mortgage loans that are non performing have been on the increase. In t banking industry, for instance the non-performing loans level has averaged 30-40% in the recent past.

The purpose of this study is to identify the **main causes of non-performing loans** from the perspective lenders and borrowers as well as measures taken by mortgage institutions to reduce the level and gua against repeated occurrence.

Kindly take some time to answer the following questions. The study is **for academic purposes only ai any data or information shall be treated in confidence.**

1. Of the total mortgage loans advanced, what proportion of these were non performing in the followii years

Year	1992	1993	1994	1995	1996	1997	1998	1999	2000
% of NPLs									
Total amounts of NPLs									

2. Which group of borrowers are most affected by Non Performing Loans or persistent defaults?

a). By age group in years : ☐ 20-30 ☐31 – 40, ☐41-50 ☐over 50

b). By amount borrowed: between Kshs__________ and Kshs. ____________

3. a). Do you have a lower rate of interest for borrowers with a special mortgage (or staff) scheme? ☐ YES ☐ NO

b). If yes, what is the average rate of interest? __________________%

c). Are there mortgage defaults in this category? ☐ YES ☐ NO.

d). If yes, what is the percentage rate __________ %.

4. What is your current distribution of loans by size (either in % terms or number of loans)

LOAN SIZE (KSHS)	%	NUMBER OF LOANS
Upto 1,500,000		
1,5001 to 3,000,000		
3,000,001 to 4,500,000		
4,500,001 to 6,000,000		
Over 6,000,000		
TOTAL %	100 %	

5. a). Do you have a Credit Assessment mechanism of ascertaining a borrower's ability and willingness to repay a loan? ☐ YES ☐ NO

b) If yes, kindly rank the factors suggested here below indicating the magnitude of importanc in the assessment of creditworthiness that your organisation attaches. *(tick where appropriate)*

REASON	RANKING			
	High	Moderate	low	None
▪ Amount of Net income	☐	☐	☐	☐
▪ Average Bank Account balance	☐	☐	☐	☐
▪ Other commitments as a % of income	☐	☐	☐	☐
▪ Source of funds for down payment of property purchase	☐	☐	☐	☐
▪ Previous credit history	☐	☐	☐	☐
▪ Debt Service coverage ratio (ie adequacy of cash flows to meet monthly mortgage instalments)	☐	☐	☐	☐
▪ Loan to Property Value ratio	☐	☐	☐	☐
▪ Job status: Temporary/Contract/ pensionable	☐	☐	☐	☐
▪ Others (Please specify and rank)				
▪ ____________________	☐	☐	☐	☐
▪ ____________________	☐	☐	☐	☐
▪ ____________________	☐	☐	☐	☐

6 a. Does your organization restructure or reschedule mortgage loans when borrowers require or are facing difficulties in meeting their obligations? ☐ YES ☐ NO

b. If YES what mechanisms are applied when rescheduling a debt?

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7. The following reasons have been suggested to be contributing to the high level of non performing loan In your opinion, what is the **impact of each of the factors in the creation of non-performing loans i your portfolio?**

REASON	RANKING			
	High	Moderate	low	None
▪ Depressed state of economy	☐	☐	☐	☐
▪ High Interest Rates	☐	☐	☐	☐
▪ High loan to Value ratio	☐	☐	☐	☐
▪ Political interference	☐	☐	☐	☐
▪ Loss of income by borrowers	☐	☐	☐	☐
▪ Deliberate refusal to pay loans	☐	☐	☐	☐
▪ Delays through the judicial system	☐	☐	☐	☐
▪ Lack of credit reference system	☐	☐	☐	☐
▪ Poor credit risk assessment	☐	☐	☐	☐
▪ External pressure from dominant shareholders	☐	☐	☐	☐
▪ Other (Please specify and rank)				
▪ i.______________	☐	☐	☐	☐
ii.______________	☐	☐	☐	☐
iii. ______________	☐	☐	☐	☐

8. What strategies have been adopted by your organization when addressing the problem of Nonperforming loans. How have these strategies been effective

STRATEGY	EFFECTIVENESS		
	HIGH	MODERATE	LOW
i.______________________________	☐	☐	☐
ii.______________________________	☐	☐	☐
iii.______________________________	☐	☐	☐
iv.______________________________	☐	☐	☐
v.______________________________	☐	☐	☐

9. In your opinion, what are the main challenges facing the mortgage industry in Kenya?

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10. What do you think would reduce the level of NPL'S in your institution? Kindly list them below.

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11. What do you think the government should do to alleviate the housing shortage especially in the urba areas?

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