UNDERSTANDING THE AFRICAN

HOUSING FINANCE MARKET

ALCB FUND

African Local Currency Bond Fund

OVERVIEW

The market for housing in Africa is affected by the twin problems of affordability (level of income and price of the house) and access to financing. Despite the significant housing stock deficit, across a large number of countries the level of effective demand remains low; this is a direct result of the high cost of the current housing purchase options available in the market and the low percentage of the population deemed capable of affording or financing these purchases through traditional mortgage loans.

Africa has the highest urbanization growth rate and least developed housing finance model in the world. The perceived low capacity of Africa's construction industry and the absence of a strong housing finance framework have been among the main impediments to the development of the housing market; the result has been high rental costs in conjunction with inadequate housing facilities, exacerbating a widening income inequality gap.

- Whilst there has been increasing investor interest in construction in the African housing market, this has historically largely focused on higher value housing, resulting in an oversupply in this segment of the market and an increasing undersupply in the low cost affordable housing market segment.
- Challenges in housing finance markets are familiar, ranging from limited bank underwriting and balance sheet capacity; high credit risk in the affordable market segment; high inflation pushing up interest rates and restricting tenors; and inefficiencies in the transfer of property and registration of security.

Given the current economic environment and existing financing options available, a majority of households in Africa can only afford a US$7,500 house, whilst the average cost of the cheapest newly built house by a private developer across the continent is $38,600[1]. This serves to highlights the affordability gap that is prevalent across the continent and the need for solutions from both sides to bridge the gap. Inefficient housing finance solutions and the absence of long-term funding exacerbate affordability on a cash-flow basis.

This paper seeks to highlight market solutions to these challenges in the African context, and the role for the capital markets in supporting increased investment in affordable housing and home ownership. These can be characterized as:

(i) Addressing housing affordability through incremental home building loans, since most low and middle-income households still only have access to the unregulated, informal housing sector.

(ii) Addressing credit risk through collection models pioneered in microfinance; and/or security and foreclosure impediments to traditional mortgages through rent-to-own finance.

(iii) Addressing the tenor and costs of housing/mortgage finance through financial innovation, for example though securitization techniques and/or offering foreign currency loans.

Some models, such as Zambian Homeloans – an ALCB Fund investee – seek to combine all three mechanisms.

One of the key challenges is to aggregate demand (and risk) appropriately in each segment of the value chain (i.e. a strong developer pipeline can be

[1] Africa Housing Finance Year book, Centre for Affordable Housing Finance in Africa, 2017

linked to a pipeline for mortgage or home finance origination) to generate sufficient volume for participants to access the capital markets.

1. AFRICAN HOUSING FINANCING MODELS

Innovations in African housing finance mechanisms include: 1) conventional mortgage finance originated by commercial banks, mortgage banks and housing finance institutions; 2) incremental mortgage/home loans developed by smaller institutions such as Micro Finance Institutions ("MFIs"), Savings and Credit Cooperative Societies and housing co-operative networks; and 3) rent-to-own housing finance.

These models are examined in more detail below with a view to: a) structure, and implementation; b) credit quality (collections and level of defaults); c) risk management framework; and d) current and potential credibility as a basis for accessing the capital markets.

1.1. MORTGAGE FINANCE INNOVATION

1.1.1. OVERVIEW

Conventional mortgage finance is still underdeveloped in Africa with low uptake rates a result of the high domestic interest rate environment and the rigid terms attached to both qualification and repayment of the mortgages given the high risk of default and the challenges of accessing or enforcing security. The ratio of mortgage debt to GDP is c.3% compared to 70% in developed economies and only 16% of the continent's population are deemed to have the minimum required income to secure a mortgage at prevailing rates. Overall, lenders operate in a high interest rate and capital constrained environment: they are affected by a combination of a limited availability of capital allocated to them to fund their housing loan portfolios and typically lend at high interest rates to manage the perceived higher risk of both secured mortgages and unsecured housing loans.

1.1.2. LOAN PRODUCTS

Mortgage finance innovations have been catered to local challenges and constraints. Common themes include: FX mismatches; high interest rates; and land titling procedures. In markets with high volatility in FX rates such as Ghana, lenders offer mortgage products indexed to foreign currency (such as USD), which offer borrowers a lower interest rate but transfers the FX risk to them. Another advantage of foreign currency lending is that it opens the door to long-term hard currency loans from DFIs, who typically do not provider long-term local currency loans at affordable levels.

Underwriting criteria will be tighter for borrowers who earn income in local currency rather than those who earn in USD. Where possible, lenders will insist on underwriting loans only secured by

Ghana Home Loans (GHL)

Ghana Home Loans is a specialized mortgage and housing finance provider that predominantly lends in dollars. GHL's offers two key solutions: Home purchase - standard mortgage product for the purchase of an existing home, and Home equity release - a product for applicants who wish to borrow on a long-term basis using their homes as collateral. In addition to these two products, the company also offers; Land Purchase Mortgage, Home Completion & Home Construction and Buy to Let. All products have similar underlying features and can have maturity of up to 20 years.

LAPO Microfinance "My Own Home" Scheme

In Nigeria, LAPO Microfinance is at the forefront of two schemes to improve access to home finance for the informal sector. Under the "Easy Home" scheme in partnership with Lafarge, LAPO is one of three MFBs that offer 2-year unsecured loans of up to NGN 1 million (USD 2,800); construction is facilitated by technical assistance provided by Lafarge and to-date, > 30,000 individuals have benefited from the scheme. Leveraging off this success, LAPO is also the pivot in a pilot programme under the Central Bank of Nigeria's "My Own Home" Scheme which also seeks to facilitate incremental home improvement and construction. The scheme benefits from funding support from the World Bank under the Nigeria Housing Finance Programme.

land where borrowers have clear title and ownership with the potential to take defaulting clients through a foreclosure process with repossessed properties sold to recover any outstanding obligations. To further manage credit risk from borrowers, lenders limit loan sizes to borrowers according to their individual repayment capacity.

Government sponsored institutions also offer a potential avenue for mortgage growth, with varying degrees of success. In addition to subsidising the cost of funding for mortgage institutions for on-lending to borrowers, recent initiatives have led to the development of uniform underwriting standards based on loan-to-value and cost-to-income ratios: adoption of these minimum standards is intended support the de-risking of lending in the sector by promoting legal efficiency and ensuring quality collateral, adequate property title, proper registration, enforcement of legal mortgages and an efficient collection process.

In the absence of a strong legal framework for land ownership and title, pension backed mortgage loans have also evolved as potential structures provided

by domestic lenders. In Kenya, retirement funds regulations allow for assignment of pension fund assets as a guarantee for financing a home. Some banks have designed specific Pension-Backed Home Loans which allow members of selected pension schemes to use up to 60% of their existing pension to qualify for financing to meet specific mortgage costs such as the initial down-payment, processing costs and related taxes. This is making mortgages more affordable to borrowers who would otherwise not be able to meet the down-payment requirement and upfront costs related to processing a home purchase. Banks pre-qualify pension funds that meet industry standards and are mostly available to salaried employees who contribute to the pension scheme frequently.

In competitive more competitive mortgages markets, banks compete to capture market share, with increasing loan-to-value ratios (sometimes offering more than 100% to cover fees related to property transfer and taxes, and to minimize the deposit required from borrowers). For example, in Botswana, the Government provides a 20% guarantee for mortgages sourced from Botswana Building Society (BBS), allowing them to issue long-term bonds (as investors benefit from the mitigation of credit risk). In general, government entities with strong balance sheets, governance and financial performance ought to be able to access the local capital markets at affordable levels (for example, less than 150-200bps above government bonds in Botswana and Zambia).

1.2. INCREMENTAL HOME LOANS

Lenders can provide flexible housing finance for low-income earners for incremental construction or home improvement. "Incremental home loans" allow borrowers to build a home in phases, minimizing the size of the loan (relative to the house value at any point in time). The characteristics of these loans can be distinguished between shorter-term unsecured loans and longer term (secured) construction mortgages.

1.2.1. UNSECURED

Unsecured housing loans in Africa adapt the methods pioneered by microfinance institutions, including collection by payroll deduction, organisation into groups, and/or provision of borrower technical assistance.

On the one-hand, lenders such as Bayport and Letshego, offering unsecured loans of up to five years, fund house building, without this being a prescribed use of proceeds. However, other lenders find that defined purpose or "use-of-proceeds" lending offers better risk mitigation than (for example) general consumer loans. Innovative strategies have been developed to better manage risks attached to lower income borrowers without a collateral package to back the loan. These typically involve lenders integrating with a wider group of third party providers to help: 1) during the underwriting process; 2) monitor the use of proceeds; 3) ensure the right expertise in used in the construction of the home; and 4) ensure on-time collection and ensure appropriate deductions.

To manage the higher risk associated with unsecured financing, such models generally involve collection by deduction from salaries rather than legal security. This is done by securing a payroll deduction code issued by the borrower's employer, enabling the financing institution to deduct customers' monthly loan repayments from their salary at source. Lenders also utilize a "credit-plus" approach, where credit financing is accompanied by technical assistance, which can be used to assist clients in all construction aspects of their housing projects. This provides a mechanism for managing risk by facilitating optimal utilization of loan proceeds.

The rationale for providing loans unsecured is based on the challenges in land titling administration systems in Africa that make it difficult for lenders to take security over the property. To manage the risks attached to the lack of security, lenders develop disbursement models which enable borrowers to access multiple and successive housing micro loans for construction in line with the borrower's capacity to pay. Under these programs, subsequent loans are issued once previous loans are fully repaid and can be increased where there is improvement in the customer's affordability.

Lenders will also provide funds in conjunction with Construction Technical Assistance (CTA) from a technical real estate advisor who offers an expert opinion on construction related matters (materials, practices, house design etc.). These relationships can also serve to boost loan origination: as an example, in institution which provides home improvement loans has contractual relationships with hardware and construction related businesses, who they have engaged under a third-party building merchants network. The origination process is facilitated by the merchants through a web-based application platform owned by the financing institution. Once approved, funds are disbursed to the merchant for the purchase of supplies for the home improvement.

Select Financial Services

Select Financial Services is a financial services provider with operations in Kenya, Lesotho, Malawi and Swaziland. The company's competitive strength lies in the provision of incremental housing microfinance loans, which it provides to salaried individuals for both renovations and home construction on an unsecured basis. In some markets, the company also collaborates with Habitat for Humanity, who offer technical advice to clients looking to build their own homes.

1.2.2. SECURED

Affordable housing loans can also be offered as secured mortgages (charge on the home title or land title deed), acting as guarantors for enhanced security. Examples include home building mortgages or micro-mortgages. Borrowers must have a reliable and frequent source of income either through a running business or employment income. Lenders focus on the value of the asset (i.e. the house) in terms of their underwriting (e.g. surveys, valuation reports, etc.), technical assistance (house design, approved merchants/contractors, etc), and loan oversight (disbursement milestones, progress inspections, etc.). Lenders may disburse funds directly to suppliers.

To mitigate against the risks of non-completion, where the loan is secured funds can be disbursed in tranches aligned with pre-agreed stages of construction with the lender taking on a stronger project management role: (i) Laying of foundation, (ii) Wall construction, (iii) Roof completion, and (iv) installation of fixtures and fittings. By releasing the funds based on construction stages, the home value continues to rise in lieu of an increase in the mortgage size; in turn ensuring an appropriate Loan to Value (LTV) is maintained. Micro lenders can also partner with land selling companies and private developers to provide financing to buyers, which is secured by the property/land acquired. In this case, the financiers keep the ownership certificates or title deeds up until the loan deductions are complete.

1.3. RENT TO OWN

Rent-to Own (RTO) models are increasingly being adopted in African housing markets as an alternative model of financing home purchases which does not involve monthly repayment obligations. In an RTO contract, a tenant signs a lease to pay an annual rent with the option to buy the house at some point during the agreement at a predetermined purchase price. RTO contracts allow potential homebuyers to lock in a price while they use the time to build up savings and creditworthiness to purchase the home at a future predetermined date. A rental period can also involve some principal amortization/repayment, like a mortgage. Formal ownership remains with the finance provider (which can be effective in legal environments with weak enforcement of title).

In Kenya, Savings and Credit Co-operative Societies are at the forefront of championing rent-to-own schemes. In July 2017, a group of 35 savings and credit co-operative societies (saccos)

Zambian Home Loans

ZHL offers long-term (up to 21 years) secured building and renovation mortgages dispersed to clients incrementally based on pre-agreed construction milestones. The Company's customer base is typically served by micro-lenders, with loan tenors typically < 5 years. The Company serves salaried employees looking to refinance their loans at a lower rate and longer tenor, and currently focusses on areas with legally enforceable title and high rental yields. The Company is also planning to roll-out micro mortgages to lower-income borrowers to extend their property and generate rental income.

Chartwell

Chartwell Group offers rent-to-own affordable housing in South Africa on a design, build, finance and own model. The company achieves this by establishing a two-year "seasoning" period in which the tenant/borrower establishes track-record; and subsequently a 20-year period before ownership is transferred.

announced plans to setting up a rent-to-own scheme that will enable their members to purchase homes under an interest-free agreement to pay an initial deposit of 10% and pay off the balance in rental payments over a period of up to 20 years. The program is backed by; the IFC under a partial credit guarantee for the housing projects; Co-operative Bank and Shelter Afrique who are providing short-term financing to develop the units; and UN-Habitat and the Kenyan government's State department for housing and urban development.

In 2014, the Nigerian Federal Government, via the Federal Mortgage Bank, worked in partnership with private developers to establish rent-to-own schemes. The scheme required investors to make a down payment of 5% of the value of the house and pay the remaining 95% in annual rental/lease payments while living in the house, over a 10-year period. Separately there have been efforts by the private sector to develop REIT structures to issue securities backed by a pool of rental properties; the focus is to reduce the cost of funding for the vehicle to improve the pipeline of properties under development as well as reduce the overall costs for individual renters.

2. ACCESSING CAPITAL MARKETS

By allocating transparent securities to match investors' risk-return appetite, capital markets can offer businesses long-term, low cost funding at scale. Long-term investors such as pension funds have low appetite for credit risk, such that bond issuers in the housing sector must offer investors a creditworthy investment proposition to minimize

Housing Finance Products Summary

Model	Providers	Tenor	Security	Underwriting	Collection
Traditional microfinance	LAPO	Up to 2 years	None	Position in community and income generation	Group- or individual based
Commercial microlending	Select, Real People	Up to 5 years	None	Employment and monthly cash-flow	Salary deduction
Housebuilding/ micro mortgages	Zambian Homeloans	2 years+	Yes	Employment and monthly cash-flow	Standing order
Government g'teed mortgages	Botswana Building Society	5 years+	Yes		
Foreign currency mortgages	Ghana Home Loans	10 years+	Yes	Relationship between income and FX rate	Standing order
Rent-to-own housing finance	Chartwell	10 years+	Yes (effectively)	Employment and monthly cash-flow	Standing order

financing costs, ensure affordable repayment schedules, and match assets to liabilities. The various African housing finance models outlined in the previous section are designed to mitigate credit risk in some way, and so should be able to access the local currency capital markets.

Given the importance of housing as an asset class, it has also been the forum for financial innovation in the capital markets. Securitization, covered bonds and liquidity facilities are emerging in response to traditional and non-traditional housing finance models in Africa.

2.1. HOUSING MICROFINANCE

MFIs are at the forefront of developing innovative incremental housing finance models to serve low-income borrowers. They require local currency funding for short-term products (working capital for SMEs) and long-term products (individual and housing loans). Microfinance institutions are increasingly seeking to access local bond markets in Africa (as they have in other regions) to complement the funding provided by local banks and impact investors. Such institutions issue bonds on the basis of their capital adequacy and portfolio performance, although significant investor education (and sometimes third-party guarantees) is required to overcome negative perceptions of the sector.

2.2. SECURED BONDS

Issuance of secured bonds, secured by a pledge over specific assets has been limited as a means of raising funding from housing finance providers. The residual challenge to mortgage providers of perfecting security with underlying borrowers translates into complications with raising finance secured against a general portfolio of assets. Potential investors are exposed to the overall business, a ratings assessment becomes critical and challenges in the quality of documentation for perfection of security can become an issue. Issuers have had more success raising finance through structured vehicles, where investors are exposed to a pool of assets with specific characteristics.

2.3. COVERED BONDS

A covered bond structure allows lenders to directly access capital markets for longer term fixed instruments and are an alternative to securitisation structures described below. To minimise credit risk and access long-term funding at the required cost, bondholders benefit from security over a collateral pool of loans that are "cherry picked" and pre-selected on the basis of strict underwriting standards. The bonds are further supported by covenants (asset cover, interest cover) and credit enhancements (substitution of mortgages within the collateral pool) to better manage the overall level of risk. Covered bond issuers will typically assess the quality of underlying mortgages on a regular basis, and underperformance can trigger a process to replace non-performing mortgages with performing loans. Credit enhancements can also include: over-collateralisation; equity contribution from the Sponsor, all with a view to de-risking the pool of mortgages to attract institutional investors. The mortgage financing institution that receives funding from the wholesale financing vehicle also acts as loan administrator, acting in the interest of note holders to monitor the security pool, cash payments and recovery process; they could be required to have a minimum servicer quality rating. By utilizing covered bonds, wholesale funding institutions can make long-term funding available to mortgage lenders, to improve affordability and allow mortgage providers to grow the market.

2.4. WHOLESALE FUNDING VEHICLES

Wholesale funding vehicles provide mortgage finance companies with a source of funding or liquidity to enable the origination and expansion of products, or reduce funding-asset maturity mismatch. Examples of wholesale funding vehicles include: 1) short-term mortgage liquidity facilities;

2) covered bonds; and 3) mortgage refinancing companies.

2.4.1. MORTGAGE LIQUIDITY FACILITIES

A Mortgage Liquidity Facility (MLF) is a financial institution designed to support lending activities by a Primary Mortgage Lenders (PML). The core function of a MLF is to act as an intermediary between PMLs and the capital markets and to provide funding at a more favourable rate and under better terms and conditions than PMLs have access to on a standalone basis. These facilities can either provide long-term funding or serve as an intermediary to support mortgage origination by providing short-term funding. The MLF model has successfully been developed in countries like Jordan (Jordan Mortgage Refinancing Company), Malaysia (Cagamas Berhad), and France (Caisse de Refinancement de l'Habitat). In Africa MLFs are currently under development, with Nigeria set to launch its first funding vehicle in early-2018.

MLFs can provide short-term liquidity to mortgage banks to support their loan origination activities: funding is typically provided to pre-finance a pool of eligible mortgages from a number of participating institutions. The liquidity vehicle effectively purchases the right to the future cash flows of the mortgages originated by beneficiary mortgage banks for a designated period. The structure reduces risk and potential cost of funding by; 1) pooling risk across a number of institutions; 2) pre-vetting mortgages and imposing standards to ensure that loans are of a certain quality and at minimal risk of non-performance; 3) providing credit enhancements (over-collateralisation, the ability to substitute non-performing mortgages and recourse to the underlying participating banks). The credit enhancements and additional levels of investor protection allow these standalone vehicles to have the necessary credit quality to access funding from Pension Funds, Insurance Companies and other capital market participants.

In receiving this short-term liquidity, mortgage banks can increase the number of mortgage originations, establish a track record of performance in their mortgage books, and establish a basis for access to long-term financing. Whilst short-term capital facilities like a Commercial Paper (CP) would enable the liquidity vehicle to meet the mortgage banks' demand for funding to originate loans, these vehicles would typically work in partnership with refinancing entities to enable them to provide longer term facilities backed by (see section 2.3.3).

2.4.2. MORTGAGE REFINANCING

Multiple housing initiatives have been launched across Africa to support the development and improve access to mortgage loans across all income bands. Examples include the Nigerian Mortgage Refinance Company (NMRC), Tanzania's Mortgage Refinancing Company (TMRC) and the Caisse Regionale de Refinancement Hypothecaire (CRRH) in the West African Economic and Monetary Union. These institutions are structured to provide the appropriate standing, credit quality and frameworks to bridge the gap between individual mortgage institutions and the capital markets and ultimately improve household access to long-term liquidity at reasonable cost. Credit enhancements available to refinancing entities are structured at both bondholder (eg. government guarantees) and portfolio level (eg. strong eligibility criteria and over-collateralisation of portfolios to be refinanced).

The main objective of mortgage refinancing entities is to: 1) encourage longer terms for loans;

Caisse Régionale de Refinancement Hypothécaire de l'UEMOA (CRRH-UEMOA)

CRRH is a specialist financing facility set up to channel long-term funding into regional mortgage markets by refinancing the mortgage portfolios of member/ shareholder banks of the West African Monetary Union. It provides valuable liquidity to multiple mid- to small-sized commercial banks providing property and housing loans across francophone West Africa. CRRH plays an important role in stimulating mortgage lending, which at this time make up less than one percent of the region's GDP. In particular, longer tenor of funding available allows member banks to provide more affordable mortgage to their clients while reducing total monthly debt service.

2) encourage more lending; 3) encourage competition; and 4) encourage better asset / liability management. The refinancing facility can be a supplement to existing deposit funding. Refinancing entities are typically sponsored or owned by lenders who will benefit from their funding and can be supported informally or formally by Government in the form of a guarantee.

Mortgage refinancing entities are structured to enable them to act as a centralised bond issuer with the ability to issue bonds quicker and at a lower rate than individual banks. In most cases, the refinancing institution establishes uniform underwriting standards for eligible mortgage loans which effectively converts mortgage loans into commodities and lowers the cost of due diligence and enables investors, rating agencies and guarantors to better quantify credit risk. The entity will then refinance mortgages (of a pre-agreed age and quality) from mortgage lenders by issuing bonds secured by a given pool of mortgages. In addition to ensuring a given quality of mortgage, structures are designed to ensure that there is sufficient credit enhancement to provide an appropriate risk level to support capital market issuances including over-collateralisation provisions and the right to substitute non-performing mortgages within the pool. Government support in the form of guarantees ensures the credit quality of loans issued by these vehicles allowing them to tap the market for funding as needed. By being highly capitalized and having a superior credit worthiness, these institutions can raise large amounts of long term funds at an affordable cost thereby reducing the cost of funds for its beneficiaries. As discussed above, they can work in conjunction with other liquidity vehicles further up the value chain as the ultimate source of long-term debt funding.

3. CONCLUSION

Across the board, the development of African housing markets has been significantly constrained. Financing providers have focussed on developing business models to manage the risks involved with lending thereby increasing the credit quality of their individual portfolios. In conjunction with this, and where individual entities have been unable to access affordable financing at long-term rates, the private sector (in conjunction with Government agency) has begun developing vehicles which pool the underlying risks and with the credit quality to raise funding and provide liquidity to mortgage originators. However, high construction costs continue to limit the development of affordable housing: in addition to making housing finance more affordable in African markets, there is a need for the sector to work collaboratively with other key stakeholders to reduce the cost of business transactions and land registration and foreclosure and facilitate improvement in quality and efficient building and construction.

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