# ASSESSMENT OF CAUSES CREATING NON-PERFORMING MORTGAGE LOANS IN KENYA.

## SUBMITTED BY

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## DEPARTMENT OF REAL ESTATE

## UNIVERSITY OF NAIROBI

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# DECLARATION AND RECOMMEDATION

This project is my original works and has not been presented for a Post Diploma courses in any other University

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Peter Murigi Ndung'u

This Project had been submitted for examination with my approval as principal

University supervisor

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**Mr. L. W. Muchiri**

# DEDICATION

The project is dedication to my family and especially to my dear wife, the late  Agnes Mugure Murigi who passed on $18^{th}$ July, 2013 before I completed the course and therefore does not live to cerebrate the joyful moment of award of the fruits of the hard work she passionly supported.

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And lastly and not least,Imay not be able to list here all those who assisted in one way or another in the course of doing this work,and therefore,take this opportunity to thank all others not mentioned above.

Thank you and God bless you

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# ACRONYMS

CSHS        Civil Servant Housing Scheme

CBK         Central Bank of Kenya

GDP         Gross Domestic Product

HFCK        Housing Finance Company of Kenya

KCB         Kenya Commercial Bank

NHC         National Housing Corporation

NPLs        Non -Performing Loans

NPMLs       Non-performing Mortgage Loans

PPP         Public Private Partnership

REIT        Real Estate Investment Trust

REMIC       Real Estate Mortgage Investment Conduits

S & L       Saving and Loan (Kenya) Limited

SACCO       Saving and Credit Cooperative Organization

# ABSTRACT

This project aimed at identifying the causes that create non-performing mortgage loans in financial institutions that offer mortgage loans in Kenya. It begans with a theoretical study of the background of the causes of the non-perfoming mortgage loans in housing market globally and in the country.This was  done through review of existing literature on non-performing mortgage loans both in Kenya and other countries.The study aimed at identifying the characteristics of the mortgage loans, causes creating non-performing mortgage loans  in the portfolios of the financial institutions granting mortgage loans in Kenya properties market and propose ways to address the identified causes of non-performing mortgage loans.

The study  focus on finanancial institutions offering mortgage loans (target population) but limit to those institutions that grant mortgage to customers or public. This is because most financial institutions especially commercial banks offer mortgage loans to their staff. There are thirty (30) financial institutions that offer mortgage loans to customers and therefore used as the study sample (CBK, 2012). These financial institutions consisted of one fully pledge mortgage company (HFCK) and  commercial banks which grant mortgage loans througth subsidaries companies licenced by CBK.Such as S & L of KCB, Rafiki of Chase bank etc. The thirty financial institutions offering mortgage loans formed the target population of study.

This research was administred through the use of structured questionnaire distributed among respondents to collect primary data. Drop and pick later method for distribution of the questionnaire was adopted. Out  of the thirty (30) questionnaires distributed to mortgage financial institutions only sixteen (16) responded, representing a response

rate of 53%. These were considered adequate for the purposes of this research study as major market players were represented.

After data analysisthe study revealed that there are various factors that causes creation of non-performing mortgage loans in financial institutions granting mortgage loans in Kenya. The main  factors being high mortgage variable  rate, loss of income, general decline in economy and poor credit assessment mechanism.


The study concluded that high mortgage rate is the main factor causing creation of non-performing mortgage loans in Kenya and hence the need to adopt far reaching approaches for the benefit of all participants within mortgage industry as proposed in this study.

# CHAPTER ONE: INTRODUCTION

## 1.1 Background to the Research Problem

Access to adequate and affordable credit by any business organization/ individual to a large measure stimulate its growth. Credit refers to money made available to borrower, which is repayable together with accrued interest at a future agreed date and time. To be advanced credit borrowers must prove that they are able to meet the repayment terms and conditions.

Financing is a major factor to almost every successful real estate transaction being either purchase of a family first home or to a multimillions' commercial development or purchase. Financial mortgage institutions are in the business of balancing their expected returns to the risks entailed in lending their funds. Such risks include defaults in payments and future changes in interest rates. Being rational investors, the financial institutions consider the returns and risks entailed in each investment before making the decisions on whether to lend or not and how much to lend. Lender's risk is reduced when its loan is secured because when a particular real estate secures a debt, the lender gains a right to foreclose and apply the proceeds settle the debts.

In the past years, Kenya has experienced rough economic times and one of the most negatively affected groups is those who had taken up loans and for various reasons were unable to services them. There have been many cases of loan defaults and consequent efforts by lenders to sell whatever property/ item which was used as security for the debts.

Since 1992, when the country embraced open market policies and deregulated many aspects of the economy including the banking sectors, the equilibrium rates of interest rates on loans were left to be determined by the forces of demand and supply in the market(Ndung'u and Ngugi, 2000). The immediate effect of the economic and financial liberalization was that the main economic indicators, mainly 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, which rose from 18.6% in January 1993 to 70% in July 1993.The level of inflation also fluctuated dramatically and this resulted to economic uncertainties and resultant loss of investment opportunities and reduced levels of economic growth. Lending interest rates have fluctuated from 18% in 1991 to highest of 32% in 1994, 21% to 18% in 2002 and 22% in 2012(Economic Survey, 1994, 2002, 2012). To 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. Therefore servicing the loans became difficult resulting in defaults leading to the increase in non-performing loans.

Non-performing loans are those loans that are not being serviced as per loan contracts and expose the institutions to potential losses. Their occurrences have impacted negatively on both lenders and borrowers to a great extent. Lenders have undergone losses, as they have to write off some debts or make provisions for them in their accounts as bad and doubtful debts. Such losses lead to dissatisfaction among the shareholders of the financial institutions. On the other hand, many borrowers have been auctioned or had their business placed under receivership.

There are many reasons for non-performing mortgage loans and neither the lenders nor borrowers can solely be blamed. The reasons range from the general economic declines, low effective consumer demand of various products including houses for rental or purchase, high and fluctuating interest rates compared to returns expected among others. In light of this, the reasons given from either the supply side or demand side calls for a study to determine the causes of non-performing loans, as this would help in focusing on the best solutions possible. The solution would point on the way forward for the mortgage industry in Kenya.

## 1.2 The Problem Statement

There are various financial institutions which give housing finance in Kenya, but the main player in the mortgage market  are Housing Finance Company of Kenya (HFCK ), Saving and Loan (S&L) of Kenya Commercial Bank (KCB) with combined  market share of more than 90% of residential property lending (CBK,2000). Other institutions that provide mortgage financing are major commercial banks, Saving and Credit Co-operative Organisation (SACCOs) and Building societies. The government through National Housing Corporation(NHC) and Ministry of Housing(Civil Servant Housing Scheme) is involved in construction of residential houses mainly for public and civil servants respectively and avail  loans mainly on tenants purchase scheme at comparatively low interest rates ( 5% ) comparaed to the market rates.

Most home buyers enter into mortgage arrangements intending to pay the amounts borrowered together with interest. This is, however, not always possible due to variations in loan terms because of variable rates offered by the mortgage institutions, for example,

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rising interest rates, resulting in higher monthly payments being required, changed 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 can be  problem to many banks and not just in the property market sector hence threaten the survival of the mortgage industry as the banks tries to cover the addation cost of non-performing loans. This has translated into higher cost of bank credit, slowed economic growth and employment opportunities. High cost of banking credit and reduced consumer demand for various products including real estate worsening an already bad situation especially for those struggling to pay often pushing them to bankruptcy.

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

Non-performing loans impact negatively on the borrowers, lenders and the economy as a whole. To borrowers, they lead to stress and its related consequencess, loss of faith in credit system  when the borrower's property is auctioned after paying for many years. To the lender there is loss of income and can even lead to bankruptcy when income does not match the expenditure.

The whole economy suffer when there is loss of confidence in the banking or credit industry,since the level of non- performing mortgage loans can affects the profitability of mortgage institutions  and  the prices of property market which can even result in collapse of financial market leading to crisis in country economy. Therefore their effects on financial and property markets and the factors that causes them are of great interest to growth of economy.

In light of this, therefore there is need for identification of factors that create non-performing mortgage loans in Kenya mortgage sector. The problem that this research seeks to address is that of identifying the factors that causes creation of non-performing mortgage loans in Kenya financial institutions offerring mortgage loans.Issues to be addressed in this research include the characteristics of mortgages loans in Kenya and factors causing creations of non-performing loans in portfolios of Kenya financial institutions offerring mortgage loans and solutions for the  identified factors for the benefit of all sector players.The government for example, can succeed in its declared policy for facilitating the private sector in  provision of  housing  to bridge the gap between the annual supply and demand of housing units in major urban areas estimated at 120,000 housing units,  if the causes of non-performing mortgage loans are adequately addressed (National Housing policy, 2004).

## 1.3 Research Questions

The study intends to answer the following specific questions:

i.    What are  the characteristics  of mortgage loans in Kenya ?

ii.   What are the causes creating non-performing mortgage loans in financial institutions that grant mortgages loans?

iii.   What are the ways of addressing the causes of non-performing mortgage loans identified?

## 1.4 Research Objectives

The primary objective of this study is identification of the causes of non-performing mortgage loans in Kenya financial institutions. The specific objectives are to:-

i.   Determine the characteristicsof mortgage loansin the Kenya;

ii.   Identify the factors that causes creation of non-performing mortgage loans in Kenya;

iii.   Propose possible ways to address the problems of non-performing mortgage loans to reduce their occurence.

## 1.5 Research Hypothesis

High mortgage rates is the main factor causing creation of non-performaning mortgage loans in Kenya mortgage sector.

## 1.6 Purpose of the study

This study aims at identifying the main causes of non-performing loans in Kenya from the perspective of lenders. Lenders targeted need not have non-performing loans but their experience with mortgage can shed light into the difficulties facing the industry. The reasons identified would provide the players in the mortgage industry be they lenders, borrowers or government with various options to be addressed in a bid to improve the sector. This is because the mortgage industry can play a crucial role in the growth of

economy through provision of adequate housing financeby elimination or reducing the rate of non-performing mortgage loans in Kenya.

## 1.7 Study Area and Scope

The total banks' loan portfolio can be classified into three main categories i.e. business, consumer and mortgages loans. The study will be limited to mortgage loans focusing on non-performing mortgage loans in Kenya in the perspective of lenders (mortgage institutions).Mortgage loans are loans that are given to various borrowers by financial institutions (mortgage companies or commercial banks) for the construction/purchase of residential houses for either rental or owner occupation. The study time is restricted to the period from 2007 -2012.

## 1.8    Justification ofthe Study

Universal Declaration of Human Rights of 1948 recognises the right to adequate housing as an important component of the right to adequate standard of living (National Housing Policy, 2004).This aspect has been enforced by  other international instrumentssuch as International Covenant on Economic,Social and Cultural Rights of 1966,The Instanbul Declaration and Habitat Agenda of 1996 and Millennium Development Goal of 2001 which recognise housing in the broader context of the shelter fabric together with the living environment.In this regard,Kenya has reaffirmed  this right under section 43 (1) (b) of the Kenya Constitution 2010 by making access to adequate and decent housing a basic right and therefore making government housing mandate more challenging.

Housing finance is one of the four key factors for housing development. The other three are serviced land, building material and labour. They are two sources of housing finances

namely personal saving and mortgage loans. Personal saving is not adequate and only few individuals have enough savings or liquid funds to enable them to develop or purchase property outright. Therefore mortgages loans remain the main option for financing housing development/purchase for many people and institutions. Mortgage institutions mobilise funds from various sources at cost and then lend to borrowers at cost known as as interest. Thus non-performing loans are threat to existence of mortgage institutions although they take the property as the collaratel which can sold to recover the debt in case of default.

Hence the study is therefore justified as it aimed at identifying the characteristics and causes of non-performing mortgage loans in Kenya. Information generated will be used to suggest ways to address the identified causes of non performing mortgage loans in Kenya. This will help in improving provision of housing finance to scale up housing development to increase the existing housing stock to ease housing demand.

## 1.9 Study Assumptions

The following assumptions were made for the study:

a) Borrowers of mortgage loans for housing development/purchase do so with the intention of repaying their debt in full and therefore benefit from the financing;

b) Mortgage financing is aimed to be fair, sustainable and beneficial to both borrower and lender.

## 1.10 Definition of terms

a) **Housing Finance** is the methods and institutions that are used for financing the construction, purchase or mortgages of housing units, such as public housing or low income housing.

b) **Bank Loan** is money that is borrowed with a contract to pay back.

c) **A mortgage** is a loan that is secured with real estate for housing development or purchase either for owner occupiers or for rental.

d) **A Non-Performing Loan** is that loan whose maturity date has past but a part of loan is still outstanding.

e) A **house** may be defined as a building or structure that has the ability to be occupied for dwelling by human beings.

f) **Housing development** includes construction and maintenance of housing units and housing infrastructure.

## 1.11 Organization of the Study

This research is organized into five chapters. Chapter one is an introductory one which outlines the background of the research problem, study problem, research questions, objectives, Hypothesis, purpose, study area and scope, justification and significant, assumptions of the study as well as operationalizing definition of the key terms used in the text.

Chapter two focuses on the literature review which results in identification of knowledge gap and the conceptual framework. This chapter detailed various scholarly arguments on factors causing creations of non-performing mortgage loans in Kenya.

Chapter three presents research methodology used to conduct the study. Chapter five presents data analysis and presentation of research finding. The fithy and final chapter gives conclusions, summary of finding and recommendations of the study. Finally, there are references and the appendices for the questionnaire.

# CHAPTER TWO: LITERATURE REVIEW

## 2.0Overview

This chapter will look at the mortgage basic concepts and legal regulations, collateral, appraisal, mortgage default, remedies for breach of mortgage covenants, determinants of mortgage interest rate, classification of non-performing loans, cost of non-performing loans and alternatives investment considerations.

## 2.1 Literature Review

### 2.1.1 The mortgage Basic Concept and Legal regulations

A mortgage is a transaction whereby one party (mortgagee) accepts a claim or tittle to property from another (mortgagor) as security for the payment of a debt, or the discharge of some obligation, for which the property is given; subject to proviso that when the loan is repaid, or the obligation discharged, the property is released or returned to mortgagor free of the mortgagee's claim (Abbott, 1987).

The word *mortgage* is a French Law term meaning "death contract", meaning that the pledge ends (dies) when either the obligation is fulfilled or the property is taken through foreclosure (http://en.wikipedia.org/wiki/mortgage-loan).

A home buyer or builder can obtain financing (a loan) either to purchase or secure against the property from a financial institution, such as a bank or credit union, either directly or indirectly through intermediaries. Features of mortgage loans such as the size of the loan, maturity of the loan, interest rate, method of paying off the loan, and other characteristics can vary considerably.

In many jurisdictions, though not all, it is normal for home purchases to be funded by a mortgage loan. Few individuals have enough savings or liquid funds to enable them to purchase property outright. In countries where the demand for home ownership is highest, strong domestic markets for mortgages have developed.

According to Anglo-American property law, a mortgage occurs when an ownerpledges his or her interest (right to the property) as security or collateral for a loan. Therefore, a mortgage is an encumbrance (limitation) on the right to the property just as an easement would be, but because most mortgages occur as a condition for new loan money, the word *mortgage* has become the generic term for a loan secured by such real property. As with other types of loans, mortgages have an interest rate and are scheduled to amortize over a set period of time. All types of real property can be, and usually are, secured with a mortgage and bear an interest rate that is supposed to reflect the lender's risk.

Mortgage lending is the primary mechanism used in many countries to finance private ownership of residential and commercial property. Although the terminology and precise forms will differ from country to country, the basic components tend to be similar:

a) Property

The physical residence being financed, the exact form of ownership will vary from country to country, and may restrict the types of lending that are possible.

b) Mortgage

Refers to the security interest of the lender in the property which may entail restrictions on the use or disposal of the property, restrictions may include requirements to purchase home insurance and mortgage insurance, or pay off outstanding debt before selling the property.

c) Borrower

The person borrowing who either has or is creating an ownership interest in the property.

d) Lender

The term refers to any lender, usually a commercial bank or other financial institution. Lenders may also be investors who own an interest in the mortgage through a mortgage-backed security. In such a situation, the initial lender is known as the mortgage originator, which then packages and sells the loan to investors. The payments from the borrower are thereafter collected by a loan servicer.

e) Principal

The original size of the loan which may or may not include certain other costs as any principal is repaid; the principal will go down in size.

f) Interest

The term refers to any financial charge for use of the lender's money.

g) Foreclosure or repossession

The possibility that the lender has to foreclose, repossess or seize the property under certain circumstances is essential to a mortgage loan; without this aspect, the loan is arguably no different from any other type of loan.

h) Completion

Legal completion of the mortgage deed, and hence the *start* of the mortgages

i) Redemption

Is the final repayment of the amount outstanding which may be a "natural redemption" at the end of the scheduled term or lump sum redemption, typically

when the borrower decides to sell the property? A closed mortgage account is said to be "redeemed".

Many other specific characteristics are common to many markets, but the above are the essential features. Governments usually regulate many aspects of mortgage lending, either directly (through legal requirements, for example) or indirectly (through regulation of the participants or the financial markets, such as the banking industry), and often through state intervention (direct lending by the government, by state-owned banks, or sponsorship of various entities). Other aspects that define a specific mortgage market may be regional, historical, or driven by specific characteristics of the legal or financial system.

Mortgage loans are generally structured as long-term loans, the periodic payments for which are similar to an annuity and calculated according to the time value of money formulae. The most basic arrangement would require a fixed monthly payment over a period of ten to thirty years, depending on local conditions. Over this period the principal component of the loan (the original loan) would be slowly paid down through amortization. In practice, many variants are possible and common worldwide and within each country.The above information can be mathematically expressed by the following formulae:-

$$AB = PMT \left[ \frac{1 - 1/(1+r)^n}{r} \right]$$

AB   =Amount Borrowed

PMT=Periodic Repayment Sum

n    =Number of repayment periods

r    =Interest Rate

Take it that any of the three factors can be changed to fit a particular borrower. Interest rate  (r) is indeed a factor of risk.

Lenders provide funds against property to earn interest income, and generally borrow these funds themselves (for example, by taking deposits or issuing bonds). The price at which the lenders borrow money therefore affects the cost of borrowing. Lenders may also, in many countries, sell the mortgage loans to other parties who are interested in receiving the stream of cash payments from the borrower, often in the form of a security (by means of a securitization).

Mortgage lending will also take into account the (perceived) riskiness of the mortgage loan, that is, the likelihood that the funds will be repaid (usually considered a function of the creditworthiness of the borrower); that if they are not repaid, the lender will be able to foreclose and recoup some or all of its original capital; and the financial, interest rate risk and time delays that may be involved in certain circumstances.

There are many types of mortgages used worldwide, but several factors broadly define the characteristics of the mortgage. All of these may be subject to local regulations and legal requirements.

a) Interest

 Interest may be fixed for the life of the loan or variable, and change at certain pre-defined periods; the interest rate can also, of course, be higher or lower.

b) Term:

Mortgage loans generally have a maximum specified term, that is, the number of years over which an amortizing loan will be repaid. Some mortgage loans may have no amortization, or require full repayment of any remaining balance at a certain date, or even negative amortization.

c) Payment amount and frequency

The amount paid per period and the frequency of payments; in some cases, the amount paid per period may change or the borrower may have the option to increase or decrease the amount paid.

d) Prepayment

Some types of mortgages may limit or restrict prepayment of all or a portion of the loan, or require payment of a penalty to the lender for prepayment.

The two basic types of amortized loans are the fixed rate mortgage (FRM) and adjustable-rate mortgage (ARM) (also known as a floating rate or variable rate mortgage). In some countries, such as the United States, fixed rate mortgages are the norm, but floating rate mortgages are relatively common. Combinations of fixed and floating rate mortgages are also common, whereby a mortgage loan will have a fixed

rate for some period, for example the first five years, and vary after the end of that period.

- In a fixed rate mortgage, the interest rate, and hence periodic payment, remains fixed for the life (or term) of the loan. Therefore the payment is fixed, although ancillary costs (such as property taxes and insurance) can and do change. For a fixed rate mortgage, payments for principal and interest should not change over the life of the loan,

- In an adjustable rate mortgage, the interest rate is generally fixed for a period of time, after which it will periodically (for example, annually or monthly) adjust up or down to some market index. Adjustable rates transfer part of the interest rate risk from the lender to the borrower, and thus are widely used where fixed rate funding is difficult to obtain or prohibitively expensive. Since the risk is transferred to the borrower, the initial interest rate may be, for example, 0.5% to 2% lower than the average 30-year fixed rate; the size of the price differential will be related to debt market conditions.

The charge to the borrower depends upon the credit risk in addition to the interest rate risk. The mortgage origination and underwriting process involves checking credit scores, debt-to-income, down payments, and assets.

### 2.1.2 Appraisal

The key factor in assessing the adequacy of the collateral is the appraisal. The appraisal contains a detailed description of the property and application of three approaches to value: the cost, market and income approaches. The *cost approach* includes an estimate

of the value of the land as vacant, the cost of replacing the improvement and an adjustment for estimated depreciation due to physical deterioration and functional of property and economic obsolescence . *The market approach* estimates the value of the property based on sales prices of similar properties (comparables) in the neighbourhood. The appraiser will generally utilize at least three comparables and make adjustments to the comparables for differences in the physical characteristics and condition of the properties. *The income approach* value the property based on the potential rental income that could accrue to it. The appraiser will capitalize the potential rent of the property using an income multiplier or capitalization rate. Because of the importance of the market approach to value, a critical factor in underwriting mortgage loan is good quality house price data. Paucity of data may hinder smooth appraisal functions when it is required by underwriters for loan assessment.

Of the three appraisal methods the most reliable for appraisal of the client property for mortgage loan is market approach  method (Betts & Ely, 2008).This is because it considered rent accrued from the property and hence connect the important of rent and interest rate in  mortgage underwriting.

### 2.1.3 Collateral

Mortgage is backed by real property, either an owner-occupied home or an investor-owned dwelling. An accurate assessment of the value of the property is fundamental to determine whether, in the event of borrowers default, the lender could recoup enough from the sale of the home to cover loses. The amount of a borrowers own funds invested in the property, also referred to as borrower equity, factors heavily into the lending

decision. For years, mortgage research consistently has shown that a borrower with a significant financial stake in the property is less likely to default.

### 2.1.4 Mortgage Default

Default means a breach of the covenant not only failure to pay the monthly instalment but also includes any other breach

### 2.1.5 Remedies for Breach of Mortgage Covenants

There are a number of basic remedies by the lender against a defaulting borrower. These remedies include the following;

a) 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, the mortgage holder will try to work some type of alternative payment program to avoid the sale of the collateral. Not only is this practice much better for the lender public relations efforts, it also avoids the time consuming, expensive and generally unprofitable foreclosure process. Foreclosure is for most part an avenue of the last resort.

b) Appointment of a receiver

   This remedy is often applied to on-going 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 a sound financial footing

c) Taking possession and leasing

This remedy is also available and applicable to such properties as can be leased and the proceeds or profit taken to services the debt. It would be useful remedy in properties which have a rental value high enough to service the debt over a reasonable time

### 2.1.6 Determinants of Mortgage Interest Rate

According to Brueggeman and Fisher (1997) they are four determinants of mortgage interest rate which includes the following:

a) The demand and supply of mortgage funds.

Most mortgage lender lenders are institutions that link the flow of funds from savers to borrowers. Borrowers use the saving in the form of mortgage credit. The market rate of interest on mortgage loans is established by what borrower are willing to pay for the use of funds over a specific period of time and what lenders are willing to accept in the way of compensation for the use of their funds.

b) The lender costs of managing the funds.

From the cost of attracting funds from savers, the cost of originating and managing the loans, losses from loan defaulter and foreclosure and when interest rates are fixed, potential losses due to unexpected changes in interest rates after a loan is made

c) 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.

d) The risks associated with mortgage.

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

## 2.1.7 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 banker and financial institutions at every stage of a loan. These are as follows;

a) Normal.

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

b) Watch.

These are good accounts, which normally would be classified under (a) above but, have exhibited some specific weakness and hence warrant management attention

c) Substandard.

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

d) 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 had dried up

e) Loss.

These are all those with outstanding arrears which are regarded as being uncollectable and where security is worthless or has been disposed of, the proceeds of which have not covered the total debt and the balance remaining is unlikely to be recovered.

## 2.1.8 Cost 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;

a) Legal fee.

The higher the level of non-performing loans the greater will be the legal costs as well as indirect legal costs of beefing up the legal departments, internal and customer consultations.

b) 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 property owner from underselling of their property.

c) Auctioneer Fees.

Private auctioneers who charge a fee mainly based on a percentage of the sales price and their direct costs of carrying out auctions.

d) Management Time.

Substantial amount spent on endless consultation with customers, rescheduling with customers, communication with lawyers etc.

e) Increased administrative costs.

Hidden costs such as telephone bills, stationary etc incurred by lenders as communicate with borrowers

f) Lost or misdirected focus.

Rather than focusing on productive activities beneficial to customers the pre-occupation is on debts collection not slated business objection.

From the above it is evident that non-performing loans have a substantial amount of costs which 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.

### 2.1.9 Consequences of Non Performing Mortgage Loans

The rise in non-performing loan ratios has serious consequences for the economy. The level of non-performing loans is a significant determinant of the level of bank costs as well as the estimates of scale economies in banking. Non-performing loans as been linked to causes of the financial crisis in many countries especially Asian financial crisis of

1997. King (2001) claims the Asian financial crisis was triggered by Japanese commercial banks that were considerably weakened by the collapse of real estate markets.

The lending policy of banks also gets affected by non-performing loan ratios. Banks will adjust their loan preference ratio and the weight of risky loans in order to avoid a crisis. This will lead to a more conservative real estate lending policy. However, the more restrictive lending policy may lead to a poor performance in the real estate sector thereby exacerbating a possible crisis.

The determinants of non-performing loans are classified into three categories: macroeconomic financial performance, real estate market performance and the lending policies of the banking sector. When both the macro economy and the real estate market perform well, the level of non-performing loans should be lower. By contrast, if the banks' loan portfolios bear more risk, non-performing loans are likely to be higher. If the relative cost of real estate borrowing is low, then we would expect more of the riskier candidates to apply for loans. In other words, a higher relative real estate lending rate will result in lower amounts of real estate loans. The credit risk and the probability of non-performing loans would thus be reduced. Also predict the ratio of corporate real estate loans with respect to individual real estate loans to be important in explaining the percentage of non-performing loans. The diversification principle suggests that corporations are not as risky as individuals due to their size and the quality of their assets. Therefore, if banks decrease the weight of individual real estate loans in their real estate loan portfolios, the level of non-performing loans should go down.

A higher non-performing loan ratio can indirectly affect the real estate market since higher non-performing loan ratios will push banks to be more conservative, thereby causing tighter lending policies and lower housing prices due to lower demand. If the financial economy is performing well, the housing prices should also be higher. The demand for housing can be proxies by the rate of change of vacant housing. When the demand for housing is lower, the prices will inevitably go down.

### 2.1.10 Alternative Investment Considerations

Common wisdom has it that capital from a broad spectrum of investors can besourced to invest in non-performing mortgages, likethat for performing mortgages through a securitization vehicle (Shanker, 2008). Unfortunately, that is not the case because of the disadvantages of certain tax rules and regulations to tax-exempt and foreign investors compared to domestic taxable investors.

The investment vehicles for mortgages include: realestate mortgage investmentconduits (REMIC), grantor trusts, owner trusts, real estate investment trusts (REITs) and partnerships. Although, there are prosand cons of each of these vehicles, as discussed below, REMIC is the most popular vehicle for mortgages because it was designed specifically to attract broad-based capital for mortgages.

(a) Vehicle Suitability and investment obstacles

The following describes the suitability considerations of the above vehicles fornon-performing mortgages, and obstacles to investing in such mortgages through these vehicles:

- REMIC

Suitable for tax-exempt and foreign investors;but execution of a REMIC transaction is subject to risks arising from the uncertainty in (a)the use of REMIC for non-performing mortgages because of a lack of guidance from the Treasury;(b) the retention of foreclosed property in REMIC until liquidation;and (c) the placement of residual of interest in REMIC due to excess exclusion of income tax liability.

- Grantor Trust

Unsuitable because assets within a grantor trust cannot be actively managed whereas an investment in non-performing mortgages requires active management through modification,refinancing,foreclosure and sale of the properties.

- Owner Trust

Unsuitable for tax-exempt and foreign investors for two reasons: (a) debt interest in the trust may not provide attractive returns;and (b) equity interest in the trust would pose tax-hurdles,as described below,causing a significant reduction in the potential return to equity investors

- REIT

Not well suitable for holding non-performing mortgages because REITs are passive entities that hold real estate assets for investment purposes and,therefore,cannot actively manage non-performing mortgage loans. The ownership and operation of a REIT is complicated by the REIT's required compliance with specific tax rules on an ongoing basis,including income and asset ownership requirements and income distribution rules.

- Partnership

Unsuitable for tax-exempt and foreign investors because a partnership poses tax burdens,which would reduce significantly the potential return to such investors.

(b) Tax Burdens to Investors

An investment in a non-performing pool of mortgages which could be restructured then sold or refinanced, or foreclosed and then liquidated,isexposed to leakage of income for tax-exempt and foreign investors, and thus to a reduced benefit for such investors. The income leakage will usually discourage these investors from investing capital in non-performing mortgages. Leakage in income arises from (a) unrelated business taxable income, (b) trade or business income, and (c) phantom income from restructuring of a mortgage loan.

## 2.2 Conceptual Framework

Any property developmenteither for owner occupier, rental or commercial is generally the single most costly investments in anindividuals' or firms' life cycle. In many countries, a typical individual or firm would normally need to save for years or even decades, to be able to afford a modest standards property. Therefore, it is vital that loans, mortgages and credits facilities are available in order to enable households and firm to acquire the necessary resources to pay for such a property. Thus, this is main concept of mortgage loans, whereby the mortgages institutions mobilized resources from various sources and loans to borrowers at small fee(mortgages interest rates) to cater for administration cost and returns to shareholders who contributed the resources.

A housing finance system is, of course, an intermediary mechanism between savers and borrowers; it is a conduit for financial resources from those who save in order for those who need to borrow for development or purchase of property. As such housing finance, when applied appropriately, is also lubricant and facilitator in the housing economy. The housing finance system functions within the framework of financial markets, often called capital markets, which supplies finance through various forms of loans,bonds,credits and mortgages services and institutions aimed at long-term investments.

Housing finance is usually regulated by legislations that protect lenders, borrowers and savers. In case of default, there must assurance that resources and rights are safeguarded and enforced. This explains the need for legislations on foreclosure, collateral, property rights and monitoring and reporting systems, which are designed and enforced in order to assure that institutions behave according to rules set by the Central bank, or another designated national state entity.

## 2.3Conclusion

The study attempt to identify the causes of non-performing mortgages loans in Kenya mortgage sector.The determinants of non-performing loans are classified into three categories: Macroeconomic financial performance, real estate market performance and the lending policies of the banking sector. When the both the macro economy and the real estate market perform well, the level of non-performing mortgage loans should be lower. By contrast, if the banks' loan portfolios bear more risk, non-performing mortgage loans are likely to be higher. The non-performing loans ratio is used to express credit risk. As the credit risk is higher, the banking return is expected to be lower.

If the relative cost of real estate borrowing is low, then we would expect more of the riskier candidates to apply for mortgage loans. In other words, a higher relative real estate lending rate will result in lower amounts of mortgage loans. The credit risk and the probability of non-performing loans would be reduced. The diversification principle suggests that corporations are not as risky as individuals due to their size and the quality of their assets. Therefore, if banks decrease the weight of individual mortgage loans in their real estate loans portfolios, the level of non-performing loans should go down.

# CHAPTER THREE: RESEARCH METHODOLOGY

## 3.1Introduction

This chapter outlines how the research study was conducted. It includes the research design adopted, the target population, data collection and analysis of the data.

## 3.2 Research Design

The research design is the conceptual structure within which research is conducted.It consists of the blueprint for the collection,measurement and analysis of data. As such the design includes an outline of the framework of study,availability of various data,and observations.It means the exact nature of the research work in a systematic manner (Kothari,2004).

This research study used descriptive research design. This design uses description as a tool to organize data into patterns that emerge during analysis.This is because it is used to identify hypothetical constructs and it can acquire a lot of information through description.There are two categories of descriptive designs:surveys and observational studies. This research was administered through the use of a structured questionnaire distributed among respondents to collect primary data.Addational secondary data was obtained through use of informational documents made available during the course of research.The design was adopted because it allowed collection of large amounts of data from the target population as compared to other methods.

## 3.3 Target Population

According to Mugenda&Mugenda population is defined as a complete set of individuals, cases or objects under consideration in any field of inquiry and has a common observable characteristic that differentiate it from other population (appendices 7.3.). The target population for this research study includes financial institutions that offer mortgage loans inthe country. Almost all banks offer mortgage loans for both staff and customers. However, the numbers of institutions offering mortgage loans to customers are thirtyas per attached appendices 7.4. These 30 institutions (comprising of one Mortgage Company and twenty nine commercial banks) constituted the target study population.

## 3.4 Sample Size

Therefore this study will use a sample size of thirty  financial institutions which offer mortgage loansin Kenya as pers attached appendices 7.4.

## 3.5 Data Collection

Given the sample size,a survey method was best in order to obtain a representative response. The survey instrument of collecting primary data used for this study was a structured questionnaire.The questions were designed to elicit data in accordance with the research questions.Drop and pick later method of data collection was applied.

The research study and data collection was carried out between April to June 2013. Of the 30 questionniares distributed,16 were filled out and returned to the research, representing a response rate of 53%. These were considered adequate for the purposes of

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this research study as major market players were represented.A list of respondents and their responses rate has been provided in the appendices 7.3

## 3.5 Data Analysis

The data collected was edited for accuracy,consistency and completeness.The data was then coded and cross-tabulated to enable the responses to be statically analyzed. Descriptives statistics were used to analyze data by way of percentage.

# CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION

## 4.1 Introduction

This chapter gives an outline of the research finding and analysis of the various responses gathered from the questionnaire. It is structured following the questionnaire format. The questionnaire was divided into two sections Aand B. Section A  was used to collect information on characteristics of mortgage loans. This addresses features  of mortgage loans such as size of the loans, repayment period,mortgage interest rate,credit assessment creteria, proportion of non-performing mortgage loans,and mortgage restructuring.

Section B addresses the factors that causes creation of non- performing mortgage loans and measures to be taken to address the identified factors.

Therefore this chapter discusses research findings from these two sections  which are based on the objectives of the study namely:-

i.   Determine the  characteristics of mortgage loans  in Kenya;

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

iii.   Propose possible ways to address the problems of non-performing mortgage loans to reduce their occurrence.

The findings form the basis of the presentation and analysis and serve as a basis on which conclusions and recommendations were made. The data was collected so as to meet the objectives of this study.There were several problems encountered in the field when collecting the data,but the main one was respondents not filling the quesionnaire in time and researcher keep on following.

## 4.2Data Analysis and Presentation

### 4.2.1 Section A: Characteristics of mortgage loans

Regarding the characteristics of the mortgage loans the respondents were asked to indicatesdistribution of mortgage loans by size, repayment period, mortgage interest rate charged, whether they have set a credit assessment or not, persistent defaulters, proportion of non-performing mortgage loans, and whether if they restructure mortgage loans or not during difficulties of loan repayment.

On distribution of mortgage loans on size the study show that the majority of mortgage size range between Ksh 5 to Ksh 7 million represented by 20.6 %.The size range of Ksh 3-Ksh 5 million follow closely at 19 % whereas themortgage size rangingfromKsh7-9 millions is third at 18.1 %. The data indicate that half of the mortgage loans sized between fromKsh 3-Ksh 9 millions, this is because most of houses pricesor cost of development in middle class area such as Buruburu,Umoja, Kasarani, Kitengela, Mlolongo, Athi River,Ongata Rongai,Kiambufall under this range.The range of Ksh10 million and above is represented by 16.5 % is mainly for development of flats for rental and some homes in high income areas. The size of mortgage loans of Ksh1-Ksh 3 millions at 25.7 % is mainly for development of houses where the owner has already acquired the land i.e it mainly for construction.From the discussion with various mortgage administrators also reveaed that most borrowers has other means of financing their housing development meaning that they do not solely depend on the mortgage loans.That why they borrow lower amount than the actual cost of their development.These other sources include private saving, loans from friends and relatives, chamas (merry go round) and loans from SACCOs.

On repayment period the data show that it depend on size of mortgage loan. For example the repayment period for mortgage loans ranging from Ksh 1 million to two (2) millions is commonly 2-3 years while three (3) million to (7) is 3 years to 5 years. Mortgage above 7 million is payable from 5 years to 20 years. This because the long the repayment period the smaller is installment per month.

The data show that the propotion in percentage of non-performing mortgage loans range from 1-5 % at 82%. 0nly 18 % of the institution has proportion ranging from 6-10 % of non- performing mortgage loans. Thus the data indicate that on average the proportion of non- performing mortgage loans may be avaraging from 5-6 %.

On persistent defaulers, the data show that defaulters are across all the groups. The data indicate thatthe group owing mortgage loans ranging 6 million to 10 milion are the main defaulters at 42.1 % closely followed by the group owing 10 million and above. The data therefore indicate that the higher the level of mortgage loan the higher the chances of defaulting.

From the data;

- 5.1% are defaulters from thegroup owing up to 1 million;

- 10.5% are defaulters in group owing mortgage 3 million to 5 million,

- 15.7 % are defaulters from group owe mortgage ranging from 5 million to 7 million,

- 42.1 % are defaulters from group owing mortgage betwen 7 million to 9 million,

- Whereas 26.3 % owing mortgage loans above 10 million.

On the type of mortgage interest rates, non of the financial institutions offer a purely fixed mortgage rates,according to the respondents this is because the interest rates have been too high to fix. Volatile interest rates make it diffucult for most banks to have fixed interest rates, this partly contributed because banks set their rates pegged on the prevailing CBK's base lending rate (8.5%). Majority of institutions, 87.5 % offer mortgage variable rates. Variable or adjustable rate of mortgage are most appealing to lenders as they allow them to better manage interest-rate risk, particularly for banks with short term deposit funding. Because of unpredictable economic environment,that is often prone to inflationary pressure is another reason for charging variable rates.Whereas 12.5% of mortgage institutions offer a blend of fixed and variable rates.A few financial institutions offer up to five years part of fixed mortgage rates.This means that the interest rates do not change for the first five years of the loan,after which they revert to variable terms for the remaining life of the mortgage.

On current mortgage interest rate chargeable by financial institutions the data show that;

- 31.5 % of the financial institutions charge interest rate between 11-15 %;

- 56.3 % charge between 16-20%,

- 12.5 % charge between 21-25 %,

- Whereas no financial institutions is charging below 10% and above 26 %.

The results above show that majority of financial institutions 56.3 % charges mortgage interest rates ranging between 16-20 % followed closely by rates between 11-15 % at

31.3 % of financial institutions. Non of the financial institutions is charging  mortgage interest rate below 10 %  although the base lending rate of CBK is below 10%, currently at 8.5% . Therefore the averaging interest charged is 18 % and ranges from 11 to 25 %.

All the respondents indicates that their  institutions have put in place a credit assessment mechanism in place to select the potential customers.They indicate that the creteria used is to investigate whether the applying customer is able or in position to repayment of the amount requested without difficulties.This is achieved through knowing whether the applicant is employed or self employed, income level of the applicant, other financial commitment, working period,  retirement age, whether you have defaulted before,and healthy status etc.

On mortgage loan restructure/reschedule all financial institutions show that they do this to help their customers cope by restructuring the mortgage loans facilities by extending repayment periods, hence reducing monthly repayments. The data show that 50 % of the financial institutions restructure mortgage loan when the customer show sign of difficulties in loan repayment, 56.3 % of the financial institutions restructure loans to increase repayment period  and only 6.3% of financial institutions restructure mortgage loans to decrease repayment period.

From the data mortgage loan is restructured/rescheduled to;

- 50%  due to difficulties in loan repayment;

- 56.3 % to increase repayment period,

- 6.3 % to decrease repayment period.

A summary of finding is as shown in table 4.1 below

Table 4.1 Characteristics of mortgage loans.

| Variable | Frequency(f) | Percentage (%) |
|---|---|---|
| **Distribution of mortgage loan by size** | | |
| UptoKsh 1,000,000 | 1270 | 8.6 |
| Ksh1,000,001 to Ksh3,000,000 | 2529 | 17.1 |
| Ksh3,000,001 to Ksh5,000,000 | 2808 | 19 |
| Ksh 5,000,001 to Ksh7,000,000 | 3037 | 20.6 |
| Ksh7,000,001 to Ksh10,000,000 | 2671 | 18.1 |
| Ksh10,000,001 and above | 2440 | 16.5 |
| **Repayment period in years(3 -7 M)** | | |
| 1-2 | - | |
| 3-5 | 8 | 50 |
| 6-10 | 2 | 12.5 |
| 11-15 | 3 | 18.75 |
| 16-20 | 3 | 18.75 |
| 21 and above | - | - |

| % of NPMLs | | |
|---|---|---|
| 1-5 | 13 | 82 |
| 6-10 | 3 | 18 |
| 11-15 | - | |
| 16-20 | - | |
| 21-25 | - | |
| 26-30 | - | |
| 31 and above | - | |
| **Persistent defaults** | | |
| Upto 1,000,000 | 1 | 5.1 |
| 1,000,001 to 3,000,000 | 2 | 10.5 |
| 3,000,001 to 5,000,000 | 2 | 10.5 |
| 5,000,001 to 7,000,000 | 3 | 15.7 |
| 7,000,001 to 9,000,000 | 8 | 42.1 |
| 10,000,001 and above | 5 | 26.3 |
| **Type of mortgage interest rate** | | |

| | | |
|---|---|---|
| Fixed | 1 | 6.2 |
| Variable | 13 | 81.3 |
| Blend fixed and variable rate | 2 | 12.5 |
| **Curent interest rate (%)** | | |
| 1 -5 | - | |
| 6- 10 | - | |
| 11- 15 | 5 | 31.25 |
| 16-20 | 9 | 56.25 |
| 21 -25 | 2 | 12.5 |
| 26 and above | - | |
| **Credit assessment mechanism** | | |
| Yes | 16 | 100 |
| No | - | - |
| **Restructure/reschedule of mortgage** | | |
| Yes | 16 | 100 |
| No | - | - |

| If Yes,reasons | | |
|---|---|---|
| Difficulties in loan repayment | 8 | 50 |
| To increase repayment period | 9 | 56.25 |
| To decrease repayment period | 1 | 6.25 |

Source:Field survey

## 4.2.2 Section B: Factors causing non- performaning  mortgage loans

The financial institutions  were asked to give factors that causes creation of   non-performing mortgage loans in their portfolios.  They give open view on various factors. The factors were summarized as shown in table 4.2 below.

According to the  financial institutions respondents, the mainfactors that causes creation of non-performing  mortgage loans is  high mortgage  rateswhich most respondents agreed with at rate of 94 %.The mortgage market has been slowed down by the high interest rate. Interest rate is amount of money charged by lenders for use of their money.Although the Central Bank has reducing it base lending rate, the financial institutions were still charging higher interest rate. They did not responds to the action of CBK to lower their lending rates sighting various reasons such as lower intake of mortgage loans. As most financial institutions does not offer fixed rates thus as economy performance keep flactuating hence the mortgage interest rate affecting those already having mortgage loans.

Higher mortgage  rates as factor causing creation of non-performing mortgage loans was followed closely by  loss of income  where 63 % of respondents agreed. Loss of income

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came as result of death of the borrower,loss of the employment or poor performance of the bussiness if the borrower was self employed due to various reasons such general decline in economy or poor management of the bussiness.

General economic decline ranked third whereby 56% of the respondents indicate it as one of the factor causing creation of non-performing mortgage loans in their portofolios.Performance of country economy is influenced by several variables includingmacroeconomic and microeconomics factors and others international factors such as world prices of crude oil.Therefore according to most respondent the institutions have no control of this factor although it major one in causing of creation of non-performing mortgage loans. They call for adoption by government of economy policy which boost or stimulate growth and of national economy and adhering to sound micro and macro economic policy.

Poor credit assessment by lenders was the fourth factors rated with 50 % by the respondents. Credit assementcreterias help in identifying the potential borrowers who are capable of repayment of amount borrowed together with interest. Thus financial institutions are supposed to put in place improved credits assessment mechanisms which must adhered to regardless of the status of the client.

Outdated and restrictives legislations and policies was fithy rated at 25%. Restrictives legislations and policies do not only hinder the growth of the mortgage sector but it also weaken the sector byreducing mortgage intake. Such restrictives legislations include refusal to accept other items like shares certificates, log books etc as corallatel excepts title deed.

Sixth factor rated at 13 % is deliberate refusal to pay loans. A borrower may delibrately refuse to repay the mortgage loans due to several reasons inorder to attract attention of the management as a way of forcing the management to respond to his/her grivances.And lastly at 6% is high default and late payment charges and penalty by banks. These are penalties and charges levied on those paying after the agreed date.

Table 4.2 Factors causing non performing mortgage loans

| Factors | Frequency (f) | Percentage (%) |
|---|---|---|
| High interest rate | 15 | 93.75 |
| Loss of income | 10 | 62.5 |
| General economic decline | 9 | 56.25 |
| Poor credit assessment by lenders | 8 | 50 |
| Restrictive and outdated laws and policies | 4 | 25 |
| Deliberate refusal to pay loans | 2 | 12.5 |
| High default and late payment charges and penalty by banks | 1 | 6.25 |

Source:Field survey

### 4.2.3 Proposed ways to addressed the challenges identified

The respondents in the research study were also asked to give ways of addressing identified factors causing creation of non- performing mortgage loans in their portfolios. They give open view on various ways that would improve on reduction of non-performing mortgage loans. These are summarized as follows:-

a) Fixed mortgage rate

b) Restructure/reschedule of the loan

c) Improvement of national economy

d) Improvement of credit assessment creteria

e) Establishment of Secondary mortgage institution

f) Strengthing of mortgage  institutions

g) Broaden customer base

h) Public Private Partnership (PPP)

i) Review of Land Act 2012

# CHAPTER FIVE: CONCLUSION AND RECOMMENDATION

## 5.1 Introduction

This research study hoped to achieve the objectives of identifying the characteristics of non-performing mortgage and factors causing creation of non-performing mortgage loans in Kenya financial institutions. From the analysis of the research findings this objective

have been achieved. This chapter will attempts to draw conclusions, summary of findings and finally puts forward policy recommendations that can be adopted to guidesthe Kenya financial institutions in improvement to reducelevel of non- performing mortgage loans in Kenya.

## 5.2 Conclusion

### 5.2.1Characteristics of Non -Performance MortgageLoans in Kenya

Form the foregoing discusion,it can be clearly understood that the following are the main features of the mortgage loans in Kenya;

- The rate of mortgage uptake estimated at around 20,000 mortgages in the market is normally low againstapopulation of 40 million. Low mortgage uptake centres on affordability and eligibility. This means that potential home buyers have given the mortgage loans a wide berth, preferring instead to rent or buy in cash. This is pushing sales down while rents are on an upward trend, with less than 20% of urban dwellers living in their own homes.

- Mortgage loans are offered on variable interest rates basis. As much as 81.3% of mortgages are on variable interest rates, which have scared off home buyers. Fixed rates at 6.2 % are hard to come by, with the best being partially fixed at 12.5 % For example KCB offers a five year fixed mortgage-rates loans after which the rates are reviewed. And there is no guarantee that the interest will not go up since it is pegged on the rates at the end of the period.

- The interest rate charged on mortgage loans on average was 18 percent and ranged in between 11 % to 25 %. The continuing high mortgage cost is putting a

profound brake on home ownership in Kenya and even affecting the uptake of properties for rental.Urgent attentions needs to be given to the increasing the accessibility and eligibility of mortgages in order to make any headways in increasing home ownership to a wider band of Kenyans.

- Mortgage market in Kenya is dominated by one mortgage company, Housing Finance Company of Kenya (HFCK) and the main commercial banks in Kenya through mortgage subsidiaries licensed by CBK like S & L of KCB and Rafiki of Chase Bank. And this presents its unique problems meaning that the short-term deposits that the banks use to lend for long-term mortgages mean they can only be offered on variable rates. Banks have also been the most reluctant to respond to CBK's rate cuts.

  The average mortgage loans size average from Ksh 5 million to 7 million.

### 5.2.2 Factor causing creation of non performance mortgage loans

The factors causing creation of non-performing mortgage loans in finance instutitions portfolios from analysis and discussion of the research study include the following:-

1. High mortgage rates

Most of the mortgage financial instutitions in Kenya offer variables morgage rates,which change with the rate of inflation or the state of the economy. A few,however,offer up to five years part fixed mortgage rates.This means the interest rates do not change for the first five years of the loan,after which they revert to variable terms for the remaining life of the mortgage.Because of unpredicable economic environment,that is often prone to

inflationary pressures.Banks in Kenya generally offer mortgage loans on variable terms,which allow them to adjust the rates upwards when the economy become volatile. Whereas such flexibility may have worked for lenders,borrowers however are disadvantaged by the action.

The tendency for financial institutions to grant mortgage loans on variable interest rate basis may have contributed to slow growth in residential mortgage market in Kenya. Although volatile interest rates makes it difficult for most banks to have fixed interest rates,financial institutions exploiting borrowers by keeping their rate high as 18 per cent whereas the prevailing CBK base lending rate has been reduced to 8.5 per cent.

2. Loss of income

The loss of income arises as the borrowers sources of income is affected whether through death, loss of employment through sacking or due to poor performance of bussiness has a result of general decline of economy.

3. General economic decline

Economic decline result in reduction in economics activities leading in contraction of bussiness including demand of rental services thus decline of rent.Reduction in rent result in decline in income hence difficulties in mortgages repayment causing increase in non-performing mortgage loans.

4. Poor credit assessment by lenders

Poor credit assessment by lenders result in lending to borrowers who are not credit worthy, either by being granted amount beyond his income or using a collateral which is of less value than the amount granted.

5. Deliberate refusal to pay loans

A borrower my deliberately refuse to pay loans to seek attentions from management for a certain grivance concerning the institution.This mostly occur if the borrower does not highly valued the property or the corallatel used is less of value than the amount borrowed.And this as result of weak or poor credit assessment by lenders.

6. Weak housing finance institutions

In many developing countries, where Kenya is one of them, the financial sector is not appropriately developed; institutions are weak or do not exist; laws and regulations are either ill-designed or simply do not exist, and the macro-economic context is not conducive for long-term investments. This affects housing affordability of households who otherwise would be able to borrow and especially excludes those with low incomes

7. Lack of long term housing finance

Funding of mortgage is done primary through bank deposits, making the industry vulnerable to shifts in short-term market liquidity. Lack of sources of long term housing finances is a serious hinderances to long term lending.

8. High default and late payment charges and penalty by banks

These are penalty and charges levied on defaulters by mortgage institutions which increases the payable amount of mortgages.As the amount continous increasing, it became difficult for the borrower to services the mortgage and finally leading to a sitution whereby the amounts demanded is higher than the current value of the collateral or the asset itself.

## 5.3 Summary of Findings

From the foregoing data analysis and discussion of the various responses gathered from the questionnaireand based on literature review the following are summary of the study findings. On Kenya the following are observed characteristics of Mortage loans:

1. Size of mortgage loans depend on value of borrowers collateral

2. Repayment period depend on size of mortgage loans

3. Near all  Mortgage institutions charge adjustable/variable mortgage interest rates

4. They are no common group (by loan size) mortgage loans defaulters. But borrowers with low income have higher rates of default. This is explained by their risk of facing unemployment and being unable to pay. Additionally, in equilibrium, banks charge higher interest rates to riskier clients.

5. All mortgage institutions have put in place credit assessment mechanism

6. All mortgage institutions restructure/reschedule mortgage loans when borrowers start having difficulty in loans serving

On factors causing creation of non-performing loans review of literature and responses of the respondents indicated that the primary determinants of NPMLs are macroeconomic variables namely interest rate, unemployment and GDP.  There is relationship between

the macroeconomic environment and loans quality. During the expansion phase of the economy is characterized by a relatively low number of NPMLs, as both consumers and firms face a sufficient stream of income and revenues to service their debts. However as the booming period continues, credit is extended to lower quality debtors and subsequently, when the recession phase sets in, NPMLs increase.

The interest rate affects the difficulty in servicing debt, in the case of floating rate mortgage loans. This implies that the effect of the interest rate should be positive, and as a result the increasing debts burden caused from arising interest rate payments should lead to a higher numbers of NPMLs.

An increase in the employment rate should influence negatively the cash flow streams of households and increase the debt burden. With regards to firms, increases in unemployment may signal a decrease production as the consequence of a drop in effective demand. This may lead to a decrease in revenues and fragile debts condition.

Macroeconomic factors which are viewed as exogenous forces influencing the mortgage loans industry are not only the factor determinants of NPMLs. On the contrary, the distinctive features of the banking sector and the policy choices of each particular bank with respect to their efforts for maximum efficiency and improvements in their risk management are expected to exert a decisive influence on the evolution of NPMLs.

## 5.4 Recommendations

The third objecive was to propose ways to address the identified factors causing creation of non-performing mortgage loans in Kenya financial instutitions. The following are recommedations to address the identifiedfactors:

1. Blend of fixed and variable mortgage rates

   The rates would be ideal for a fledgling mortgage market like Kenya's. According to the World Bank, the choice of whether to levy fixed rate or variable rate interest in a given market largely depends on the inflationary environment, both the level and the volatility of prices and interest rates.

   For the mainstream mortgage lenders, the cost of funds remains the greatest hurdle to providing cheaper rates. The cost of funds is dependent on government policy and borrowing. A huge borrowing appetite by the state means high borrowing rates even for the lenders. Mortgage rates are determined by the government. For example if the rate for 10-years government bond is 14 per cent, then the cost of funds for mortgage sector will be just as high.

2. Restructuring of Non-performing mortgage loans

   Since the market environment sometime can be unfavorable to foreclosure, both borrower and lender can suffer considerable loss in a foreclosure. It is therefore in the interest of the lender to restructure the mortgage to a level the borrower can afford to pay, and the mortgage is transformed into a performing mortgage, instead of foreclosing on the mortgage.

3. Improvement of national economy

   Improvement of national economy will increase incoming generating activities and then enhance livelihood earning strategies. Decline in general economic activities lead to lose in employment and hence loss of income. Loss in income led to difficult in repayment of mortgages and finally defaulting causing increase in non-performing loans.

For mortgage sector to function effectively there is needs for more economic and political stability. On stability in the macro-economic the government must act to stabilize factors such as exchange rates, lending rates and inflation that cause economic turbulence.

4. Provision of long term housing finances

Because of its price and longevity as an asset, housing requires longterm finance from capital markets, loans with long maturity. Availability of longterm housing is a serious problem in most developing countries. Many lending institutions are caught in the 'borrowing short and lending long' fix, making housing finance less attractive than other forms of lending. Interest rate regime should encourage long term savings and lending while inflation should be tamed by the central bank to create an enabling environment for operation of mortgage market finance through the capital market. Market should be allowed to determine fair rate for funding and investing in the mortgage market.

5. Establishment of secondary mortgage market

The secondary mortgage is the function of financing and, subsequently, selling the originated mortgage to institutional investors. This activity includes the warehousing of the mortgage between the time the mortgage is closed and subsequently sold to an investor. It is arguably the most critical function in the secondary mortgage.

A properly structured secondary mortgage can provide significant benefits to a housing finance system, and ultimately to the entire economy. The primary benefit is an increase in the availability of funds for housing. A secondary

mortgage can overcome a geographic mismatch between the suppliers and demanders of funds in the absence of nationwide banking or of an efficient payment system. By expanding the pool of funding options available to primary mortgage lenders, there is less pressure on governments to provide direct and often subsidized credit to homebuyers. Finally, an active secondary market enhances the marketability of securities, reducing the risk of investment and ultimately, the mortgage rates. Not only will improved marketability lower the relative costs of mortgage securities, it can also be a catalyst for the development of the overall bond market.

6. Strengthening of housing finance institutions

There is a need to strengthen the housing finance sector in country by review of restrictive and outdated housing finance legislations and policy. There is also need to streamline the sector framework.

7. Improvement on credit assessment by lenders

Poor credit assessment by lenders result in lending to borrowers who are not credits worthy.This happen either by being granted amount beyond their income or using collaterals whichare of less value than the amount granted. And this mostly happen through aides of lenders staff (corruption) and politically connected clients in case of public owned institutions.

Therefore there is a need of improvement of credit rating/assessment by lenders through engaging of personnel's of higherintegrity and morals. A part from high moral the lenders must put in place high penalties for personnel implicated with corroding with customers to defraud the mortgage institutions.

Financial institutions should also develop programmes to share information of borrowers to avoid the perennial defaulters from other institutions.

8. Public Private Partnerships (PPP)

Partnership is the most suitable investment vehicle to raise capital for investment in non-performing mortgages; domestic taxable investors will benefit the most from investments in such mortgages. Accordingly,the proposedstructure involves establishing a partnership managed by the general partner or a management company.

9. Broaden mortgage clients base

Uptake of mortgage loans in country is low because of neglecting non-formal workers who could potentially boost the aggregate loan portfolio. Large numbers of Kenyans are in the self-employed category as opposed to the small number in formal employment. The standard requirement for proof of regular income eliminates most whose income may be irregular.

## 5.4 Areas of further study

The area of non- performing mortgage loans is vast and very little research has been done especially in the Kenyan context.One area for research would be the factors determining the creation of non-performing mortgage loans in perspective to borrowers.

Another area is the effects of non-performing mortgage loans in provision of housing finance especially low income housing in Kenya.

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# APPENDICIES

## 7.1 Letter for Permission for Research

**UNIVERSITY OF NAIROBI**

**DEPARTMENT OF REAL ESTATE AND CONSTRUCTION MANAGEMENT**

P.O. Box 30197, 00100 Nairobi, KENYA, **Tel: No. +254-2-2724529**
**E-mail:** *dept-recm@uonbi.ac.ke*

28 February 2013

Ref: B42/82059/2012

## 7.2 Questionnaires

UNIVERSITY OF NAIROBI

DEPARTMENT OF REAL ESTATE

POST GRADUATE DIPLOMA IN HOUSING ADMINISTRATION

**QUESTIONNAIRE TO MORTGAGE FINANCE INSTITUTIONS**

Introduction

Housing Financing is mainly by way of mortgage, which often use the property as the security for the loan. In the recent past the numbers of mortgage loans that are non-performing have been on the increase. The purpose of this study is to identify the main causes of non-performaning loans from the perspective of lenders and as well as measures taken by mortgage institutions to reduce the level and guard against repeated occurrence.The study is for academic purpose only and data or information shall be treated in confidence

**SECTION A: CHARACTERISTICS OF MORTGAGE LOAN**

1. Name of the institution………………………………………………

2. What is your current distribution of mortgage loans by size?

| Loan Size | Frequency |
|-----------|-----------|
| Up to Ksh 1,000,000 | |
| Ksh1,000,001 to Ksh 3,000,000 | |
| Ksh 3,000,001 to Ksh 5,000,000 | |
| Ksh 5,000,001 to Ksh 7,000,000 | |
| Ksh 7,000,001 to Ksh 9,000,000 | |
| Ksh 10,000,001 and above | |

3. Loan repayment period in years?

| Years | Frequency |
|---|---|
| 1-2 | |
| 3-5 | |
| 6-10 | |
| 11-15 | |
| 16 -20 | |
| 21 and above | |

4. Of the total mortgage loans advanced, what proportion (%) of these were non-performing in the following year?

| Year | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Total Mortgage | | | | | | |
| NPML | | | | | | |

5. Which group of borrows are persistent defaults?

| Loan Size | Frequency |
|---|---|
| | |

| | |
|---|---|
| Up to Ksh 1,000,000 | |
| Ksh1,000,001 to Ksh 3,000,000 | |
| Ksh3,000,001 to Ksh 5,000,000 | |
| Ksh 5,000,001 toKsh7,000,000 | |
| Ksh 7,000,001 to Ksh 9,000,000 | |
| Ksh 10,000,001 and above | |

6. Type of mortgage interest rate offered?

      i. Fixed……

     ii. Variable…..

    iii. Blended of fixed and variable rate…..

7. Current interest rate? ……………………….

8. a) Do you have a lower rate of interest for borrowers with a special mortgage?

- Yes ….,

- No…….

b) If yes, what is the average rate of interest?……………………………………

c) Are there mortgage difficulties in this category?

- Yes……,

- No………..

9. Do you have a credit assessment mechanism of ascertaining a borrower's ability and willingness to repay a loan?

- Yes….,

- No……

10. If yes, what are criteria's used?....................................................................................

11. Does your organization restructure/ reschedule mortgage loans when borrowers are facing difficulties?

- Yes…,
- No…….

12. If yes, why was the rescheduling of loan repayment necessary?

    i.    Difficulties in loan repayment

    ii.    To increase repayment period

    iii.    To decrease repayment period

    iv.    Others (specify)


## SECTION B:FACTORS CAUSING CREATION OF NON PERFORMING MORTGAGE LOANS

13. In your opinion what are the factors that causes creation of non performing mortgage loans in your portfolio?......................................................................................................

........................................................................................................................................

........................................................................................................................................

........................................................................................................................

14. What do you think would solve the problem of non-performing mortgage loans in order to support mortgage market in Kenya?....................................................................................

..................................................................................................

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..................................................................................................

# 7.3 A list of Financial Institutions in Kenya

Appendix XII

RESIDENTIAL MORTGAGES MARKET DEVELOPMENT – SURVEY DECEMBER 2012

| | Institution | Dec-11 | | | | Dec-12 | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | Mortgage Outstanding (Ksh. M) | No. of Mortgages Accounts | Value of NPLs Mortgage (Ksh. M) | No. of Mortgages NPLs Accounts | Mortgage Outstanding (Ksh. M) | No. of Mortgages Accounts | Value of NPLs Mortgage (Ksh. M) | No. of Mortgages NPLs Accounts |
| 1 | Kenya Commercial Bank Ltd | 18,105 | 4,073 | 1,024 | 204 | 31,455 | 5,091 | 2,218 | 282 |
| 2 | Housing Finance Company Ltd | 25,777 | 4,932 | 1,579 | 310 | 30,293 | 5,235 | 2,331 | 396 |
| 3 | Standard Chartered Bank Ltd | 7,753 | 1,251 | 119 | 32 | 9,723 | 1,480 | 162 | 30 |
| 4 | CFC Stanbic Ltd | 8,807 | 1,210 | 83 | 9 | 9,488 | 1,340 | 190 | 24 |
| 5 | Cooperative Bank of Kenya Ltd | 2,166 | 289 | 42 | 1 | 6,643 | 398 | 312 | 33 |
| 6 | Barclays Bank Ltd | 4,372 | 939 | 22 | 14 | 4,341 | 1,021 | 19 | 6 |
| 7 | National Bank of Kenya Ltd | 3,100 | 154 | 81 | 18 | 4,123 | 221 | 572 | 15 |
| 8 | Consolidated Bank Ltd | 2,764 | 302 | 69 | 4 | 3,848 | 566 | 286 | 28 |
| 9 | Equity Bank Ltd | 3,387 | 682 | 24 | 6 | 3,684 | 702 | 35 | 10 |
| 10 | Commercial Bank of Africa Ltd | 2,769 | 452 | 87 | 11 | 3,194 | 516 | 153 | 21 |
| 11 | Development Bank Ltd | 2,273 | 276 | 69 | 9 | 2,617 | 579 | 147 | 45 |
| 12 | I&M Bank Ltd | 1,546 | 171 | - | - | 2,309 | 293 | 26 | 4 |
| 13 | Chase Bank | 777 | 169 | 8 | 29 | 1,531 | 163 | 28 | 17 |
| 14 | African Banking Corporation Ltd | 1,237 | 100 | 7 | 1 | 1,506 | 103 | 37 | 10 |
| 15 | Bank of Africa Ltd | 482 | 39 | - | - | 1,212 | 143 | 5 | 1 |
| 16 | Family Bank Ltd | 330 | 87 | 1 | 1 | 1,193 | 214 | 7 | 3 |
| 17 | Eco-bank Ltd | 2,269 | 391 | 359 | 39 | 1,136 | 302 | 183 | 30 |
| 18 | Gulf African Bank Ltd | 590 | 95 | 2 | 1 | 1,069 | 145 | 3 | 1 |
| 19 | NIC Bank Ltd | 248 | 37 | - | - | 715 | 133 | - | - |
| 20 | Bank of Baroda Ltd | 434 | 52 | 7 | 4 | 434 | 127 | 2 | 4 |
| 21 | Diamond Trust Bank of Kenya Ltd | 300 | 35 | - | - | 423 | 50 | - | - |
| 22 | Prime Bank Ltd | 262 | 22 | - | - | 350 | 31 | - | - |
| 23 | Fidelity Bank Ltd | 315 | 34 | - | - | 261 | 28 | 115 | 1 |
| 24 | Jamii Bora Bank Ltd | 66 | 158 | 28 | 70 | 218 | 184 | 7 | 6 |
| 25 | Transnational Bank Ltd | 71 | 17 | - | - | 192 | 49 | 25 | 2 |
| 26 | Bank of India | 99 | 37 | - | - | 101 | 38 | - | - |
| 27 | Victoria Commercial Bank Ltd | 66 | 8 | - | - | 63 | 7 | - | - |
| 28 | Habib Bank Ltd | 17 | 12 | - | - | 18 | 11 | - | - |
| 29 | Oriental Commercial Bank Ltd | 21 | 5 | - | - | 17 | 5 | - | - |
| 30 | Dubai Bank Ltd | - | - | - | - | 3 | 2 | - | - |
| 31 | Imperial Bank Ltd | - | - | - | - | - | - | - | - |
| 32 | K-Rep Bank Ltd | - | - | - | - | - | - | - | - |
| 33 | Giro Comercial Bank Ltd | - | - | - | - | - | - | - | - |
| 34 | Equatorial Commercial Bank Ltd | - | - | - | - | - | - | - | - |
| 35 | First Community Bank Ltd | - | - | - | - | - | - | - | - |
| 36 | Middle East Bank Ltd | - | - | - | - | - | - | - | - |
| 37 | UBA Bank of Kenya Ltd | - | - | - | - | - | - | - | - |
| 38 | Charterhouse Bank Ltd | - | - | - | - | - | - | - | - |
| 39 | Credit Bank Ltd | - | - | - | - | - | - | - | - |
| 40 | Fina Bank Ltd | - | - | - | - | - | - | - | - |
| 41 | Guardian Bank Ltd | - | - | - | - | - | - | - | - |
| 42 | Habib A.G. Zurich | - | - | - | - | - | - | - | - |
| 43 | Paramount Universal Bank Ltd | - | - | - | - | - | - | - | - |
| 44 | Citibank N.A. | - | - | - | - | - | - | - | - |
| | Total | 90,401 | 16,029 | 3,612 | 764 | 122,160 | 19,177 | 6,862 | 969 |

Source: Commercial Banks

## 7.4 Study Sample (List of financial Institutions offering Mortage)

|    | Institutions |
|----|--------------|
| 1  | Kenya Commercial Bank |
| 2  | Housing Finance Company Ltd |
| 3  | Standard Chartered Bank Ltd |
| 4  | CFC Stanbic Ltd |
| 5  | Cooperative Bank of Kenya Ltd |
| 6  | Barclays Bank Ltd |
| 7  | National Bank of Kenya Ltd |
| 8  | Consolidated Bank Ltd |
| 9  | Equity Bank Ltd |
| 10 | Commercial Bank of Africa Ltd |
| 11 | Development Bank Ltd |
| 12 | I & M Bank Ltd |
| 13 | Chase Bank Ltd |
| 14 | African Bank Corporation |
| 15 | Bank of Africa Ltd |
| 16 | Family Bank Ltd |
| 17 | Eco-bank Ltd |
| 18 | Gulf African Bank Ltd |
| 19 | NIC Bank Ltd |
| 20 | Bank of Borada Ltd |
| 21 | Diamond Trust Banks of Kenya Ltd |
| 22 | Prime Bank Ltd |
| 23 | Fidelity Bank Ltd |
| 24 | Jamii Bora Bank Ltd |
| 25 | Transnational Bank Ltd |
| 26 | Bank of India |
| 27 | Victoria Commercial Bank Ltd |
| 28 | Habib Bank Ltd |
| 29 | Oriental Commercial Bank Ltd |
| 30 | Dubai Bank Ltd |

Source: Field Study

## 7.5 A list of Respondents and their Responses Rate

| S/N | Institutions |
|-----|--------------|
| 1 | Kenya Commercial Bank |
| 2 | Housing Finance Company Ltd |
| 3 | Standard Chartered Bank Ltd |
| 4 | CFC Stanbic Ltd |
| 5 | Barclays Bank Ltd |
| 6 | National Bank of Kenya Ltd |
| 7 | Equity Bank Ltd |
| 8 | I & M Bank Ltd |
| 9 | Chase Bank Ltd |
| 10 | Commercial Bank of Africa Ltd |
| 11 | Family Bank Ltd |
| 12 | Eco-bank Ltd |
| 13 | NIC Bank Ltd |
| 14 | Fidelity Bank Ltd |
| 15 | Jamii Bora Bank Ltd |
| 16 | Transnational Bank Ltd |
| | **16/30 *100=53%** |

Source: Field Study