Housing Finance in Uganda

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Foreword

This report seeks to provide a broad, high level overview of the current state of housing finance mechanisms in Uganda and to evaluate them against a benchmark of a fully functioning housing finance system. The brief has been to identify the constraints and impediments to the development of a modern system and make recommendations for a housing finance policy that will minimize the effects of these impediments and provide a comprehensive solution that will reduce government involvement, cause the private sector to increase its investment and introduce international standards of transparency and practice.

The report does not go into detail but rather concentrates on the fundamental issues.

Housing finance must be viewed within the context of a financial system and a housing market. The approach has been to regard housing finance as a financial product that should be provided by financial institutions within open financial markets. The report draws heavily on best international practice in devising the benchmark and analysing what needs to be done in Uganda.

The first two chapters set the scene by developing a framework in which housing finance in developing countries can be analysed. The next five chapters describe the present arrangements. Chapter 8 sets out the main conclusions of the report and suggests a future strategy based on the analysis. Chapter 9 specifically considers what role secondary market activity might play in Uganda.

The report is based on a study of relevant literature and a visit to Uganda during which the consultant met a number of people in the private sector and the government, all of whom were unfailingly helpful in providing information and ideas. The consultant is grateful to IFC officials and others who provided helpful comments on a draft of this report.

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A note on currencies
The Ugandan currency is the shilling. This is abbreviated in a number of different ways –Ush, Shs and Uxs in particular. The abbreviation Shs, as used in the annual report of the Bank of Uganda, is used in this report.

For the convenience of readers amounts in shillings are shown also in US dollars, converted at the September 2004 exchange rate of $1 = Shs1,700. The dollar figures have been rounded to avoid a spurious impression of accuracy.

Executive summary

Housing finance – essential features and importance
Housing finance is the mechanism by which the construction or purchase of housing by individuals is financed. There are three basic mechanisms –

1. Financing construction over time out of current income.
2. Savings.
3. A loan to be repaid out of future income, the loan being either informal, a loan from a formal banking institution but not secured by mortgage or a mortgage loan.

As countries develop, so they move away from the first and second mechanisms towards the third and within that towards mortgage loans.

The benchmark - a fully functioning housing finance system
A fully functioning housing finance system is one in which high percentage loans are available to buyers of new and existing houses over long periods at the finest margin over the cost of funds – which ranges from two percentage points in the most advanced countries to 8 – 10 percentage points in developing countries.

Such a system will exist only where most or all of these conditions are met –

- Economic and political stability.
- Physical infrastructure to support house building.
- Well-managed, well capitalised financial institutions able to access the retail deposit and capital markets.
- A sound legal framework covering land ownership and the rights and obligations of lenders and borrowers.
- Mechanisms to enable houses to be bought and sold efficiently.
- The government does not distort the market by directing lending, interest rate controls, subsidies or favouring particular types of institution, but rather accepts an enabling role.

The framework in Uganda – key points

- A stable political environment.
- A population of 24.6 million, increasing by 3.7% a year.
- A predominantly rural economy and one of the poorest countries in the world.
- Rapid economic growth and relatively low inflation.
- Short term interest rates in single figures.
- A system of land law, title registration and mortgagee rights that is more than adequate for an effective housing finance system.
- 4.5 million dwellings, 78% of which are owned. However, owner-occupation is much lower in urban areas – just 28%.
- A small and under-developed financial system. Most activity does not pass through the banking system.
- A small number of strong banks, most of which are foreign owned. However, their retail business is small and largely concentrated in urban areas.

- A limited wholesale financial market, dominated by Treasury Bills.
- The National Social Security Fund is a major financial institution with assets in excess of $200 million.

Analysis - the primary housing finance market

The government has estimated that there is a need for 377,000 new houses a year, largely to cater for the increase in the population.

There is no private sector large scale house-building. Almost all houses are built on an individual basis, most incrementally, financed by current income but over a period of many years. Remittances from abroad, savings and some short term bank and other lending provide some finance.

The formal housing finance market is tiny with just $32 million outstanding in respect of about 1,500 properties. There are two mortgage lenders -

1. The Housing Finance Company is a parastatal. At the end of 2003 it had mortgage loans outstanding of $25 million. It is a deposit taking business but half of its funds have come from the sale of government owned houses. The National Social Security Fund has now taken a stake in the company.
2. DFCU is primarily a development bank. It has recently been privatised; CDC owns a majority stake. DFCU commenced mortgage lending in 2002 and had loans outstanding of $7 million at the end of 2003.

The commercial banks are actively considering entering the mortgage market.

Mortgage lending rates are 16-19%. The spread over the average cost of funds is in the 12-15% range and the gross margin is 4 – 5%.

Uganda does not have a fully functioning housing finance system. However, it meets almost all the input tests for having such a system.

Recommendations

An appropriate housing finance strategy for Uganda should rest on two premises –

- The provision of loans to finance house construction and purchase is a banking function which should be carried out by private sector institutions as part of their mainstream business and not in a special protected mechanism.
- The role of the government is to provide the necessary legal and regulatory framework, together with the provision of infrastructure and utilities which house builders require.

Uganda already has all the necessary legislation and procedures in please, a significant contrast to most developing countries. The task therefore is to increase the volume of mortgage business, which will both bring down the cost of mortgages and stimulate large scale development.

The immediate priority is to remove the current delays at the Land Registry which are inhibiting the market. This requires increased staffing and better management within the present structure. The cost of this would be tiny and the benefits large. There is a plan for a longer term upgrading of the whole system.

The necessary increase in the volume of lending activity requires additional funding which can come from one or more of three sources –

1. The banks using some of their retail funds to finance long term mortgage loans.
2. The National Social Security Fund making long term funds available to mortgage lending institutions at an arm's length basis.
3. Long term loans by international agencies as a pump priming mechanism.

There are four further measures which should be taken –

1. The Housing Finance Company of Uganda should be sold by its current shareholders so that it becomes a private sector institution competing on equal terms with others, albeit with the advantage of being the market leader and having expertise in the market.
2. Brokers and agents should be regulated in accordance with accepted international standards. There has already been significant malpractice and the scope for this will increase as the size of the market increases unless the necessary regulatory measures are put in place.
3. The Bank of Uganda should review its regulatory requirements for mortgage lending taking into account international practice.
4. Given the wish of financial institutions to sell mortgage loans or to issue mortgage securities in the longer term, the necessary framework should be put in place through standardising lending terms and documentation and improving the standard of appraisals.

Initially, such a strategy would benefit the upper income groups in the formal economy, able to afford house purchase. Over time there should be a "trickle down" effect if mortgage rates fall as a result of increased lending and if mortgage lending encourages higher saving with formal financial institutions. The strategy would contribute significantly to a widening and deepening of the financial system, desirable in itself.

An effective housing finance market requires high quality information – on house prices, rents and the activities of lending institutions and other intermediaries. There is a dearth of such information in Uganda. The websites of parastatals and government departments are generally well out of date and have little relevant information. Annual reports are difficult if not impossible to find.

The Ministry of Housing, Works and Communications and the Bank of Uganda should between them take responsibility for undertaking research, collecting statistics and publishing relevant information.

Chapter 1

Housing finance – essential features and importance

This chapter briefly sets the scene for an analysis of a housing finance market. It defines, describes the basic forms of and analyses the importance of housing finance.

A definition of housing finance
Housing finance can be defined simply as the mechanism by which the construction or purchase of housing by individuals is financed. It is distinct from financing construction by a commercial developer, although often there is a link between this and housing finance.

Why housing finance is needed
The purchase of most goods and services is funded out of current income so financing mechanisms are not needed. Only where expenditure on an item is large in relation to income is financing needed. The purchase of cars is often financed with the help of loans. Lower income groups also borrow to purchase other consumer durables.

For housing however, a finance mechanism is needed by almost all purchasers. Housing is the most expensive item which most people ever purchase. The average price of a house is somewhere between three times and twenty times average income, typically being lower in more industrialised countries and higher in low income countries.

Clearly, only a few households can afford to pay for their housing out of current income. Also, because housing has a long life, frequently over fifty years, there is a good case for spreading the costs of purchasing or constructing it over the life of the product.

There are just three ways in which house purchase or construction can be financed by individuals –

- Using current income.
- Savings.
- A loan to be repaid out of future income.

These mechanisms, which are generally used in combination, are now considered in turn.

Current income
Where people have very low incomes or no formal income at all then it follows that they are unable to accumulate savings and also will be in no position to borrow money because they will be unable to repay it. However, such people still need housing. In every developing country, most housing is built by its occupiers, generally over a period of years. Typically, they will buy materials as they need them and as they can afford them and do all of the labour themselves. They may receive help from their family and local community in exchange for giving help to others at another time.

This incremental process is sometimes combined with informal, and to a lesser extent formal, loan finance as income levels increase from the lowest.

Savings

Most people accumulate some savings over time. Typically, and certainly in industrialised countries, these are held in monetary form but savings can also be in physical assets and even cattle. There are several rationales for saving including the "rainy day" principle, but most importantly saving is to fund large items of expenditure of which housing is the largest. There is evidence that people will be encouraged to save for the purpose of subsequent purchase or construction of a house.

Rarely will loan finance provide 100% of the cost of building or buying a house so some personal savings are essential. In a mature housing market, where people buy and sell houses a number of times during their lives, any profits from the sale of one house, which can be regarded as a form of saving, are generally ploughed into the purchase of a subsequent house. Typically therefore, people buying for the second or subsequent time put in more savings and require a lower loan than those buying or building for the first time.

Income earned abroad plays a major role in financing housing in many developing countries. People can earn much more abroad than at home and many people work abroad for a time so as to build up savings to buy or build a house at home or to help finance the housing of relatives. Earnings from abroad can also be used to finance incremental building.

The savings of other family members are also used by many people to pay for their housing. It is worth noting that in many industrialised countries parents contribute to the purchase price of housing which their children buy.

Loan finance

There are three basic types of loan finance for house purchase.

The first is informal finance, that is a loan from a relative, a local community organisation or some form of rotating credit society which typically exists in many developing countries. Such loans are generally for small amounts and for short terms. They are typically used only for incremental building to finance any "lumpy" items of work such as purchase of the plot or putting on a roof. By its very nature, little data is available about this form of finance.

One stage up from informal finance is a bank loan not secured by the property. This covers a wide range from what is almost informal finance to what is in effect mortgage finance. Where those buying or building are unable to obtain a loan secured on the property, and therefore at the most favourable rate, they may use loans from the banking system that are not secured and which therefore generally carry a higher interest rate. Such loans can be similar to informal loans, that is for relatively short periods to help finance incremental building. They are more likely to exist where mortgage security is

not available, which in most cases means because the law either does not allow loans to be secured against property or if it does that the security is meaningless in practice. In many developing countries, in particular where, on the face of it, there are no long term house purchase loans, banks may in practice fund house purchase for construction by making a short term loan not secured on the property which is then rolled over several times so that it has the characteristics of a long term loan.

In countries where a mortgage offers no security to the lender a formal bank loan may look exactly like a mortgage loan other than the security, and indeed may carry a similar rate of interest to what a mortgage loan would carry. This can happen where the lender has an alternative form of security such as a guarantee by a bank or an employer, or a guarantee by the developer of the property underwritten by insurance.

The most efficient method of financing house purchase is by a mortgage loan, that is a long term loan secured on the property. The essential feature of a mortgage loan is that if the borrower defaults the lender has the property as security and is able to recover their loan through the sale of the property, although there will be exceptional cases where the market conditions might prevent this happening. Because the security offered by mortgages is so good, the rate of interest on a loan secured by a mortgage will be lower than the rate of interest on other bank loans. The exceptional security offered by mortgages is also recognised by international regulatory standards which provide for a lower capital requirement for residential mortgage loans. In turn, this enables lenders to charge a lower rate than would otherwise be the case.

It is necessary to note one special form of loan finance for housing, that is finance provided by the developer. Developers do not want to fund those who buy the houses they build but in some cases have no choice but to do so in the absence of a proper mechanism. With developer finance the buyer pays for the dwelling over a period of perhaps seven years in regular instalments. Title does not pass until the final payment is made, exposing the buyer to considerable risk. There is no formal loan and therefore no rate of interest. However, the total amount paid is significantly more than a cash buyer would pay; an effective interest rate can be calculated by comparing the cash price with the extended purchase price and would normally be very high compared with what a reasonable mortgage rate would be.

The quality of a housing finance system

Every housing finance system includes all of the mechanisms described above, that is use of current income, savings, and three types of loan – informal loans, bank loans not secured by mortgage and mortgage loans. The distinction between the three is also very blurred, particularly in countries where extended families are the norm. For example, a house may be constructed using a combination of remittances from abroad from the children of the occupiers, a cash contribution from parents, informal loan finance, and physical help with construction by other members of the extended family.

In developing countries, it is rare for more than 5% of housing construction to be financed through the formal banking system. Incremental building financed out of

current income is the norm. As developing countries grow, so informal credit, non-mortgage bank credit and finally mortgage credit become more important.

In the most advanced countries, a typical first time buyer will expect to be able to borrow at least 80% of the purchase price of the property at the lowest loan rate available on the market, typically just two percentage points above the cost of funds.

The task for a developing country is to shift its housing finance system as far as possible towards the mortgage end of the spectrum and away from the incremental building end.

Why housing finance is important

Land ownership and mortgage finance go together and there is strong evidence that secure land tenure contributes to economic growth. Galal and Razzaz (2001) have commented –

> "The case for reforming land and real estate markets is compelling when viewed either from the poverty reduction or a broader economic development prospective. There is extensive and growing literature in support of the positive association between land distribution, poverty reduction, and economic growth. There is also extensive literature, which suggests that reforms to secure land tenure increase the productivity of land and its value. Since most of the assets owned by the poor are held informally, this finding suggests that land and real estate reform are especially beneficial to this disadvantaged group."

Galal and Razaz cite studies showing that rural poverty and landlessness go hand in hand and that there is a correlation between inequality in land ownership and economic growth. They review the literature on the effects of insecure tenure on the value of land. The studies show that residential plots with a clear title sell at a premium of between 25% and 50% over comparable plots without a clear title. Deininger (2003) confirms this –

> "A first benefit from increased tenure security that can easily be measured is the increase in land users' investment incentives. Some studies have reported a doubling of investment, and values for land with more secure tenure are reported to be between 30 and 80% higher than those for land where there is a higher probability of losing it."

Galal and Razaz go on: "The literature assessing the impact of land tenure arrangements on productivity indicates that insecure land tenure arrangements translate into lower output per unit of land, while more robust rights contribute to productivity. Again, this is manifested in urban areas where investment in housing is correlated to the sense of security of tenure as well as in rural areas which focused on increased agricultural output."

Making a housing finance system more efficient is important for any country at any stage of development. The more efficient the housing finance system the cheaper and simpler it will be for people to buy and sell houses. The lower the cost of mortgage finance in relation to the cost of funds, the more people will be able to buy and repayments on loans for all buyers will be a lower proportion of income. In turn this increases the demand for

housing. A more efficient housing finance system therefore enables people to be better housed and also stimulates the house building and supply industry.

Finally, housing finance is important because it contributes to a deepening of the financial system. In many developing countries, only a tiny proportion of the population have bank accounts, and inefficient means are used for both transactions and saving. If people see that saving with a formal financial institution will help them obtain a loan in due course they will save. This contributes to a general formalisation and monetisation of the economy with all the efficiency gains that that entails.

Chapter 2

The benchmark – a fully functioning housing finance system

This chapter sets out what a fully functioning housing finance system looks like and describes the various inputs needed to achieve that outcome. This provides a benchmark against which the Ugandan housing finance system, or any other system, can be measured.

The output test

A fully functioning housing finance system cannot be described by reference to institutions or loan instruments. These are the means to an end; an effective housing finance system can use any combination of institutions and instruments. Rather, the test for a fully functioning system must be that it meets three characteristics –

- Loans to finance house purchase of at least 70% of the value of the property are readily available on demand from a number of competing institutions for periods of at least 15 years.
- Loans are available for the purchase of secondhand as well as new properties and for the purchase of apartments as well as single family dwellings.
- The rate charged is a reasonable spread over the cost of funds. The spread covers costs of administration, bad debts and profits. The following table shows typical spreads in very round terms.

Interest rate spreads

	Banking business generally %	Mortgage business %
OECD countries	4	2
Middle income countries	7	5
Sub-Saharan Africa	13	10 - 12

The more efficient systems should be able to produce spreads well below these levels.

The effectiveness of housing finance arrangements can partially be measured by an analysis of mortgage debt/GDP ratios. However, a word of caution is necessary. Mortgage debt may not be a fair reflection of loans for house purchase. As was explained in Chapter 1, some non-mortgage loans used for house purchase can have similar characteristics, including interest rate spread, as mortgage loans. The following table shows average mortgage debt/GDP ratios.

Mortgage debt/GDP ratios

	Typical mortgage debt/GDP %
USA	90
Western Europe	45
Central Europe	7
Developing countries	2

However, it should be noted that countries in a similar stage of development have widely differing mortgage debt/GDP ratios. An EMF study (2004) shows that in Western Europe the residential mortgage debt/GDP ratio ranged from 13% in Italy to 100% in the Netherlands with the average being 45%. In the Eastern European states the range was from 5% in the Czech Republic and Poland to 8% in Latvia and Hungary.

The proportion of the value of housing construction financed by the formal housing finance system is another measure of the effectiveness of a housing finance system. This is very difficult to measure and there are no relevant international studies. However, data for the UK shows that the number of loans on new houses is around 70 – 80% of the number of new private houses built each year. Other industrialised counties show a similar level.

Input tests – macro level

A fully functioning housing finance system cannot be created independently of the political and economic state of a country. Conversely, if a country is economically and politically stable then the chances are that a reasonably effective housing finance mechanism will develop even if a number of the other input tests are not met.

Political stability is important. People investing their own money in housing need to be certain that they will not lose their investment as a result of political action which may range from a civil war to retrospective legislation and cancellation of property rights. It takes a long time for the effects of political instability to wear off in this respect. For example, in Britain for many years investment in private rented housing was depressed partly because of a fear, unjustified, that there would be retrospective legislation which would work to the detriment of landlords.

Corruption is an important feature of the extent of political stability. Corruption is a major problem in many emerging markets. Where a country has a high degree of corruption then the housing market will be particularly affected given the long term nature of housing transactions and loans to finance house purchase. If bribes have to be paid in order, for example, to secure permission to build or to buy a house or to have title registered or even to obtain a loan, then however good a system might look on paper it will not work well in practice.

Monetary stability is equally important. The purchase of a house is a long term financial transaction generally involving loan finance. If interest rates are high and volatile then it is not possible for long term loans to be made regardless of which housing instrument or

financial institution is in the market. High inflation also discourages the saving that is necessary to fund house purchase loans. As with political stability, the effects of economic instability can take a long time to wear off even if economic conditions change dramatically.

Input tests – housing

The vast majority of all housing in most countries, and certainly all developing countries, has been privately constructed with no form of government support and indeed often in the face of government discouragement. Informal housing cannot generally be financed to a significant extent by formal housing finance mechanisms. A fully functioning housing finance system can operate only within a framework that permits properties of a satisfactory standard to be constructed and sold.

Building codes are an important part of this infrastructure. People purchasing houses and lenders financing the purchase of houses need to be certain that properties have been built to a satisfactory standard and that they are not vulnerable to damage or even destruction by weather or other natural elements including, for example, earthquakes.

The State has the responsibility for ensuring the provision of some of the *physical infrastructure* such as roads, electricity and water supply. While developers can work round inefficiencies in this respect, these can greatly increase the cost of dwellings and therefore increase the affordability problem.

Good urban planning helps to provide a satisfactory environment in which the value of investment in housing will be maximised. Ideally large scale development is needed. This not only reduces unit cost significantly but also allows for community facilities such as schools, roads and open areas, and depending on the scale sometimes also services such as refuse collection and security.

Investment in housing requires the necessary legal mechanisms (covered subsequently) to be in place. Developers, whether individuals or companies, need to be certain that they have *adequate legal title* to the land on which they are investing their money or to the property they are purchasing.

In practice, most housing development in emerging markets is financed by the developer, whether a company or an individual. However, the availability of *banking finance for developers* separately of any finance required to purchase a property will facilitate an increase in construction activity.

There is also a negative test in respect of housing. It is tempting for governments to impose *social obligations on developers*, for example to provide low cost housing or to contribute to infrastructure costs. It is not unreasonable that there should be some such obligations but they need to be transparent, not imposed retrospectively and reasonable in relation to a particular project.

Input tests – the financial system
The acquisition of housing is best financed by large loans, typically three to four times the annual income of the borrower, over an extended period, typically between 15 and 25 years. Such finance can be made available only from financial institutions.

A housing finance institution can raise its funds from one of three sources –

- Deposits by individuals. People will deposit money in financial institutions only if they have confidence in the soundness of those institutions and if they receive in return a reasonable rate of interest. There is also some evidence that people will be more inclined to save money with financial institutions if they believe that they will subsequently be able to obtain a loan to finance house purchase from those institutions.
- The capital markets. It needs to be borne in mind that much of the funding in the capital markets comes originally from retail investors and is transformed into larger financial instruments through financial institutions.
- Long terms savings institutions such as pension schemes (which may be compulsory) and life insurance companies.

A fully functioning financial system, regardless of the housing finance element, requires *sound prudential regulation* by a competent regulator, generally although not always the Central Bank. That regulation must aim at ensuring that financial institutions are sound financially, able to meet their long term liabilities. If regulation is too lax financial institutions will fail causing a lack of confidence in financial institutions. If regulation is too strict banks will be prevented from expanding and will increasingly be by-passed.

Subject to the legal test described below being met, loans to finance house purchase are generally regarded as more secure than other types of loan and therefore the capital that financial institutions need to back house purchase loans is less than that needed to back other loans. This needs to be recognised by the financial regulator.

There are also some negative aspects of this test which require governments not to do things. *Governments must not engage in directive lending*, that is forcing financial institutions to lend to particular sectors or to individuals to whom they would not otherwise lend. Such directive lending is invariably done for political reasons rather than to benefit a particularly needy interest group. It distorts the market and reduces the amount of money that can be loaned in the remainder of the market.

Similarly, there should be *no artificial restrictions on interest rates* that can be charged. The effect of putting a ceiling on interest rates is to reduce the amount of lending. Financial institutions do not respond to interest rate ceilings by reducing their lending rates; rather they respond by reducing or ceasing lending completely.

Regulators and governments should not seek to stipulate loan characteristics. Ideally borrowers would like long term loans at a low fixed rate of interest that they can redeem at any time without penalty. However, such loans are prudentially sound only if the general level of interest rates is low and stable. As no country can guarantee these

conditions for the future mortgage loans must be designed accordingly. Fixed rate loans can be financed only by fixed rate funding. In all emerging markets and most developed markets there is an insufficient supply of long term fixed rate funding. A disadvantage of fixed rate loans is that borrowers become locked into to a loan at a rate that might soon be well above a market rate. If borrowers are allowed to redeem without penalty than the lender faces a significant loss. Recognising these points, most mortgage lending is either on the basis of rates fixed for a limited period – say three years – or is at a variable rate. In some countries the lender is free to vary the rate of interest as they wish, competition from other lenders preventing this power being used to exploit borrowers. Other countries require variable rate loans to be tied to a cost of funds index outside of the control of the lender. A country seeking to develop a housing finance market must allow lending institutions the greatest possible freedom in determining the characteristics of loan instruments, subject only to preventing captive borrowers from being exploited. For example, the combination of a variable rate and a significant prepayment penalty is unreasonable.

Governments may be tempted to favour particular types of institution or even to seek to restrict house purchase lending to one or a few institutions, typically with a name including the words "housing bank". While specialist housing finance institutions may well be desirable in a developing country and while it may well be reasonable for government or international agencies to provide the capital for such institutions, such support should not extend to preventing artificially other institutions from operating in the same market. In fact there has been a general move away from a special housing finance circuit served by a specialist government backed lender and a move towards regarding housing finance as a basic banking product which retail banks are best able to provide and which contributes to the deepening of retail banking facilities.

Input tests – security

What distinguishes housing finance loans from other loans is the exceptional security that is afforded. That security rests on a combination of factors –

- The loan is normally *repaid by the borrower out of his income* independently of the value of the property or indeed any rent that can be earned by letting it out.
- The loan is *secured against a physical* asset rather than, for example, a building being constructed or a business where the security is just the cash flow. In the event of the borrower defaulting on the loan the lender is able to take possession of the property and sell it so as to recover its loan. The physical asset can also be rented out to produce income to cover the cost of the loan.
- House purchasers normally have some *insurance* which helps to protect the lender, and the lender may also be able to benefit from insurance.

Where these conditions, particularly the second, are not met then although a loan may be used to finance the purchase of the house, it is not a mortgage loan that is secured on the property and accordingly will be more risky and therefore will not benefit from the low rate of interest that mortgage loans carry.

In order to provide this security the government has responsibility in two areas –

1. Establishing and maintaining a *sound system of land ownership and title registration* such that the owner of the property or the lender has the security of the property.
2. A *mortgage law* which provides that in the event of the borrower defaulting on the loan the lender is able to take possession and sell the property with vacant possession so as to recover its loan. In many countries this right does not exist or is restricted, and accordingly loans carry a higher rate of interest because the lender does not have the security of the property. It is important that this test is not only met in theory, that is by an appropriate law being in place, but also in practice, that is that the lender is able to obtain possession without incurring undue costs or having to wait an undue period. The legal system has to be able to handle possessions in an efficient way and lenders must have certainty in this respect rather than operate in the knowledge that they will not be able to obtain possession at all or the extent to which they will be able to depends on the efficiency of the court process, and in some countries the extent to which judges can be bribed.

Input tests – housing transactions

The process of purchasing a house is at best complex and even in the most advanced economies can be both costly and time consuming. The more the cost can be minimised the more efficient the market will be. Conversely, if the process is unduly expensive or time consuming then it will not be possible to establish a fully functioning housing finance system. An efficient mechanism requires –

- A *network of professional appraisers* operating according to generally accepted principles such that developers, house purchasers and lenders all have reasonable certainty as to the value of a particular property. The appraisal process is greatly facilitated if the test on building codes is met, that is appraisers do not have to go to undue lengths to satisfy themselves as to the structural soundness of the property. The appraisal process is also facilitated the larger the market and therefore the more transactions there are and also the greater the general availability of data on house values and prices. There may be scope for the government to facilitate the acquisition, analysis and sharing of such data.
- *Agents who facilitate the sale process*, who can be lawyers or appraisers or they can be an independent profession. The scope for malpractice in this market is substantial and some regulation of it is needed.
- The process of *transferring title must be efficient and relatively cheap* such as not to frustrate the house purchase process or to impose a tax on house purchase.

Insurance and guarantees

A fully functioning housing finance system is facilitated if a number of different types of insurance are in place –

- *Property insurance* to cover against damage to the property thereby helping to maintain the value of an investment in property by an individual and a lending institution.

- *Life insurance* which can pay off an outstanding house purchase loan in the event of the death of the borrower. This provides additional security both to the borrower, or rather to his family, and also to the lender.
- Specialist *credit risk insurance* such that in the event of a borrower defaulting, a property being taken into possession and sold at a loss, the lender is able to recover part or all of the loss through a pooling of risks with other lenders through a mortgage insurance programme. In a number of countries, including developed countries, the government is active in the mortgage insurance market. In a developing market government action may well be necessary to facilitate the development of mortgage insurance. Appendix 2 briefly describes mortgage insurance.

In markets where all the other security tests are not met, in particular in relation to taking possession, then guarantees can also play an important part by providing additional security. Often guarantees are made by friends or relatives or by employers and in such cases there is some moral pressure on the borrower not to default on the loan. However, guarantees as a substitute for primary security are a second best solution and serve to restrict the number of people eligible for housing loans.

Input test – transparency and fairness
This test is somewhat vaguer than other tests and also to some extent embraces points already made.

Governments in most economies, but particularly emerging markets, are inclined to use subsidies to deal with an obvious affordability problem. However, subsidies to house purchasers, particularly interest rate subsidies, cannot contribute significantly to a fully functioning housing finance system and may be counter-productive –

- Governments cannot afford to provide significant subsidies to house buyers.
- Those who purchase houses, particularly in developing countries, are among the higher income groups and there is no merit in providing subsidies from which the poor are automatically excluded.
- Subsidies in whatever form distort the market, generally in ways not anticipated by those who introduce them.
- In practice, subsidies and corruption become closely entwined. The main beneficiaries of subsidies tend to be those who support or work for the government, in particular civil servants.

Similar points apply in respect of directing financial institutions or private developers to behave in a particular way. Such directions again introduce distortions into the market which are likely to have an unfair result and given that they are generally not transparent they also introduce greater uncertainty into a market where certainty is important.

Any government support should be limited to general tax or other incentives which have the effect of encouraging large scale development and increasing affordability. However, it is important to ensure that any such incentives are not captured by the developer. If

there are any tax breaks or other incentives for individuals these should be capped at a low level.

Input test – the enabling role of government

Governments may create and support particular housing finance institutions, instruments or programmes but they do not create housing finance systems. Every country has a housing finance system, most of which operate independently of any government policy. The government's role is not to decide the best form of mortgage instrument, what type of institutions should be allowed to make loans to house buyers or the terms of those loans. But in practice this is what many governments seek to do while failing to do those things that governments must do.

The government does have a major enabling role in respect of the development of a fully functioning housing finance system and if that role is not performed then there will not be a fully functioning system. That enabling role comprises –

- Ensuring that sound arrangements are in place in respect of land ownership and title.
- Ensuring that in practice housing finance institutions that lend on the security of property are able to use that property as security should they need to.
- Establishing and implementing effective building codes.
- Providing or enabling the physical infrastructure without which housing development cannot take place.
- Regulating financial institutions to ensure that they remain sound.
- Regulating agents who facilitate the purchase and sale of houses.
- Providing some limited pump priming, for example through mortgage insurance, to stimulate to the growth of the market.

To fulfil this role is challenging even for the most competent of governments as it requires concerted action by a number of different government departments and agencies in which there are all the jealousies and politics inherent in any political system. The government's enabling role therefore includes an important leadership function with clear responsibility being given to a minister and officials to ensure that all of the necessary arrangements are in place, and as importantly that the government does not seek to meddle in and micro-manage the housing finance system.

Overview

This chapter has given a formidable list of tests that have to be met if there is to be a fully functioning housing finance system. Where the tests are not fully met then work-arounds can often ameliorate the position. For example –

- Where there are no effective building codes or the appraisal process is not well developed then a lending institution will lend a lower proportion of the value of a property.
- Where a lender is not able to realise its security then it may take additional security in the form of a guarantee from an employer or a relative.
- Where in practice it is impossible for financial institutions to make long term loans to house purchasers then developers will sell properties on a hire purchase

basis, that is the purchaser buys them over a shortish period, typically no more than seven years, with title not passing to the purchaser until the final payment is made.

- Where there are interest ceilings these can partially be overcome by charging fixed fees in addition to interest.
- Where there is no efficient land registration system or generally title to a property is not clear then title insurance can help to deal with the problem.

However, the effect of all of these work-arounds is to increase the cost of house purchase loans and reduce the number of people able to qualify for them. The example has already been given that if guarantees are required from employers, then those without employers able to give such guarantees are denied access to the market. Some of the work-arounds illustrate the counterproductive effect of regulations. For example, if banks are not able to realise their mortgage security they will be less inclined to lend and developers will instead sell directly on a hire purchase basis where the purchaser has far less security and can be vulnerable to losing his home even when he has met 90% of the payments on it. The rate of interest on such developer finance is also much higher than the rate of interest that would apply on a loan secured on property. Another illustration comes from Russia. Lenders cannot generally take possession of a borrower's principal home. Lenders get round this by making a loan to a company that owns the property with the person living in it officially having a second and principal place of residence. If the house buyer does not keep up repayments then the lender quickly has possession.

Some of the input tests are so important that no housing finance system can operate unless they are met. To a large extent others are of more peripheral importance but the key point remains that to the extent that the tests are not met then the resultant housing finance system will be further and further removed from the fully functioning system described at the beginning of this chapter.

A fully functioning housing finance system requires all the input tests to be met; the absence of just one can be sufficient to stifle the development of a system. In their analysis of reforming land and real estate markets, Galal and Razzaz (2001) come to the following important conclusion –

> "Partial reforms may not always lead to the desired outcome. In some cases, there is the possibility that the individual reform was intended to relax a constraint that was not binding in the first place (eg providing individual titles in areas with strong communal property rights). But it is also possible and even likely that reforms to secure property rights may not lead to the full benefits because mortgage finance is missing, or the prices of goods and services derived from land and real estate are distorted. In other words, instruments such as land redistribution, land registration, credit subsidies, physical upgrading, etc are each likely to be necessary but not sufficient to induce poverty reduction or growth. They are more likely to deliver positive outcomes if they are well co-ordinated as part of a reform package. This conclusion suggests the need for an integrated framework to approach land and real estate reforms."

Chapter 3

The political, demographic and economic framework

Political stability
Uganda has enjoyed a period of political stability since the National Resistance Movement came to power 17 years ago. There remain some concerns as a result of both internal and external factors. Internally, the issue is what will happen when President Museveni's term of office comes to an end in 2005. Externally, there is the threat of conflict related to unrest in the northern part of the country.

The IMF staff assessment of the poverty reduction strategy in August 2003 commented that the New Leadership Code needed to be aggressive enforced. It also commented on weaknesses in the justice system and the need to ensure predictability in court judgments.

Population
The population of Uganda in mid-2002 was 24.6 million and has been growing at an annual rate of 3.7% since 1990. 51% of the population is under the age of 15 and only 2% is over the age of 64. 86% of the population live in rural areas. The largest urban areas are Kampala (1.2 million) and Mbara (1.1 million).

Income levels and economy
Gross national income per capita in 2002 (Atlas method) was $240, low even by African standards and well below Tanzania ($290) and Kenya ($360). On this basis Uganda is one of the poorest countries in the world. However, on a purchasing power parity basis, Uganda comes out more favourably with a per capita income of $1,320 as against $990 in Kenya and $550 in Tanzania. The variation is probably largely explained by Uganda being a rural economy.

Agriculture accounts for around 31% of the economy compared with 22% for industry and 46% for services. There has been a significant shift over time from agriculture (which accounted for over 70% of GDP in the 1970s) to industry and services. Agriculture remains the main source of employment – accounting for about 80% of the labour force. Coffee accounts for 25% of exports, other agricultural products accounting for most of the remainder. Uganda has a substantial trade deficit, financed mainly by aid.

The Ugandan economy has made substantial progress in the last eight or so years after the problems of the 1990s. GDP has been growing by 6.7% a year since 1995 and the rate of inflation has fallen from 33% in 1990 to under 6% in 2003. The current rate is near zero. Similarly, interest rates have fallen with short term rates now under 8%. The exchange rate fell from Shs1,720 to the $ in 2001 to Shs2,000 in 2003 but has since recovered to Shs1,700 in September 2004. Economically, Uganda has been one of the top performing countries in Africa in the last decade.

The scale of the informal sector

As in comparable countries, the informal sector plays a major role in the economy. The position is usefully summarised in the *Global Report on Human Settlement 2003* -

> "The informal sector plays a very important role in national economies and, more importantly – in the context of this report – is the livelihood of many slum dwellers. For example, in Uganda, small-scale trade is reported to contribute 95 per cent of the urban economy. In Nigeria, it was estimated in 1993 that the informal sector adds between 20 and 30 per cent to the GDP.
>
> The informal employment sector tends to vary strongly with city development levels, ranging from about 54 per cent of all employment in Africa to 3 per cent or less in the HICs. As indicated earlier, unemployment rates tend to be rather meaningless in countries with high levels of informal employment; but unemployment also falls away with increasing development levels.
>
> In Africa, the informal sector accounts for about 20 per cent of GDP and employs about 60 per cent of the urban labour force. In sub-Saharan Africa, the informal sector accounts for 42.5 per cent of non-agricultural GDP and about 78 per cent of non-agricultural employment. It is also estimated that more than 90 per cent of additional jobs in urban areas there during the next decade will be created in micro- and small-scale enterprises in the informal sector.
>
> About 2 million people, or 16 per cent of the labour force, are employed in almost 1 million micro-enterprises and small enterprises in Kenya. Recent studies in five Sub-Saharan countries estimate that micro- and small-scale enterprises (MSEs) employ an average of 22 per cent of the adult population, compared to only 15 per cent in the formal sector. MSE employment in Kenya was over 1 million people in 1994, or one-third of all working people. They contributed roughly 13 per cent of the GDP at that time. More than three-quarters of the enterprises had only one or two workers. "
>
> Source: UN-Habitat (2004).

The World Bank publication *Doing Business* (2004) estimated that the informal economy accounted for 43% of Uganda's total economy, around the Sub-Saharan African average.

Social indicators

Life expectancy at birth is 43, on a par with comparative countries. Uganda has made significant progress in dealing with HIV/aids over the last few years. In 2001, 4.6% of females aged 15 – 24 had HIV compared with the Sub-Saharan Africa average of 9.4%. On social indicators generally Uganda performs better than the Sub-Saharan Africa average (see Appendix 3).

The property reduction programme has also had some success. The proportion of population living below the poverty line in 2002 was 38% compared with 56% in 1992. Over the same period primary school involvement increased from 38% to 86% and the adult literacy rate from 56% to 69%.

Chapter 4

Land ownership and mortgages - the legal framework

Uganda has a system of land law, title registration and mortgagee rights that is more than adequate for an effective housing finance system. The following summary of the legal position draws heavily on Mugambwa (2002).

The constitution
The 1995 constitution provides the basis for land law and tenure policy. Article 237 declares that land is vested in the citizens of Uganda to be owned in freehold, mailo, leasehold and customary tenure. Non-citizens can own only leasehold land. The constitution required legislation to be enacted with two years.

The Land Act 1998
The Land Act became law following five years of controversial debate. It provides the institutional framework for the reform of land tenure but maintaining, or reinstating, much of the traditional tenure arrangements. The Act provides for five types of tenure -

- Government land.
- Freehold
- Mailo land
- Leasehold
- Customary tenure.

Government land is that land used by the government when the constitution came into effect. The other types of tenure are now described.

Freehold tenure
This is similar to freehold tenure in other countries and gives absolute rights of ownership. There is provision for former government land and customary land to be converted to freehold. In practice, little land is held on a freehold basis.

Mailo land
Mailo land is a slight variation on freehold land. It is confined to Buganda (which covers the major urban areas including Kampala) and follows the 1900 agreement between the British government and the chiefs of Buganda. Half of the land was allocated to chiefs and other notables in perpetuity and this land has subsequently been subdivided. Individual parcels of land can be registered and certificates of title issued. The constitution and the 1995 Land Act formalised the nature of mailo land. Mugambwa comments that "mailo tenure is virtually freehold tenure".

However, there are some special features of mailo land. Owners have tended to believe that they can do anything with it including sub-division, mixed development and even development without access. This helps to explain why much of Kampala looks like an unplanned mess. It is also possible for the same piece of land to be registered more than

once. Fraud is a problem, which the Land Registry cannot easily detect. It follows that verifying title for mailo land is more complex than for freehold land and therefore costs more. The value of mailo land is slightly depressed as a consequence.

About 90% of land in Kampala is held on the mailo basis so it is in effect the main form of tenure is the largest urban area where formal mortgage lending is likely to be concentrated.

Leasehold land

The leasehold tenure is similar to that elsewhere. Any owner of freehold, mailo or customary tenure can grant a lease to another person; in the case of non-citizens this is for a maximum period of 99 years. Leases are normally granted subject to development or other conditions.

The Land Act provides for leasehold land to be converted to freehold tenure subject to certain conditions.

Customary tenure

In pre-colonial times land was held on a communal, clan or nomadic tenure and regulated by customary principles and authorities. Under the British all land except mailo land became crown land; customary tenants had no security of tenure. The Public Lands Act 1969 gave customary tenants security of tenure and the right to apply for a lease. Mugambwa (2002) summarises the nature and importance of customary tenure today –

> "With the exception of land in Buganda and urban areas, most land is owned under customary tenure. The specific tenure varies according to the ethnic group and region of the country. In some parts of the country, ownership of land is mainly communal, based on clans, with individual usufructuary rights over specific plots. But generally there is an evolutionary change towards individual ownership. The trend is more pronounced in the densely populated districts in the southern and eastern parts of the country and less so in the northern and north-eastern parts.
>
> From a legal perspective customary land tenure, mailo land, and freehold are similar in that ownership of land under all three systems is in perpetuity."

The constitution empowers all Ugandan citizens owning land under customary tenure to acquire certificates of ownership. However, the procedure for so doing is somewhat bureaucratic. The Land Act also allows owners of customary land to apply directly to convert their land to freehold.

Condominiums

Recent legislation provides a framework for condominiums, one of the intentions being to facilitate the sale of properties owned by the National Housing and Construction Corporation. The early indications are that it is proving difficult to use the framework, although largely for administrative rather than legal reasons.

Registration of titles
Uganda uses the Torrens system of land registration that was introduced by the Registration of Titles Act 1922. The Act applies automatically to mailo, freehold and leasehold land. Owners of customary land who wish to register their ownership must convert it to freehold land. The Torrens system has two essential features –

- Interests in land are created or transferred by registration not execution of documents.
- Indefeasibility of title, that is once land is registered title is guaranteed, although there are some exceptions to this general rule.

Mortgages
The Registration of Titles Act specifically provides for land to be mortgaged. Customary land can be mortgaged but as it is not registered an equitable rather than a legal mortgage is created. The Act implies covenants against the mortgagor including payment of the mortgage debt, maintenance and repair of the property and a right of the mortgagee to enter and inspect the property at any time. In addition, the Mortgage Decree 1974 implies in every mortgage a covenant against a mortgagor to preserve the value of the property.

The Mortgage Decree provides that where a mortgagor breaks any term of the mortgage agreement the mortgagee can pursue one or more of five remedies: action on the personal covenant, take possession, appoint a receiver, sale and foreclosure. Mugambwa comments that "power of sale is the most important and common remedy for realisation of security under a mortgage agreement. The right to sell may be exercised without recourse to court where such right is expressly reserved in the mortgage agreement. Otherwise, the sale must be conducted with the sanction of the Court." Mugambwa continues: -

> "Section 9 of the *Mortgage Decree* provides that if a mortgage agreement allows the mortgagee to sell the land without reference to court, the sale must be conducted by public auction unless the mortgagor and subsequent mortgagees, if any, consent to a sale by private treaty. The power of sale arises if the mortgagor defaults in payment of the mortgage debt for a continuous period of one month."

In the case of customary land the mortgagee requires a court order but otherwise the remedies are the same as for land which is registered.

Although the law does specifically provide for securitisation or the sale of mortgages there is nothing legally to prevent such activity.

The system in practice
Legally, Uganda has a system of land law and registration and mortgage law that is ideal for a mortgage finance system. There is clear ownership of land, in practice largely under the mailo system, which can be seen as analogous to freehold, and customary tenure in rural areas. Mortgagees have adequate rights to realise their security; indeed unlike in other countries it is not necessary to obtain a court order – except in the case of

customary land. However, having the right legal framework is not sufficient. It must also work in practice.

The land registration system is not ideal in practice because the Land Registry is unable to cope with demand. This delays transactions and puts parties at risk while the land or mortgage is waiting to be registered. This is a serious irritant rather than a showstopper. A World Bank analysis summarises the problems as follows –

> "The transaction costs of using land as collateral are high. The title registration system is inefficiently administered and maintained, and poor security of the physical files has provided opportunities for fraudulent and corrupt activity, compromising the integrity of the title registry. The problems with the land registry make it costly to verify the status of the land, which in turn affects the ability to sell the land and associated real estate."

However, the practical problems are partially offset by a cultural acceptance in Uganda that failure to make mortgage payments will result in the loss of the home. Mortgagors unable to meet their repayments know that they will be better served by a voluntary sale rather than allowing the property to be sold by the mortgagee and generally seek to come to an arrangement with the lender.

The World Bank has agreed to finance a longer term programme to bring the Land Registry up to modern day requirements. The project will cover –

- Rehabilitation of existing land records and upgrading of unsurveyed mailo titles.
- Establishing a land information system and expanding the coverage of land information.
- Strengthening the capacity of the relevant public institutions.

Notwithstanding the deficiencies in the present arrangements the fact remains that in general, unlike in most developing countries, the land ownership and mortgage legal framework are conducive to the development to a fully functioning mortgage market rather than a serious impediment to its creation.

Chapter 5

Housing

This chapter provides basic information on the housing situation and policy in Uganda. It draws heavily of *The Brief Status Report on the Housing Sub-Sector 1986 – 2003* (Ministry of Works, Housing and Communications, 2004).

The housing stock
There were 4.5 million dwellings in Uganda in December 2003. 78% of these were owned, 18% were rented and 4% were occupied rent-free. However, these figures mask substantial differences between the urban and rural sectors. The owner-occupation rate was over 90% in rural areas and just 28% in urban areas. In urban areas the proportion of renters increased from 14% in 1992/93 to the 2002/03 figure of 65%. This probably reflects the inability of people to finance house purchase.

The following table analyses the housing stock by type of dwelling.

Distribution of the housing stock by type of dwelling, 1999/2000 %

Type	Urban	Rural	Total
Detached/independent	34	63	58
Mizigo (informal)	56	5	13
Huts	5	31	27
Other	5	1	2
Total	100	100	100

Source: Ministry of Works, Housing and Communications (2004).

The table shows that over half of dwellings in urban areas are informal compared with just 5% in rural areas.

It is estimated that in 1991 there were 2,691,000 housing units so the stock has increased by an average of 150,000 a year. There has been a steady improvement in housing conditions since the early 1990s, illustrated in the following table.

Quality of housing 1992/93 – 2002/03

Characteristic	1992/93 %	2002/03 %
Corrugated iron roof	37	63
Brick walls	22	51
Cement floor	15	24
Electric lighting	6	9

Source: Ministry of Works, Housing and Communications (2004).

Again, these figures conceal differences between urban and rural areas. The proportions are all significantly higher in urban areas, particularly cement floors (67%) and electric lighting (40%).

Housing need
The Ministry or Works, Housing and Communications has made the following estimate of current housing conditions.

Population	25,588,000
Households	4,900,000
Estimated housing need	5,023,000
Estimated housing stock	4,501,000
Estimated backlog	522,000
Upgrading need	1,856,000

Source: Ministry of Works, Housing and Communications (2004).

Going forward to 2020 the Ministry estimates an annual need for new housing of 377,000 units, made up of –

Replacement dwellings	103,000
New demand	226,000
Backlog	31,000
Household size	17,000
Total	377,000

The major component of this forecast is the anticipated population growth. It is assumed that the population will continue to increase at 3.4% a year, to reach 45,100,000 in 2020.

Taking the minimum cost of a new dwelling at a very conservative $15,000 the annual figure of 377,000 translates into an annual financing need of $5.6 billion. This compares with the total assets of the banking system of $1.3 billion at the end of 2003 of which mortgage finance comprised just $32 million.

Infrastructure and costs of construction
While the situation is not perfect, in generally it seems that the provision of infrastructure and utilities is not a significant constraint to house building. Utility and building material prices are high, partly reflecting the relative absence of large scale development and also the costs for a landlocked country of importing some materials.

The construction process
The significant increase in the number and quality of houses since the early 1990s is reflected in statistics for building material production. Between 1986 and 1999 production of cement increased 23 fold and production of iron sheets 33 fold.

However, there is only a very small formal housing construction industry in Uganda. The improvement has largely been achieved by individuals building and improving their homes on an incremental basis. This process is common to all developing countries and is well understood. Basically it comprises –

- A person buys a plot of land, using savings, perhaps with the help of some informal loan finance from a rotating credit society or from their family. A plot of land will typically cost Shs3 – 5 million.
- The person constructs the house over time doing much of the building work himself. The speed of construction depends largely on the ability to purchase materials, which are largely financed out of income. The process typically takes 5 – 8 years and can be as long as 15 years. This explains why most African cities look like building sites and also why parts of the city centre are characterised by streets full of building supplies, some of which have been recycled.
- Occasionally, some informal, and exceptionally formal, loan finance may be used to finance particularly lumpy items of expenditure, in particular the installation of the iron roof which again can cost Shs3-5 million.

In the less formal part of the market the plot is simply occupied at zero cost but because of the lack of security of tenure the housing is likely to be very basic and with a limited life.

The private construction industry

Kampala in particular has a number of more expensive houses that have been constructed by building firms. Each property is built individually and to order. There is virtually no large-scale speculative building. There are some private developers who will assemble a site for a modest number of houses – say up to 500. However, the houses will be built only when each plot is purchased and the building contract is agreed. The process is hugely inefficient, not allowing for proper project management. The construction of individual houses depends on the speed with which payments are made. It is not possible to undertake a comprehensive development that will enhance the value of individual properties.

One of the largest such developers is Akright Projects Ltd. A private company, established in 1999, the company is developing eight estates with a total capacity of 2,337 units, targeting upper and middle income earners. The company sells serviced plots, builds to order, provides shell houses and sells a limited number of completed houses in the price range of Shs60 – 80 million ($35,000 - $47,000). The company has an arrangement with DFCU Bank for a 30 month loan to salary earners to purchase plots and it also has an arrangement with the bank for mortgages.

The company has entered into a joint venture with an American firm to build 400 affordable housing units a year between 2004 and 2008. The price range will be from Shs25m ($14,700) to Shs34m ($20,000).

The company has no difficulty in acquiring land; the major constraint on its business is the absence of long-term mortgage finance.

The National Social Security Fund formed a joint venture with a Kenyan based firm, Mugoya Estates Ltd, with the intention of building 6,500 units between Kampala and Entebbe. However, the terms of the joint venture have been challenged and led to the suspension of the Board of the Fund. It remains to be seen what will happen to this project.

There are many well constructed expensive houses in Kampala. Much new development is financed by Ugandans living outside the country. Even such building uses the incremental process. After the plot has been acquired an architect will be employed to supervise construction. The purchaser will buy the materials and employ labour-only subcontractors to do the building work. Building may well still take several years as the purchaser is able to pay for successive stages of the construction process. When the houses are completed they may well be rented out to expatriates in the short term.

As Uganda has a thriving construction industry and a huge demand for housing the absence of a large scale private housing development industry can be attributed almost entirely to the absence of finance to enable people to purchase their homes. Speculative and large scale development is not feasible in such circumstances.

The National Housing and Construction Corporation (NHCC)

The National Housing and Construction Corporation (NHCC) is a parastatal body established in 1964. Its objectives are to build and sell houses, to encourage Ugandans to own houses and to engage in related functions.

Its marketing brochure states that "the company has built over 2,300 executive flats, maisonettes and bungalows in top class residential areas at prime locations around the city of Kampala …. and middle to low income housing estates were built in several locations around the city." The company has also built a number of major office blocks.

The Company's website includes details of a number of current projects –

- Sales of plots for Shs3.85 million ($2,260).
- Sales of shell houses which have utilities up to the boundaries of the plot, external window and door frames and tarmacked roads. The purchaser completes the house with his own resources.
- The "growing house", a one bedroom dwelling ready for occupation which can be added to subsequently.
- Completed units. Prices are in the Shs42 – 100 million ($25,000-$59,000).

Purchasers typically pay a deposit of 10%, the balance being paid over 2 – 3 years.
The company is currently seeking to sell 1,565 apartments under the terms of the Condominium Property Act 2001. These properties are being sold to sitting tenants, but it is understood that take up so far is relatively modest.
The company has assets totalling $70 million and an annual turnover of around $6 million. It is the government's intention to sell 49% of its interest in the company to the private sector.

The rental market and suppressed owner-occupation in Kampala
The significance of the absence of long-term loans for house purchase is illustrated by the unusual role rental housing plays in Kampala. Between 1992/93 and 2002/03 the proportion of rented properties increased from 14% to 65% while the proportion of owned properties fell from 77% to 28%. To a large extent this reflects the inability to buy as opposed to an unwillingness. On the supply side it is understood that when an owner-occupier moves upmarket they will normally keep ownership of their original property, renting it out, rather than selling it as is normal in other countries. Again, this reflects the inability of people to purchase even when they can afford to do so. Even professional people who in most similar cities would purchase homes are often renters. This frustrated demand for home ownership is accentuated by the strong cultural preference for this form of tenure in Uganda.

The rental market in Uganda is accordingly thriving and rents are high. The NHCC website reports that rents are $150 – 200 a month for flats and $300 - $2,000 a month for bungalows. Rental yields are high – in the 8 – 11% range. There is some speculative construction and purchase for rent and many small landlords.

Planning
Planning and land zoning tend to exist more in theory than in practice. There is little capacity to enforce the law.

Building Control
Building control is similar to planning. Theoretically, this is a local authority responsibility there is no capacity to establish or enforce building codes. This is more of a problem in the commercial building sector, where there have been a significant number of accidents with fatalities, than it is for residential housing where most buildings are single storey. The absence of effective controls was amply illustrated in September 2004 when following a serious accident the local newspaper on one day included –

- An advertisement by the Architects Registration Board and the Uganda Society of Architects advising the public to seek the advice of registered and qualified architects.
- An advertisement by the Uganda Association of Consulting Engineers and the Uganda Institution of Professional Engineers announcing their intention to carry out an investigation of the accident and to propose a way forward.
- An article quoting the Uganda Builders and Clients Association saying that accidents occur because building is not supervised by the Uganda National Builders of Civil Engineering and Contracting.

The government is in the process of drafting a Building Control Bill.

Housing policy
Since the early 1990s the Government has accepted that its role in housing is one of enabling. In the words of *The Brief Status Report on The Housing Sub-Sector 1986 – 2003* its role includes: “legislative tasks, regulatory functions, spatial planning, provision of basic infrastructure, regulation of the operation of the land, housing and financial

markets to ensure efficient housing delivery system, monitoring and evaluation of policies and programmes, research in appropriate technologies and development of safety and quality standards". The document identifies the following challenges faced in the housing sector –

- Lack of capacity to plan, guide, and enforce development control as well as managing urban development.
- Inadequate mortgage and development finance.
- High cost of construction and maintenance of infrastructure.
- Low effective demand in the low income urban population.
- Weak private sector, lacking capacity to invest in housing development.
- Constraints affecting access to land, cost of land and tenure systems.
- Use of improved building materials.
- Application of appropriate construction technologies.

The following possible interventions are identified –

- Sites and services schemes in urban areas targeting middle income earners.
- A national programme for settlement planning, recognising that many local councils do not have any plans.
- Slum upgrading programmes in urban areas.
- Development of planned rural growth centres.

Chapter 6

Financial institutions and markets

Overall structure and financial depth
The IMF Financial System Stability Assessment (April 2003) commented:

> "The financial system in Uganda is small, underdeveloped, and dominated by the commercial banks. The financial sector is relatively small, with total assets equivalent to 29.5% of GDP in June 2002. It is underdeveloped, with indicators of financial depth being low in absolute tetms and relative to most African comparators. For example, broad money's share of GDP is only 13%; bank branch penetration is low at one branch per 130,000 Ugandans and most of these branches are urban based, despite the fact that 90% of the population lives in rural areas; and financial markets are embryonic. In terms of structure commercial banks dominate the financial system, accounting for over 82% of financial assets, and traditional bank deposits represent the major form of financial saving. Other financial intermediaries are limited in number, small in size and relatively ineffective. These include pension funds, insurance companies, microfinance institutions and other non-bank financial intermediaries."

It is worth noting that figures from the Economic Commission for Africa show a significant deepening of the financial markets in recent years. Between June 2001 and June 2002 M2/GDP increased from 8% to 15%, private sector deposits as a share of GDP from 5% to 11% and banking system assets as a share of GDP from 12% to 27%.

The IMF assessment also noted that the financial system was not interconnected with the banking system's equity investments in and lending to non-bank financial institutions being negligible.

The IMF report summarised the financial structure in June 2002 as follows -

- 15 commercial banks, mostly foreign owned, which between them have 128 branches and total assets of Shs2,450 billion ($1,440 million).
- 7 Credit institutions (including Post Bank and the Housing Finance Company of Uganda), all locally owned, with 22 branches and total assets of Shs200 billion ($118 million).
- The National Social Security Fund with assets of around Shs254 billion ($150 million).
- 100 deposit taking microfinance institutions with assets of Shs30 billion ($18 million).
- 4 life insurance companies with assets of Shs60 billion ($35 million).

It should be noted that the total assets of around $2,100 million compare with a figure of under $500 million in 1992.

Banking
This brief description of the banking system draws heavily on data in the DFCU prospectus, issued in July 2004, and the IMF Financial Stability Assessment published in April 2003.

The banking system went through a difficult period in the late 1990s with a number of failures in 1998. The largest bank, UCB, was financially weak and the process of dealing with it – now resolved – took some time.

There are 25 commercial banks in Uganda. The following table shows key statistics for the largest 10.

Largest 10 commercial banks, 31 December 2003

Bank	Total assets Shsbn	Deposits Shsbn	Loans Shsbn	Loans/Deposits %
Stanbic	834	663	166	25
Standard Chartered	747	589	169	29
Barclays	289	213	159	75
Citibank	206	132	35	27
Centenary	146	115	66	57
Bank of Baroda	136	107	25	23
Crane	128	107	48	45
DFCU	124	77	40	63
Orient	87	61	28	46
Nile	70	44	22	50
Total	2,276	2,108	758	36

Source: DFCU prospectus from banks' published accounts.

The four largest banks are all major international banks. Stanbic, the South African based bank, acquired the troubled UCB in 2003. UCB was historically the major bank in Uganda, accounting for 50% of the activity of the banking system in the mid-1990s. At its peak it had 189 branches, but this number had fallen to 68 at the time of the acquisition by Stanbic.

Centenary (formally the Centenary Rural Development Bank), Crane, DFCU, Orient and Nile are all locally based.

A feature of the balance sheets of the banks is the low loan to deposit ratio, particularly for Stanbic and Standard Chartered, which between them hold about 60% of the deposits of the banking system. The IMF attributed the low level of lending to inadequate credit discipline, contractual enforcement problems, scarcity of projects and lack of collateral. Lending is predominantly short term. Building and construction accounts for under 4% of total lending. There is also a high concentration of loans to big borrowers; about 40% of loans are to the largest five borrowers.

The commercial banks operate with a wide interest rate spread. In June 2004 the weighted average interest rates on deposits were –

Demand deposits	1.1%
Savings deposits	2.1%
Time deposits	6.2%
All deposits	1.2%

The average interest rate on loans was 21%. Administration costs account for about eight percentage points of the loan rate and bad debts for probably a similar proportion.

National Social Security Fund

Pensions are dominated by the National Social Security Fund (NSSF). The NSSF is a provident fund and theoretically covers all employees in the formal private sector. Participation is mandatory. The contribution rate is 10% for employers and 5% for employees.

The NSSF was strongly criticised in the IMF 2003 Financial System Stability Assessment. This concluded that Uganda's private pensions systems generally, and the NSSF in particular, were ineffectual and that they failed to protect Ugandan employees' post retirement futures and did not adequately preserve the long term nature of their funds. The combined pension related funding roughly accounted for an amount equal to 2% of GDP, far less than in most developing countries. This low figure, notwithstanding high required payments, was attributed to low participation, past mismanagement and poor financial performance. The IMF commented that, from a development perspective, the NSSF, as one of the few non-donor sources of long term investment capital, had a highly sub-optimal investment strategy, investing over half of its funds in short term bank deposits and treasury bills and 40% in real estate.

Following the IMF report, a new board of directors was appointed and an external audit undertaken. Subsequently, there has been a major improvement in the financial position of the fund.

NSSF has improved its efficiency is raising funds; it now collects Shs8bn ($5 million) a month as against Shs4.8 billion ($3million) in 2003. Its total assets now exceed $200 million. It has pursued employers who should be paying and has even found employers coming forward to pay arrears.

NSSF only covers the formal private sector. There is some interest from the informal sector in having a similar arrangement. However, the fund could increase its coverage in areas such as the police and army. The scheme does not cover the civil servants. There is a separate unfunded scheme which has a deficit of around Shs300 billion ($165 million).

Although NSSF has long term liabilities it has not in the past made long term loans; rather 50% of its funds have been in short term deposits.

Micro-finance

The IMF Financial Sector Assessment (2003) described the micro-finance industry in the following terms –

> "Uganda has a fairly well developed and diversified micro finance industry involving two commercial banks, two NBFIs, up to 100 NGO type organisations, and numerous financial co-operatives (SACCOs). However, the industry is very small relative to the needs of the rural and micro finance subsectors, which represent the bulk of Uganda's population and more than 50% of its GDP. These institutions together have relatively few branch locations, a small deposit base, and a small loan portfolio. Every significant micro finance institution (MFI) has received substantial donor support and private investors are becoming increasingly interested in those that give promise of becoming commercially viable. However, staffing and administrative logistics constrain growth and the industry cannot sharply increase its rural activity quickly."

The IMF was similarly dismissive of SACCOs – "Most of the estimated 700 SACCOs in the country are dysfunctional. Two co-operative umbrella organisations are operating, with external support, pilots attempting to bring a total of thirty rural SACCOs up to internationally recognised standards for credit unions. If the SACCO sector can be revitalised, it is most likely to come through the organic growth of these pilots, but it will take time to inculcate the culture and transfer the knowledge and operational systems beyond the initial pilot SACCOs."

Ledgerwood et al (2002) estimated that there were 1,400 micro finance institutions with a loan portfolio of about Shs97 billion ($57 million), 340,000 active borrowers and 900,000 active savers. Those institutions with loan portfolios tend to be urban based. The average loan size was under Shs300,000 ($180) and loan terms are generally between one and twelve months. The loans were almost entirely to businesses. No more than eight were "at or nearing financial self-sustainability" with over 10,000 active clients, 10 -15 were "moving towards operational self-sufficiency" and had 5,000 – 10,000 active clients, about 40 were some way from reaching self-sustainability with 500 – 3,000 clients, and the remainder were community based with a minimal number of clients.

The government tolerates the necessarily high interest rates charged by MFIs and sees them as playing a significant role in the poverty eradication action plan. Their small size combined with small loans mean that lending rates are typically in excess of 30%. This is unattractive as a means of financing construction; most low income people are better advised to defer construction until they have the necessary finance rather than to borrow at such rates.

Under the Micro-Finance (Deposit-Taking) Institutions (MDI) Act 2003 MFIs can apply to be supervised by the Central Bank and will be able to take deposits. However, it is anticipated that fewer than 10 will take up this option

DFCU Group – Uganda
DFCU Group (formerly Development Finance Company of Uganda) plays a major role in financing development related projects in Uganda. It was established by the Commonwealth Development Corporation (CDC) and the Government of Uganda in 1964. ACTIS, formerly CDC Capital Partners, a British venture capital company, has a 60% shareholding. The remaining shares were until recently held by the IFC (21.5%) and the Government of Uganda (18.5%). These two shareholdings have recently been sold through a public offering.

DFCU is a diversified financial business with operations ranging from commercial banking to long term lending to mortgage lending. It has plans to develop its mortgage lending substantially, and is described in more detail in Chapter 7.

Housing Finance Company of Uganda
The Housing Finance Company of Uganda is a specialist mortgage lender owned by the National Housing and Construction Corporation and the National Social Security Fund. Again, its activities are described more fully in Chapter 7.

Wholesale markets
The wholesale markets are very modest.

The Treasury Bill market is the largest. In October 2004 outstanding bills totalled Shs1,256 billion ($740 million). The commercial banks are the major holders (65%) with the Bank of Uganda also being a significant holder (17%). The secondary market is minimal and is mainly over the counter trade by the primary dealers all of which are commercial banks. More recently, Treasury Bonds have been issued with maturities of between two and ten years. Bonds issued by the end of October 2004 totalled Shs285 billion ($170 million), over 80% of which are for two and three year terms.

The Uganda Stock market has only five listed shares and a very small turnover. Turnover was as low as Shs51 million ($30,000) in July 2004 and Shs624 million ($370,000) in a more active month, May 2004. The total capitalisation of the market in September 2004 was Shs1,342 billion ($790 million).

It is hoped that the liberalisation of the pensions market over the next few years combined with the growth of life insurance business will increase demand for longer term instruments.

Financial Institutions Bill
After a very long gestation period a new Financial Institution Bill became law early in 2004. This considerably improves the regulatory framework including strengthening licensing, specifying corporate governance requirements, tighter restrictions on insider lending and large exposures and arrangement for prompt corrective action for distressed banks.

Financial supervision
The Bank of Uganda is responsible for regulating banks, credit institutions and deposit-taking micro finance institutions. It has adopted a risk-based approach to supervision. It is widely regarded as an effective regulator. It has a good dialogue with individual financial instructions and also with the banking industry collectively through the Uganda Bankers Association with which it has monthly meetings. The Bank's most recent Annual Supervision Report reports that all banks and non-bank financial institution were in compliance with the statutory minimum capital requirements of Shs 4 billion ($2.35 million) and Shs 1 billion ($0.6 million) respectively. The average core capital to risk weighted assets of the banks as at December 2003 was 14.4% while for credit institutions it was 20.0%.

Savings
The formal personal savings market is very modest. Only 10% of the adult population (about 1 million people) are "banked", with Stanbic (including the former Uganda Commercial Bank) having about half the market. Branches are confined to the urban areas. Access to formal financial services in rural areas is very limited or non-existent.

Interest rates
The following table shows Treasury Bill and bond yields as at 6 August 2004 -

3 months	6.89%
6 months	8.77%
9 months	11.87%
1 year	12.71%
2 years	13.88%
3 years	14.99%
5 years	13.66%
10 years	17.41%

Source: *Bank of Uganda Monthly Economic Review*, August 2004.

Note: The figures are the mid-point between the average bid and offer yields.

Rates have fallen rapidly since 2003. The 3 month rate averaged 16% in 2003 and reached a peak of 20% in December 2003.

The table shows a strong upward sloping yield curve although with a dip at the five year point. However, the fact that there have been very few bond issues mean that the curve should be interpreted with caution. There has been a very large spread in the bids for the longer term government bonds.

Chapter 7

The housing finance market

This chapter describes the primary housing finance market in Uganda. After briefly commenting on the size of the housing finance market, it analyses how houses are paid for and the house purchase process, then describes in some detail the two primary lenders, Housing Finance Company of Uganda and DFCU, and finally examines why the banks are not in the market.

The size of the housing finance market
At the end of 2003, outstanding mortgage advances were Shs54 billion ($32 million). The number of outstanding mortgages was around 1,500. There are 4.5 million houses in Uganda with a total value well in excess of $30 billion. In short, the formal housing finance mechanism has financed around 0.1% of the total supply of housing. This is low even by the standards of developing countries, although by no means unique. Diamond (2000) points out that there are few emerging markets where the mortgage finance system is larger than 10% of GDP; in Uganda the figure is under 2%. In industrialised countries there is a wide range from under 20% in Austria, Italy, Greece and France to over 50% in Germany, the USA and the UK.

A detailed exercise would be necessary to attempt to calculate the effective demand for formal housing finance loans. However, it is clear that that demand is substantial and is not a constraint to the development of an effective housing finance system. The proportion of owner-occupation in Kampala in particular is very low and many professional people are renting simply because they are unable to borrow money to enable them to buy. The rents they are paying are in many cases sufficient to cover the costs of a formal loan. Both the lenders currently in the market report a demand for loans much greater than they are able to supply even at rates of interest in the 16 – 19% range. If rates fall (as they should given an increase in volume) then the demand would be even greater. The fact that demand cannot be met has led to a negative impression of HFCU in particular and mortgage finance in general.

The DFCU prospectus (2004) including some results from a market survey conducted in 2003. This estimated that only individuals with a net income above Shs600,000 ($350) could qualify for a mortgage facility of at least Shs10 million ($5,900) and that there were only 40,000 salaried people in Uganda in this bracket. The survey also found a strong demand for housing loans from the informal sector. However, these figures almost certainly understate the true demand in that they take no account of more than one earner in a household, earnings from the informal economy and also the effects of any reduction in mortgage rates which itself could come from economies of scale as mortgage business expands.

The general conclusion must be that the demand for long term mortgage finance is not a constraint at present, nor it is likely to be in the foreseeable future.

How is housing paid for?
Chapter 5 on housing illustrated the significant improvement in the number of houses, housing conditions and construction activity in the last ten years. All of this has happened, and therefore has been financed, but clearly not through the formal mortgage mechanism.

There are many Ugandans working and living abroad who wish to return eventually to Uganda and whose remittances may well go into funding housing development. On completion such houses may become part of the thriving rental market, at least in the short term. There is no way of estimating the extent of this activity which may well be quite large.

In addition to formal mortgage lending there is probably some bank lending which, although theoretically short term in nature, in practice constitutes a long term mortgage loan. That is, a loan may be given for a short period, say three to four years, with an informal understanding that it will be rolled over, therefore in practice being a long term loan. The loan may well be secured by a mortgage and even be repaid as if it were a long term repayment mortgage. Some consumer loans for periods of up to two years may also be used to finance incremental building.

Chapter 5 explained how developers finance their activities. There is virtually no speculative building; rather they provide a comprehensive service to individuals but construction occurs only as it is paid for by the individual buyer.

This type of housing finance market is typical of those in developing countries. Formal institutions play a tiny part with development being financed directly by the owners of the property who, in most cases, also take responsibility for building. This system is hugely inefficient and costs much more than when houses are constructed in a continuing process. In the case of middle income housing, there is no opportunity for large scale developments. Even if a developer has assembled the necessary land and provided the infrastructure and is able to project manage the construction in an efficient way this is not sufficient. Developers know that they will not be able to build speculatively and sell houses at or near completion because potential buyers are unable to borrow the necessary funds, even if they can afford the interest rate. Accordingly, each house is built on an individual basis, the timing of construction depending on payments by the home buyer.

The house purchase process
In most developing countries the principal obstacles to the development of a mortgage market are the absence of land registration and the inability of lenders to realise their security should the need arise. These are not problems in Uganda as was explained in Chapter 4. In urban areas there is a comprehensive land title system and comparatively little scope for dispute on the validity of title.

However, this system is administratively inefficient. It should take only a few days to register a transfer a property and a mortgage but currently it can easily take six months. This is currently a serious problem for mortgage lenders and particularly for those

considering entering the market. They are at risk until the loan is registered and the delays may well lead to the potential borrower giving up. There is a programme to mechanise and generally improve the land transfer system but this will not have any effect for several years.

There is a professional valuing and surveying profession in Uganda which can be relied on by lenders. Surveyors have to be authorised by the Surveyors Registration Board. Appraisals are generally done by the investment method, capitalizing rents at a rate of between 8% and 12%. There is insufficient activity to enable transaction data to be used.

Although legislation provides for the Board to regulate estate agents it does not currently do so. There are a few estate agents dealing with the top end of the market who operate in a very professional way. There are also "briefcase" agents who operate with no regulation and often to very poor standards. There have been recent examples of such agents, including the largest, Property Masters, defrauding potential homebuyers and sellers.

Housing Finance Company of Uganda (HFCU)

Until recently, the Housing Finance Company of Uganda (HFCU) was the only formal mortgage lender in Uganda and in effect was synonymous with mortgage lending. The Company was established in 1967 through the acquisition of the business of the former First Permanent Building Society, a British style institution which had been established in the colonial times. Until recently, shares in the Company were held equally between two public sector institutions, the National Housing and Construction Corporation and DFCU. In 2003, the National Social Security Fund acquired the shareholding of DFCU for Shs3.8 billion ($2 million).

The Company operates to some extent on traditional building society lines and offers a number of savings, deposit and chequing accounts. However, its main source of funds has been the "Pool House Collection Fund". Civil servants have been allowed to buy the housing they occupied which had been owned by the State. The house price paid was recorded as a mortgage on the books of HFCU, the repayments on which would in due course provide further funds for lending.

The main terms on which HFCU will lend are –

- Construction, purchase, extension or improvement of residential and commercial property and purchase of plots in urban areas.
- Monthly repayment not exceeding 35% of ascertainable monthly income, or, in the case of the self-employed, audited accounts for two financial years.
- The property must have a valid land title and building plans with local authority approval. Construction must be in permanent materials and the building must have water and electricity.
- The minimum loan size is Shs5 million ($3,000) and a maximum loan to value ratio is 70% for residential units in Kampala, 60% for urban plots and 50% for residential units in other towns.

- Repayment term of a maximum of 20 years for residential units, 10 years for commercial properties and 5 years for urban plots.
- The current interest rate is 16% for residential units and 18% for commercial units and for urban plots. The rate is variable.
- The loan is repaid on an annuity basis.
- The borrower must have a bank account with HFCU.

Although HFCU has been in business for a long time it remains a small institution with fewer than 1,500 loans outstanding and mortgage assets of Shs43 billion ($25 million). It deals mainly with the upper end of the market. Typically, its loans are in the Shs60 – 100 million ($35 - $60,000) range. HFCU has seldom been able to meet demand and has tended to be in and out of the market. As it is portrayed as the housing finance lender in Uganda both it and housing finance generally are seen as being unreliable.

The most recent balance sheet and income and expenditure accounts of the Company are shown in the table below.

Housing Finance Company of Uganda, Balance Sheet, 31.12.03

	Shsm	$m	%
Assets			
Mortgage advances.	43,348	25.5	77
Financial assets	8,924	5.3	16
Property and equipment	2,312	1.4	4
Other	1,224	0.7	2
Total	55,808	32.8	100
Liabilities			
Customer deposits	20,245	13.2	36
Pool House Collection Fund	23,358	13.7	42
Other	2,150	1.3	4
Total	45,753	26.9	82
Financed by			
Share capital	1,000	0.6	2
Revaluation reserves	338	0.2	1
Retained earnings	4,659	2.7	8
Proposed dividends	200	0.1	-
Long term loan	3,857	2.3	7
Total	10,055	5.9	18
Shareholders' funds and liabilities	55,808	32.8	100

Housing Finance Company of Uganda, Income and expenditure, 2003

	Shsm	% of mean assets
Income		
Loan interest	7,124	14.5
Fees and commission	625	1.3
Other	2,667	5.4
Total	10,415	21.2
Expenditure		
Interest	1,471	3.0
Loan loss provisions	2,769	5.6
Management expenses	3,408	7.0
Total	7,676	15.6
Profit	2,740	5.6
Tax	994	2.0
Net profit for year	1,746	3.0

Source: Derived from Annual Report and Accounts

The table shows that HFCU is operating with an interest spread of around 11 percentage points. It has been able to keep the mortgage rate at a relatively low level (16%) because it has had access to the Pool House Collection Fund which in effect is a cheap loan to it. Management expenses are high at 7% of mean assets. Loan loss provisions, at 5.6%, are very high but this partly reflects the strict loan loss provisioning required by the Central Bank. It is anticipated that the figure will fall in 2004.

The Pool House Collection Fund accounts for a high proportion of the loan loss provision. Outstanding advances under the scheme at the end of 2003 were Shs13.8 billion ($8 million) but non-performing loans were Shs3.4 billion ($2 million), that is non-performing loans were 25% of the total. By contrast, under 10% of other loans were non-performing.

HFCU is regulated by the Central Bank as a non-bank institution.

The ownership and capital structure of HFCU have recently changed. The National Social Security Fund has taken a 50% equity investment in the Company, not as a strategic investment but rather because it intends to play a significant role in the mortgage market and sees HFCU as a means by which it can channel money into mortgage loans. NSSF and the other shareholder, NHCC, will be increasing paid-up share capital to Shs20 billion ($11.8 million), which will provide the capital strength to enable the Company to raise further loan finance including from NSSF.

However, the Company is also moving from a position in which it enjoyed a monopoly and was never able to meet demand into one in which it is likely to be one of a number of significant mortgage lenders, some with considerable financial strength. It is not clear that HFCU will easily be able to meet this challenge.

DFCU

DFCU (formerly the Development Finance Company of Uganda) has over the past two years joined HFCU as a formal mortgage lender. DFCU has recently offered shares to the public. The issuing prospectus gives useful information not only about its activities but also about its intentions in relation to the mortgage market.

DFCU was established as a private limited company in 1964 by the Government of Uganda and the Commonwealth Development Corporation. In the same year, DEG, the German investment group, became a shareholder. In 1984, the Company took over CDC's shareholding in HFCU and IFC became a shareholder in it. The Company changed its name to DFCU Ltd in 2000 and it commenced mortgage lending in 2002. In 2003, DEG sold its 24.7% equity interest to CDC, and DFCU sold its 50% stake in HFCU to the National Social Security Fund, this holding having become inconsistent with its own direct mortgage lending activity. In 2004, the Company sold 40% of its issued share capital, 18.5% being Government of Uganda shares and 21.5% being IFC shares. Following the share sale, DFCU is 60% owned by the CDC group and 40% owned by private investors.

DFCU Ltd is the holding company for a bank, a leasing company and two property companies, with mortgage lending being directly done under the name of DFCU Ltd.

The table below shows a simplified balance sheet for DFCU as at 31 December 2003.

DFCU Ltd, Balance Sheet, 31 December 2003

	Shsm	$m	%
Assets			
Loans and advances	73,857	43.4	34
Bank balances	45,519	26.8	21
Finance loans receivable	29,423	17.6	14
Investment properties	13,499	7.9	6
Other	53,079	31.2	24
Total	215,377	127.0	100
Liabilities			
Borrowings	73,571	43.2	34
Customer deposits	77,224	45.4	36
Interest payable	18,923	11.1	9
Other			
Total	172,526	101.5	80
Minority interest	4,513	2.7	2
Shareholders' equity	38,337	22.6	18
Total equity and liabilities	215,377	127.0	100

Source: DFCU Prospectus, 1 July 2004.

Mortgage loans outstanding at the end of 2003 were Shs11.4 billion ($7 million), an increase from Shs2.5 billion ($1.5 million) at the end of 2002. The increase in its mortgage assets during the year of Shs9.81 billion compares with Shs11.7 billion for

HFCU. Mortgage loans accounted for 15.4% of outstanding loans at the end of 2003. The prospectus states that DFCU hopes to dispense up to Shs20 billion ($12 million) in 2004 and to reduce the existing market gap with HFCU significantly by the end of 2005.

The prospectus states that the average margin on mortgage finance is 4.2% but this is expected to decline to 4.0% as a result of the expected revitalisation of HFCU and new entrants into the market.

DFCU lists its business objectives in respect of mortgage finance as –

- To be a key player in Uganda's mortgage market by providing an alternative mortgage provider to meet the current demand gap.
- To provide affordable and accessible mortgages to its target clientele.
- To provide residential mortgages to as wide a market in Uganda as possible.
- To increase the housing stock in Uganda through supporting real estate development.
- To deepen the secondary market for mortgages to ultimate securitisation of its mortgage portfolio.
- To create a stable middle class of homeowners and to enhance the wellbeing of Ugandans.

DFCU offers owner occupier mortgages for the purchase, completion, renovation or furnishing of a home, buy to let mortgages, equity release mortgages and commercial and industrial mortgages. The loan terms are from three to fifteen years and DFCU will lend up to 70% of the value of the property. Borrowers must open a bank account with DFCU. Like HFCU, DFCU operates with variable mortgage rates. It has recently increased its mortgage rate to 19%.

Some personal lending by DFCU has in effect also been used to finance house purchase and construction.

The prospectus states that DFCU will encourage more structured real estate development and is creating alliances with estate developers and Ugandans overseas.

DFCU is seeking to fund its mortgage portfolio through the wholesale markets. It has raised over Shs20 billion from development partners including NSSF, FMO (the Netherlands development finance company) and OPEC (Organisation of Petroleum Exporting Countries Fund for International Development). The prospectus states that DFCU already has plans to securitise its mortgage portfolio through creating a special purpose vehicle to hold mortgage backed securities which would then be listed on the Uganda Stock Exchange. However, it is recognised that "a lot of preparatory work is required before this can be achieved and hence an ……. issue is not expected in the immediate short term."

The National Social Security Fund

The National Social Security Fund is the only substantial holder of long term savings. It sees housing loans as a proper use for its funds and sees the wider benefits to the

economy of a more effective housing market. It has acquired an interest in HFCU as a vehicle for its lending into the housing market. This may well be because it could see no other vehicle rather than because of any wish to own the company in the longer term. It sees mortgage securities as being appropriate in the longer term and believes that these would be attractive to international investors.

NSSF will lend to HFCU on commercial terms over 10 years and it is also willing to lend to other housing lenders on similar terms. It anticipates that insurance companies will also be willing to enter the market, partly because of the spin off for other form of insurance business.

The NSSF has entered into a controversial joint venture with a Kenyan developer, Mugoya Estates, to build 6,500 housing units between Kampala and Entebbe. This has resulted in the suspension of the Board of the Fund. Clearly there will be a re-evaluation of the role the Fund plays in the housing and housing finance markets.

The commercial banks

The commercial banks do not provide long term mortgage loans. However, a modest amount of their personal lending is used to finance incremental construction and some personal loans are rolled over so in effect they become long term loans to fund house purchase or construction. The rates of interest are generally well over 20%.

Until recently high interest rates meant that long term lending was not considered viable for the banks and in any event they could earn a good return on Treasury bills. Now, the banks are actively looking at the mortgage market and some are likely to begin lending in the relatively near future. The point was made earlier that the banks have relatively low loan/deposit ratios and also that their lending is highly concentrated. Diversification into well secured mortgage lending would address these issues and longer term would help them increase their retail business generally.

The banks do not regard mortgages as an incremental product but rather see the need to invest in the necessary systems and expertise. They are likely to draw on their experience from neighbouring countries.

The banks are generally comfortable with the legal and regulatory framework. In particular, they have a high regard for the central bank, the Bank of Uganda. Their main concerns are –

1. The *delays at the Land Registry*. The banks will want the mortgage to be registered at the time they make the loan so they have the necessary security.
2. *Consistency of valuations* coupled with the validation of valuations by the Government Valuer.
3. The *absence of large scale developments* in which a significant proportion would be pre-sold. Such developments would give the banks greater security than developments built as individual buyers could afford to pay. The banks would however prefer to share the risk on such developments.
4. The difficulty of *accessing long term funding*.

Despite its small size the banking market is very competitive. If one bank offers mortgage loans as a product it is likely that other banks will follow for competitive reasons. The experience of other countries is that they may do so directly or in partnership with a specialist lender – in practice DFCU or HFCU in the case of Uganda. While it might seem unusual for a bank to act in this way it is sometimes a pragmatic approach. Mortgage lending requires different skills and systems compared with commercial and personal lending; rather than acquire these skills it may be faster and cheaper for a bank to buy them from another institution, at least initially.

The banks are potentially strong competitors in the mortgage market with their ability to use short term deposits which cost much less than longer term funding – as is the case in most industrialised countries. The banks should have no difficulty in funding say five year loans, with the expectation that they could be rolled over, using a proportion of their deposits subject to having a satisfactory maturity mismatch policy and controls. The banks can also safely accommodate mortgage loans on their balance sheets. It is fairly typical for 10 – 20% of a bank's loan portfolio to be in mortgages.

The banks see the need to increases their funding capabilities if mortgage lending is to become a significant activity for them. Uganda is still largely unbanked and bank branches are confined to urban areas. The banks also need to be able to access wholesale funds. Securitisation, in the longer term, is attractive to them.

Micro-finance organisations

Micro finance organisations seem to play little or no part in financing house construction. A recent study of the industry by Nannyonjo and Nsubaga (2004) did not mention housing. However, it is probable that smaller rotating credit societies are used to a limited extend to help finance incremental building. Some of the larger organisations are beginning to experiment with loan products for housing improvement and construction.

Central Bank supervision

The Bank of Uganda treats mortgage loans in the same way as other loans. Given the very small scale of mortgage lending and the fact that most lending has been by a parastatal credit institution and there has been no formal bank lending this is not unreasonable. Mortgage loans therefore have the same risk weighting as other loans. There is no preferential treatment for such loans as there is in many other countries; international rules allow a 50% risk weighting for residential mortgages.

The Bank has strict provisioning requirements. There must be a 25% provision where a loan is three months in arrears, 50% where a loan is six months in arrears and 100% where a loan is 12 months in arrears, with no allowance being given for the value of the security. At first sight this is fairly harsh but it is probably a useful discipline while the market is developing.

Chapter 8

Developing a housing finance strategy

Comparison against the benchmark
Uganda does not have anything resembling a fully functioning housing finance system and the formal mortgage system has played a negligible role in the provision of housing. In respect of the output tests outlined in Chapter 2 –

- Loans are not available even at prevailing interest rates for those who wish to purchase or build houses.
- The mortgage rate represents a spread of around 13 percentage points over the cost of funds, typical for Sub-Saharan Africa but well above a reasonable level.
- Formal housing finance has played a role in less than 0.2% of housing transactions.

Although Uganda does not meet the output tests, it scores very well for a developing country on the input tests. In respect of housing, there is a reasonable number of well constructed houses, and provision of infrastructure is satisfactory.

Most importantly for a developing country the land title system is effective if slow in operation and mortgage lenders are able to exercise their right to realise their security. This sets Uganda apart from most other developing countries where these are major obstacles to the development of housing finance.

However, there are no large scale developers in Uganda. This can be attributed largely to the absence of a formal housing finance mechanism to give developers the reassurance they need that they will be able to sell properties that they build. This in turn contributes to an inefficient building industry and high cost of materials.

Uganda has a financial system able to provide long term housing finance loans, although raising funds for long terms is difficult.

The house purchase process works reasonably satisfactorily although there is scope for regulation of estate agents and perhaps improvements in the quality of appraising. The biggest single problem at present is the delays at the Land Registry.

Uganda has insurance companies which provide the necessary property and life insurance. As yet mortgage insurance is not available, but this is not a priority.

The framework governing housing finance is reasonably transparent and fair compared with other countries. There is little attempt by government to direct credit or control interest rates. It is accepted that subsidies are simply not an option.

The government also accepts that its role is one of enabling and is willing to play its part to ensure that the necessary arrangements are in place.

The financial markets are conducive to the development of housing finance. Inflation is now very low, although this is not yet reflected in the level of interest rates. Banks and other financial institution are financially sound and well regulated.

The Land Registry

There is one important issue the government needs to address in order to facilitate the growth of mortgage finance. Delays at the Land Registry are a significant deterrent to banks entering the mortgage market and also give the wrong signal about the government's intentions in relation to the development of the market. A long term programme has been agreed to bring the Land Registry up to modern standards. However, in the short term, it is essential to reduce delays to the absolute minimum. This should be achievable through a modest increase in staff and more effective management. There should be no overall cost as fees charged should cover the cost. The aim should be to deal with all applications within a specified period – say two weeks. Taking action on this would be a clear indication that the government is serious about developing a housing finance market and would be greatly re-assuring to mortgage lenders, particularly the banks who are now considering entering the market.

The need for large scale development and an increase in formal financing

The major issue for Uganda is how to move from having an adequate framework to having a plentiful supply of mortgage finance combined with a significant increase in large scale development. The two are closely linked. Developers will be reluctant to engage in large scale developments unless they can be fairly certain that mortgage finance on the necessary scale will be available. Conversely, banks in particular would like the comfort of knowing that there will be a sufficient supply of good quality houses built by a reputable developer on which they can lend before committing the necessary resources to the mortgage market. There may be an enabling role for government and international agencies to resolve this problem.

At first sight there is no reason why developers should not be interested in the huge potential of the Ugandan market. There are four groups of institutions that have the capacity to be large scale housing developers in the Ugandan market –

- Large scale developers based in other countries.
- The large construction companies in Uganda, which currently concentrate on commercial and industrial building, might add housing developments to their portfolio. In many countries, construction companies build housing as well as commercial developments.
- There are some small to medium scale local developers which have the potential to expand considerably.
- A privatised National Housing and Construction Corporation. It is the intention to privatise the company. Given its current range of activities there is no reason why this company should be state-owned. It is well placed to be a large scale housing developer and its experience should enable it to compete in an open market.

Everything is reasonably in place for mortgage lending to expand considerably. Within a few years it can be expected that the following institutions will be significant mortgage lenders –

- The Housing Finance Company of Uganda should be transformed into a vibrant private sector specialist mortgage lender (see below).
- The DFCU has set out its stall as a significant mortgage lender and can be expected to expand.
- Some of the major banks with retail business can be expected to start mortgage lending. Once one of the banks comes into this field the others may feel bound to follow for fear of losing their customer base. The banks will not regard mortgage finance as simply an add-on product to what they already do but rather will have to make the necessary investment in expertise and systems as well as ensuring that they have adequate funding for this new source of business.

As mortgage lending increases so the cost of mortgages will fall, providing a further stimulus to demand and reducing the costs paid by borrowers. Currently, rates are between 16% and 19% while retail deposits cost just 3% and wholesale funds under 10%. In round terms, the spread between deposit rates and mortgage rates is 13% and the risk lending premium, that is the difference between lending rates and the Treasury Bill rate, is about 13% as well. In an industrialised country this spread in respect of mortgages is about two percentage points while in middle income countries it is in the five to eight percentage point range. The wide spread in Uganda can be explained by –

- A very low volume of business and thus overheads cannot be widely spread.
- This is a relatively new business and is yet there is insufficient evidence that mortgage loans are much less risky than other forms of lending.
- The provisioning requirements of the Bank of Uganda.
- This is a new business for DFCU and will be a new business for the banks, and initially they must be expected to take a cautious approach.
- As long as the demand for mortgage finance exceeds the supply, rates can be expected to be above a level that would apply in a competitive market place.

A significant increase in the volume of lending, provided it is undertaken in a sound way, should address all of these points. Unit costs should fall markedly and provided the default experience is satisfactory loan loss provisions should fall and capital requirements should also reduce. Competition between lenders should lead to a further reduction in rates. In the short to medium term a reduction in the interest rate spread of around three percentage points should be a reasonable expectation. This in term would help to stimulate demand.

Funding mortgage loans

The willingness of financial institutions to make mortgage loans is of course not sufficient. They must also have access to the necessary funding. There is no reason why retail deposits cannot be used to fund long term mortgage loans, as they are in many other countries. While at first sight it might not seem prudent for short term deposits to be lent over say ten or fifteen years, in practice most housing finance systems work on this basis and do so safely. The supply of long term funds is insufficient to fund the demand for

mortgage loans. Most deposits, particularly retail deposits, are relatively stable. It is reasonable for a proportion of these deposits to be used to fund long term loans. The interest rate risk is minimised by mortgage loans carrying a variable interest rate.

The mortgage lenders will also seek longer term sources of funds, perhaps through loans from international agencies, or from domestic institutions such as NSSF and life insurance companies, and perhaps also through bond issues on the domestic capital markets. In the short term, such issues will need to be liabilities of the bank with the possibility of mortgage bonds being considered in the longer term.

There is a general wish to see mortgage securities issued in the long term. It would be sensible for the mortgage lenders to get together at a fairly early stage to put in place arrangements that will facilitate this. Improved standards of appraisal and standard documents would certainly be required. It may make sense to look at mortgage insurance at the same time using the expertise of a specialist mortgage insurer. In a number of countries the mortgage insurers have played a major role in establishing standard loan terms and documentation.

The Housing Finance Company of Uganda

HFCU has expertise in the mortgage market and is perceived as a specialist lender and to some extent as being synonymous with the mortgage market. Some years ago the general thinking was that developing countries needed a special housing finance circuit operating with the benefit of some favourable regulatory or tax treatment. This is no longer the prevailing view. State sponsored housing banks have generally failed. Even previously successful specialist private sector lenders such as building societies in the UK, Australia and South Africa, and savings and loan associations in the USA, have increasingly transformed themselves in mainstream banks. The prevailing view now is that mortgage finance is a mainstream banking activity that should be provided by banks.

HFCU should not, as of right, be seen as having a pivotal role in the Uganda housing finance system. It should earn a role in competition with others; its expertise and current position as market leader give it an advantage in this respect. HFCU is currently a parastatal, owned by two government agencies, one of which, the National Social Security Fund, is in some disarray after its adventure into the property development market. HFCU's future must be as a private sector institution. This could be achieved by the company being floated on the stock market, the proceeds buying out the government interests. However, the company would need to be significantly restructured before this could be attempted. It should be noted in this respect that NSSF acquired its interest in HFCU for just Shs3.8 billion ($2 million). The company needs more capital as a basis for raising long term funds to finance mortgage lending. A more practical solution would be for the company to be sold to a private sector institution willing to provide additional capital and expertise to enable a large scale lending operation to be developed.

Micro-finance organisations

At first sight, micro-finance organisations should play a significant role in financing incremental construction, and the larger ones which will be regulated by the Bank of

Uganda should become significant retail banks with housing loans as one of their main products. However, there is little evidence to suggest that the industry is capable of anything more than a very modest role in the foreseeable future. As the industry develops so there should be scope for sharing of best practice and expertise so as the help them develop as housing finance institutions.

Prudential regulation

The Bank of Uganda is a competent and respected banking regulator. It is well placed to play a significant part in helping to develop a vibrant housing finance market. It should develop expertise in the market, based on best practice internationally combined with a thorough understanding of market developments in Uganda.

There are three aspects of prudential regulation that it should review in the near future –

- The extent to which banks can use short term deposits to fund long term mortgage loans. This is relevant to the commercial banks considering entering the market. The point has already been made that it is normal practice for a proportion of short term deposits to be used to fund long term loans, provided that the lending is at a variable rate as it is in Uganda.
- The provisioning requirements for mortgage lending. At present these are onerous provisioning requirements for mortgage loans that are in arrears for three months or more with no allowance being made for the value of the security. The validity of this requirement should be reviewed in the light of experience.
- The capital required to back mortgage loans. Currently all loans carry the same risk weighting, whereas the international standards set by the Basel Committee of Banking Supervisors allow residential mortgage loans to have a 50% risk rating – to be reduced to 35% under the new Basel 2 rules. The Bank should consider an early reduction in the risk weighting to 50% for loans that meet certain standards, say a maximum loan to value ratio of 70% and a maximum repayment to income ratio of 25%, provided it is satisfied that the bank has in place adequate systems to manage the risk.

Appendix 1 deals with prudential supervision in more detail.

Summary – a proposed strategy

An appropriate housing finance strategy for Uganda should rest on two premises –

- The provision of loans to finance house construction and purchase is a banking function which should be carried out by private sector institutions as part of their mainstream business and not in a special protected mechanism.
- The role of the government is to provide the legal and regulatory framework and the provision of infrastructure and utilities which house builders require.

The immediate priority is to remove the current delays at the Land Registry which are seriously inhibiting the development of the market. The cost of this would be very small compared with the benefits.

The major issue, given the fairly sound framework that already exists, is to increase the volume of mortgage business, which will both bring down the cost of mortgages and stimulate large scale development.

The necessary increase in the volume of activity requires additional funding which can come from one or more of three sources –

1. The banks using some of their retail funds to finance long term mortgage loans.
2. The National Social Security Fund making long term funds available to mortgage lending institutions at an arm's length basis.
3. Long term loans by international agencies as a pump priming mechanism.

There are four further measures which should be taken –

1. The Housing Finance Company of Uganda should be sold by its current shareholders so that it becomes a private sector institution competing on equal terms with others, albeit with the advantage of being the market leader and having expertise in the market.
2. Brokers and agents should be regulated in accordance with accepted international standards. There has already been significant malpractice and the scope for this will increase as the size of the market increases unless the necessary regulatory measures are put in place.
3. The Bank of Uganda should review its regulatory requirements taking into account international practice.
4. Given the wish of financial institutions to sell mortgage loans or to issue mortgage securities in the longer term, the necessary framework should be put in place through standardising lending terms and documentation and improving the standard of appraisals.

Initially, such a strategy would benefit only the upper income groups in the formal economy, able to afford house purchase. Over time there will be a "trickle down" effect if mortgage rates fall as a result of an increased volume of lending and if mortgage lending encourages higher saving with formal financial institutions.

Poorer households can best be helped by ensuring that they have security of tenure which will encourage them to invest in their homes, primarily through incremental building. Any measures which can help reduce the cost of building supplies will also benefit the lower income groups.

The need for great transparency

An effective housing finance market requires high quality information – on house prices, rents and the activities of lending institutions and other intermediaries. There is a dearth of such information in Uganda. The websites of parastatals and government departments are generally well out of date and have little relevant information. Annual reports are difficult, if not impossible, to find. The Ministry of Housing, Works and Communications and the Bank of Uganda should between them take responsibility for undertaking research, collecting statistics and publishing relevant information.

Chapter 9

Prospects for secondary market activity

There is considerable interest in Uganda in the possibility of secondary market activity, in particular issuing securities backed by mortgages, as a means of increasing the provision of mortgage finance. This chapter briefly explains the concept of secondary market activity, then summarises a World Bank paper dealing with the specific issue of mortgage securitisation and emerging markets before considering the prospects for mortgage securities in Uganda.

The basic principles
The demand for mortgage finance in many countries, including Uganda, is huge. The provision of mortgage loans is a retail banking activity and retail banks raise most of their money by deposits. However, mortgage loans are long term. Lending institutions therefore invariably have the capacity to take on new mortgage business and to service mortgage loans in excess of their capacity to fund it. Raising wholesale money is one way of improving the situation. However, lenders may be constrained by their capital from increasing their business as much as they would like. If loans that have already been made can be removed from the balance sheet of the lender then the scope for new lending is increased. There are three basic ways in which this can be done –

- The sale of a package of loans to an institution that wishes to hold long term mortgage loans in its portfolio, for example an insurance company or a pension fund which has long term liabilities. In such a case the lender will probably continue to service the loans, and some allowance for this activity must be taken in calculating the capital required by the lender.
- Selling bonds backed by a portfolio of loans which remain on the balance sheet of the lending institution. In the event of the lender defaulting then the loans act as security for the holders of the bonds. The advantage to the purchaser of the bonds is that they are able to obtain a higher rate of interest than on government securities but they do not have the hassle of administering mortgage loans.
- Selling securities backed by a pool of mortgages which then are no longer on the balance sheet of the lending institution.

Secondary market activity is an exciting concept for some people who see it as a route to obtaining more money for house purchase loans. However, the reality is rather more complex. The sale of mortgage loans, the issue of mortgage bonds or securitisation are merely alternative means of obtaining finance. They do not create new finance in themselves and there are considerable costs in using securitisation in particular.

Securitisation in emerging markets
A recent Work Bank paper (Chiquier, Hassler and Lea, (2004)) analyses the issue in detail. This section briefly summarises the report. The report concludes that, despite numerous attempts, there have been only limited successes in introducing mortgage

securities in emerging markets on a significant scale. Two main reasons are given for this –

- The infrastructure requirements for mortgage security issuances are demanding, time consuming and costly.
- It is highly unlikely that mortgage securities can be successfully issued in countries with weak and underdeveloped primary mortgage markets. "There must be a modicum of standardisation in mortgage instruments, documents and underwriting, reasonable standards of servicing on the part of lenders and issuers and professional standards of property appraisal."

The report notes that government involvement is not a guarantee of success but that there must be an underlying market need for capital market funding and investor demand for mortgage securities.

The report lists three prerequisites before investors will be interested in mortgage related securities –

- They must offer attractive risk adjusted returns. Mortgage securities will be seen as an alternative to government bonds which provide a benchmark yield.
- Investors must have a capacity for mortgage related securities.
- Investors must be able to invest in mortgage related securities, that is they must have the necessary legislative and regulatory authority and the regulatory treatment must be appropriate.

The report lists five legal conditions that must be met for mortgage backed securities –

- An adequate legal, tax and accounting framework for both investors and borrowers.
- Facilities for lien registration.
- Ability to enforce liens.
- Ability to transfer or assign security interest.
- Protection of investors against the bankruptcy of the originator or the servicer.

In addition there are three primary market prerequisites as well –

- Standardisation of documents and underwriting practices.
- High quality servicing and collection.
- Professional standards of property appraisal.

The prospects for secondary market activity in Uganda

Uganda does not meet the tests laid down by Chiquier, Hassler and Lea. The primary market is primitive and there is insufficient data which would enable mortgage securities to be issued in a way that would be attractive to investors. This is not a viable option in the short term. However, this does not mean that the issue should be ignored.

Although the issue of a mortgage security is unlikely in the short term there may well be opportunities for primary lenders to sell mortgage loans to institutional investors. Normal practice is for "seasoned" loans, that is those that have been running for a minimum period, say two years, that meet defined characteristics in respect of, for example, loan to

value ratio, loan to income multiple, loan term and so on, and for the lender to continue servicing the loans. In this way many of the benefits of mortgage backed securities are achieved but without the huge costs being incurred. Alternatively, investing institutions can use lending institutions to originate and service loans which they hold on their balance sheets.

Secondly, while mortgage securities might be some way off, it is sensible at this early stage of the development of a mortgage market in Uganda for policies, procedures and lending practices to be able to facilitate the issue of mortgage backed securities at a later stage should this become appropriate. In fact, Uganda is reasonably well placed in this respect. The legal tests mentioned above are already met. There is probably a need to improve documentation and appraisal standards but this should not be too difficult. Insurance services also need to be better developed, including perhaps some form of mortgage insurance (described in Appendix 2).

What is lacking in Uganda is a thriving primary mortgage market. In such a market the return on mortgage loans should be competitive with that on government securities after allowing for the risk element. At present, investors would have no way of knowing the risks of holding mortgage backed securities. When the primary market has been functioning fully effectively for several years there should be data available to illustrate the low default rate on mortgage loans and therefore the high security that mortgage securities would offer.

Appendix 1

Prudential supervision of mortgage lending

[Note: this appendix is a modified and updated version of a chapter in the consultant's report *The development of the mortgage market and prudential supervision in Russia,* prepared for the World Bank, June 2003]

House purchase loans can be made by banks or by non-banking institutions. The regulatory regimes for the two types of institution can legitimately differ but they need to be constructed in a harmonious way so that there is no opportunity for regulatory arbitrage. This appendix concentrates on supervision of banking institutions and then draws some implications for the supervision of non-bank institutions.

The Basel rules

In most countries there is now a well established framework for the supervision of mortgage lending by banking institutions based on guidelines produced by the Basel Committee of Banking Supervisors. Although the rules apply to international banks the principles are widely accepted as the benchmark for banking supervision. The current set of rules is known as Basel 1. In 2004 agreement was reached on Basel 2 which will supersede Basel 1 over the next few years.

Supervision of bank lending for house purchase should be regulated as part of the normal prudential supervision of banks. This assigns risk weights to various categories of assets. Loans generally carry a 100% risk weighting for which an 8% capital requirement is considered the minimum. Government securities carry a much lower risk weighting reflecting the security they offer. Because loans secured on residential property are more secure than bank lending generally, under the current Basel rules loans to house purchasers carry a 50% risk weighting. Under the new Basel 2 rules the risk weighting is reduced to 35%. The full text from the Annex to the new rules is set out below –

> **"Claims secured by residential property**
>
> 15. Lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk-weighted at 35%. In applying the 35% weight, the supervisory authorities should satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules. Supervisors should increase the standard risk weight where they judge the criteria are not met.
>
> 16. National supervisory authorities should evaluate whether the risk weights in paragraph 15 are considered to be too low based on the default experience for these types

of exposures in their jurisdictions. Supervisors, therefore, may require banks to increase these risk weights as appropriate."

The Basel 2 rules require that when qualifying residential mortgage loans are past due for more than 90 days they will be risk-weighted at 100%, net of specific provisions. If such loans are past due but specific provisions are no less than 20% of their outstanding amount, the risk weight applicable to the remainder of the loan can be reduced to 50% at national discretion.

National regulators will make their own rules within this general framework. The British Financial Services Authority is proposing to apply the 35% weight to the proportion of a loan up to 75% loan to value ratio with a 75% weighting thereafter. They are also considering allowing companies that do not have systems in place to use this framework to weight all residential mortgages at 45%.

This lower risk weighting than for normal loans is justified on both theoretical and empirical grounds. The theoretical grounds are that –

- Unlike most commercial loans the income earned to repay the loan does not derive from the investment financed by the loan. Loans are repaid out of income earned by borrowers and borrowers prioritise loan repayments because failure to do so might mean them losing their home.
- If borrowers lose their income then other means may be available to repay the loan, including income from other family members, savings, income from renting out part of the property, social security payments and in some countries the proceeds of insurance policies.
- If borrowers are unable to repay their loans the lender is still protected because it can possess the property with vacant possession and sell it. The lender is likely to be able to recover the loan from the proceeds because the security is readily marketable (unlike the security for many commercial loans), the loan will have been for no more than 80% of the value of the property, the chances are that house prices have risen since the loan was taken out and insurance may cover any loss that the lender may make.

Empirical evidence also shows that residential mortgage lending is safer than other forms of bank lending. This is demonstrated not only by the loss experience but also by the willingness of lenders to make residential mortgage loans at a narrow spread over the cost of funds. In developed economies this is typically under two percentage points.

It is important to note that the 50% risk weighting follows from the theoretical points in this section, backed up by empirical evidence on the loss ratio. If this supporting evidence is not available in an economy the 50% risk weighting cannot be justified.

Supervision of the quality of a mortgage lender's portfolio

Banking regulators also need to consider the quality of a bank's overall portfolio of mortgage loans to assess whether the capital it holds is adequate, or put another way whether the risk weighting is appropriate. If a portfolio is relatively risky then the

regulator can legitimately require a higher capital requirement. The following factors are relevant to the security offered by individual mortgage loans and to the quality of the mortgage loan portfolio of a bank –

- The loan to value (LTV) ratio. Empirical evidence shows that this is a particularly significant factor in determining the likelihood of mortgage defaults and resultant losses. The rating agency, Fitch ICBA, has established the following relationship between LTV and expected loss from the experience of six countries (Australia, Germany, Holland, Spain, the UK and the US).

LTV range	Expected losses relative to LTV of 75.01%-80%
50.00% and below	0.00
50.01% - 60.00%	0.09
60.01% - 65.00%	0.25
65.01% - 70.00%	0.46
70.01% - 75.00%	0.70
75.01% - 80.00%	1.00
80.01% - 85.00%	1.39
85.01% - 90.00%	1.92
90.01% - 95.00%	2.67
95.01% - 98.00%	3.40
98.01% - 100.00%	4.14

  It will be seen that a loan with an LTV of 75-80% has a four times greater expected loss than one with an LTV of between 60-65% and a loan with a LTV of 95-98% has an expected loss 3.4 times higher than a loan with an LTV of 75-80%. Because the LTV ratio is so significant lenders (and regulators) may put a ceiling on the ratio, typically 75 – 80%. A market has also developed for mortgage insurance (see below) which insures the top slice of the loan and, in a mature market, may allow a loan to exceed the maximum ratio.
- Loan to income ratio. Other things being equal, the higher the loan to income ratio, the greater the risk of default. A regulator may wish to see a maximum loan to income ratio and may look at the average loan to income ratio for a bank in comparison with other banks. However, this does assume that the income figure is meaningful, which is not always the case in emerging markets.
- This spread of risk, for example large exposures, the geographical spread of lending and the spread of lending between types of home buyer.
- Insider lender, in particular lending to purchasers of properties the construction of which the bank has financed or which the bank itself owns, such as property taken into possession because the borrower has defaulted.
- Appropriate credit checks on the borrower.
- Any guarantors, for example a relative or an employer. In developed systems these are unusual and pose their own problems. In transitional economies they

may be necessary to compensate for weaknesses in the security, but there should be a medium term objective to reduce reliance on such guarantees.
- Mortgage insurance. In many countries there are arrangements by which lenders can insure the "top slice" of a loan. Such arrangements might, for example, provide that in exchange for a premium an insurance company will meet any shortfall up to, say, 20% of the value of the loan in the event of the borrow defaulting, the lender repossessing the property and selling it but being unable to recover its debt. There are a number of other types of mortgage insurance. The institutions which can provide such insurance include commercial insurance companies and governmental agencies. Mortgage insurance schemes can also be a means by which other lending requirements can be enforced. For example, mortgage insurance might be available only if loans meet certain requirements, such as a maximum LTV ratio, a maximum size and a maximum loan to income ratio.

Supervision of the interest rate risk

The prudential supervision and capital requirements for banks also need to recognise any interest rate risk that the lender takes. In theory, a bank can take no interest rate risk either by –

- Making fixed rate loans funded by fixed rate liabilities of the same maturity. For example, 25 year loans would be funded by 25 year bonds, five year loans by five year bonds or deposits, etc.
- Making variable rate loans funded by variable rate deposits, that is the rate of interest on loans can be increased at any time in line with the increase in the cost of deposits. In some systems, the lender has discretion as to when, and by how much, to change interest rates with the market providing the necessary protection to borrowers. In other systems interest rates must be tied to a cost of funds index.

In practice, however, a lender cannot entirely eliminate interest rate risk whichever system it uses. Fixed rate loans present a risk when interest rates fall. If the borrower has the right to redeem the loan at any time without penalty or with a penalty that does not reflect the loss that the lender could incur then the lender carries a substantial risk. Even if the borrower cannot redeem there is an increased default risk if interest rates fall as borrowers may refuse to continue paying what they see as an above market interest rate. This particular risk is reduced the more stable the general level of interest rates. The lender can also reduce the risk by limiting the period for which a rate is fixed. For example, a loan can be for a fixed rate for five years, the borrower then having the option of rolling over the loan into another fixed rate loan or a variable rate loan. However, the lender may suffer the same risk as the variable rate lender if interest rates rise rapidly over this five year period.

With variable rate loans the risk of default is increased if interest rates rise rapidly as borrowers may be unable or unwilling to meet the higher repayments. To a limited extent, lenders can mitigate the effects of higher interest rates by extending the loan term. Again, in a stable economy with relatively stable interest rates this risk is reduced.

Generally, long term lending of any form is risky in an economy where interest rates are unstable. Short of government guarantees (for example compensating lenders when borrowers prepay long term loans in response to an interest rate fall) there is no means of isolating totally lending institutions from interest rate risks in respect of long term residential mortgage lending. Beyond the obvious points (such as not allowing long term loans to be made without long term liabilities to back them) banks and regulators must look to the stability of interest rates generally and managing the resulting risk. In an unstable environment, particularly one characterised by a high rate of inflation and correspondingly high interest rates, banks (and their supervisors) may decide that it is imprudent to make any loan with a maturity of more than three or five years. In these circumstances, to the extent that banks finance house purchase at all they do so through a succession of short term loans, although the borrower can never be certain that the next loan will be forthcoming.

Term mismatch

At first sight lending for say 25 years requires matching liabilities. However, in practice the demand for long term mortgage loans far exceeds the availability of long term funding. Any mismatch can be managed in one of two ways. The first is through use of the variable rate mortgage which enables banks to respond to an upward movement in interest rates by increasing their mortgage rates rather than being un-competitive and facing a liquidity crisis as deposits are withdrawn. The second is for there to be a limit on the proportion of short term deposits that can be used to fund long term loans. In practice, perhaps 80% of retail deposits are fairly stable so using 15 – 20% to fund long term loans may well be regarded as safe, particularly if variable rates are used.

Loan loss provision

There is scope for alternative practices in respect of loan loss provision, much depending on the state of development of the mortgage market. In a mature market a bank may be permitted to establish its own loss provision based on its actual record. Typically, a bank will review the whole of its lending portfolio and make a bulk provision, rather than a bottom-up approach based on individual loans. However, a supervisor should permit this approach only if it is confident that the bank is being realistic and that its track record is reliable in respect of forecasting actual losses. In a developing market a supervisor should take a more interventionist approach with some broad requirements, generally relating to loans that are so many days in arrears and properties in possession. It is important that these rules do not become too detailed and restrictive such as to deter banks from making residential mortgage loans or restructuring those loans subsequently. For example, it is inappropriate to require provisions (even if zero) to be made for every single loan given that the loans can be categorised into broad groups quite sufficient for the purposes of provisioning. The supervisor's main objective must be to ensure that there are systems in place so that banks know the status of all their loans and make reasonable provisions. The role of auditing is important here.

Supervision of lending by non-banks

The purpose of the supervisory mechanism outlined in the previous sections is to protect bank depositors by ensuring that banks are well capitalised for the nature of their

business. The purpose of international harmonisation of the rules is to prevent regulatory arbitrage, that is banks locating their business in territories with a favourable regulatory regime and thereby being able to compete unfairly in markets where the domestically based institutions are subject to more stringent regulation.

Should non-bank mortgage lenders be subject to the same prudential requirements as banks? (This is a quite separate issue from any requirements to protect the borrower, for example in respect of the information they must be given and the arrangements under which possession may be taken. These requirements should apply to all mortgage loans.) The answer depends on the nature of the lender.

If the non-bank lender is a private institution in which banks do not have an interest there is no case for prudential regulations applying because there are no depositors to protect. However any bank lending to such institutions should be treated like other bank loans, with a 100% risk weighting and subject to rules in respect of large exposures, concentration of risk etc. If the funding is through the securities market then the institution must comply with the requirements of the securities regulator. In practice, few such private organisations exist. Where they do they are generally engaged in secondary market activity. Their funders are likely to require them to match some of banking regulator's requirements, for example in respect to loan to value ratio and concentration of risk. Where mortgage insurance exists the insurer will have the same requirements for loans regardless of whether they are made by a bank or a non-bank.

Where a non-bank lender is owned by a bank or a group of banks the activities of the lender should be consolidated with the parent bank. There may be sound business reasons why a bank prefers to undertake some or all of its residential mortgage lending through a subsidiary which is not itself a deposit-taker; avoiding regulatory requirements is not a sound business reason. The rules on consolidation must prevent such arbitrage. For example, not requiring consolidation unless the bank's holding is at least 40% of the total equity of the non-bank gives obvious scope for arbitrage.

Supervision of mortgage lending by non-banks is most crucial in respect of state owned mortgage banks. These have been created in many emerging markets, with almost universal adverse effects. The banks exist only because of a state guarantee and generally they have access to funds from the state budget. Such banks invariably lend to the middle classes and are often inefficient. They compete unfairly with private institutions and thereby hinder the development of a private and sustainable mortgage market.

There is a case for state mortgage banks to help develop a mortgage market where none previously existed, and in any event policy cannot wish away those banks that already exist. The longer term objective must be to abolish or privatise such banks. In the meantime the supervisory regime applying to commercial banks should be applied equally to them. This prevents unfair competition with private banks and is justifiable in its own right through helping to secure more effective and transparent management of the banks. It also helps the banks put themselves in a position that will enable them to operate effectively when cut off from state support if that is feasible.

Appendix 2

Mortgage insurance

Mortgage insurance is a specialist form of credit insurance which provides protection to the lender. In the event of a borrower defaulting on their loan and the property being taken into possession and sold but not at a price sufficient to cover the outstanding debt and costs then the insurance policy pays out to the lender. One form is for the "top slice" of the loan to be insured, that is, for example, any amount in excess of say 70% of the valuation. An alternative is for a proportion of the whole loss to be met by the insurance company.

Mortgage insurance schemes can take various forms but a common feature of most schemes now, particularly after substantial losses were incurred on mortgage insurance business in the 1990s, is an element of co-insurance whereby the lender assumes some of the risk.

Most mortgage insurance, even in industrialised countries with sophisticated financial systems, is provided by specialist government agencies. These were often established in difficult and different circumstances when an element of government "pump priming" was needed to help a mortgage market develop. It proves very difficult in practice for such institutions to divest themselves of their business even when they are able to do so.

In a few countries, notably the United Kingdom, mortgage insurance is provided by the major insurance companies. In the past this insurance has often been tied in with other forms of insurance, for example insurance of the houses being mortgaged.

In America, in particular, there are a number of specialist private insurance companies, which are now seeking to operate internationally.

Mortgage insurers do not simply accept the risk that is presented to them by the lender, although a number did in the past with serious consequences. As a condition of insuring loans, the mortgage insurer will normally insist that a number of criteria must be met, for example –

- A maximum loan to value ratio.
- A maximum loan to income ratio.
- The property meeting defined characteristics, for example in relation to the type of construction.
- The borrower should not previously have defaulted on a loan.
- A reasonable spread of loans in respect of type of property and location.
- A protocol according to which accounts are serviced.
- The provision of data on lending and prompt notification of loans falling into arrears.

The annex sets out the criteria currently used by the Canada Housing and Mortgage Corporation to illustrate these points.

Mortgage insurance, if properly managed, can offer considerable benefits to the lender and to those purchasing houses. The lenders will be able to offer either a greater volume of lending or more high percentage loans than would otherwise be the case because the risk that they face is reduced.

The criteria imposed by the mortgage insurers impose an element of external discipline on the lenders that can help prevent them making bad loans and ensure that they are run in a sound way.

The criteria established by mortgage insurers become generally accepted as standard lending criteria. They may be used, for example, by regulators to determine which loans qualify for reduced capital backing. Where there is any form of secondary market then the criteria are likely to determine the loans that qualify to be sold or to be securitised.

Mortgage insurance facilitates the collection, analysis and dissemination of data on mortgage lending, in particular the relative risks of particular types of loan characteristic or borrower. In many countries it is the mortgage insurers who often provide most of the key data about the operation of the mortgage market. The best example of this is the Canada Mortgage and Housing Corporation, originally established as a mortgage insurer and which now is the source of data on the housing market.

However, being in the mortgage insurance business also carries risks. The business must be treated as insurance, subject to the disciplines that apply to other insurance companies. The business must be properly underwritten and the premium charged to the lenders must be a fair reflection of the risk of the business being taken on. Where mortgage insurance is given too easily then this is likely to facilitate bad lending, ultimately at a significant cost to the insurer. Where the insurer is a government agency there is a temptation, often not resisted, to use mortgage insurance as a weapon to require mortgage lenders to behave in a way that is not commercial or prudentially sound. For example, mortgage insurance might be made available on favourable terms in respect of a particularly risky group of borrowers for political reasons. Lenders may find that if they wish to do business they have no choice but to do the business that the mortgage insurers want even if in their own minds they know that it is not sound.

For a country developing a housing finance system, mortgage insurance can play a useful part. It is the one area where government intervention is required and can be provided at a reasonable cost in a way that is even handed and not distortive of competition, provided of course that the risk business is run on sound insurance lines.

Annex

CMHC requirements
Set out below are the requirements to qualify for Canada Mortgage and Housing Corporation homeowner mortgage loan insurance –

- 1-4 units, one of which must be occupied by the borrower.
- 95% maximum loan to value ratio for single units, falling to 90% for 3-4 units.
- An interest rate which falls within certain criteria in relation to the lender's "posted rate".
- A maximum loan period of 25 years.
- Housing costs must not exceed more than 32% of gross household income.
- For new buildings, the builder must be registered with a home warrantee provider.
- There are maximum house prices where the loan to value ratio exceeds 90%.

The standard application fee is $165. The premium is linked to the loan to value ratio reflecting historical experience that the higher the loan to value ratio the greater the risk of default. The premium on the total loan is 0.5% for loans up to 65% of valuation, then rising steadily to reach 3.25% for loans between 90% and 95% of valuation.

Appendix 3

Comparator countries

Introduction
This appendix briefly compares the current housing finance mechanism in Uganda with those in comparative countries. No original research has been undertaken in those countries; rather the analysis draws on published information.

The comparative countries selected are Kenya, Tanzania, Ghana, Malawi and Zambia, each of which was formerly a British colony and which share some of the history in relation to housing finance but also generally similar problems.

Population, income and housing data
The table below shows comparative data for the five countries and Uganda.

Comparator countries

	Population 2002 m	Urban population as % of total	Per capita PPP NI 2003 $	Access to sanitation 2000 %	Access to safe water 2000 %
Uganda	23	14	1,440	77	52
Kenya	31	35	1,020	87	57
Tanzania	35	34	610	90	68
Ghana	20	37	2,200	72	73
Malawi	11	16	600	76	57
Zambia	10	40	850	78	64

Source: 2004 World Development Indicators database, World Bank.

On a purchasing power parity basis, Uganda is richer than Kenya and significantly better off than Tanzania and Malawi, although not as well off as Ghana. One of the few available pieces of data on housing, that is access to safe water and sanitation, shows Uganda as being marginally below average. However this can largely be explained by the low level of urbanisation in Uganda. For example, in urban areas access to water supply in Uganda was 85% compared to an average of 90% for the other countries.

There is little other comparative housing data. However, Knight Frank (2004), the property consultants, has published information on comparable prime residential rents which perhaps confirm the strength of the rental market in Kampala. The average figure for Johannesburg and Kampala was $4,000 a month, compared with $3,000 in Darr es Salaam, $2,600 in Nairobi, $2,200 in Lusaka and $800 in Blantyre.

On social indicators, Uganda is on a par with the comparator countries.

Sub-Saharan Africa: social indicators

Region/country	Infant mortality rate (per 1,000 live births) 2000	Under-five mortality rate (per 1,000) 2000	Life expectancy at birth (years) 2000	Combined gross enrolment rate, primary, secondary, and tertiary (%) 1999	Adult literacy rate, ages 15 and older (%) 2000
Sub-Saharan Africa	107	174	48.7	42	61.5
Uganda	81	127	44.0	45	67.1
Ghana	58	102	56.8	42	71.5
Kenya	77	120	50.8	51	82.4
Nigeria	110	184	51.7	45	63.9
Tanzania	104	165	51.1	32	75.1
Zambia	112	202	41.4	49	78.1
Zimbabwe	73	117	42.9	65	88.7

Source: UNDP (2002).

Comparative data on the depth of financial markets is shown in the following table.

Financial depth and efficiency 2002

Country	Domestic credit by banks/GDP %	Liquid liabilities/GDP %	Interest rate spread %	Risk premium on lending %
Ghana	31.9	30.7		
Kenya	43.2	42.6	13.0	9.5
Malawi	14.3	16.2	8.1	8.8
Tanzania	10.0	23.0	13.1	12.9
Uganda	15.4	20.2	13.5	13.2
Zambia	58.7	61.3	18.1	8.0
Sub Saharan Africa	65.5	36.2	13.0	
Middle income countries	82.9	79.0	6.7	
High income countries	168.5	105.6	3.8	3.5
World	**150.7**	**97.5**	**3.7**	

Source: 2004 World Development Indicators 04, World Bank.

In respect of financial depth Uganda is well below the Sub-Saharan average and particularly well below Kenya. However, it is on a par with Tanzania. The interest rate spread and risk premium on lending in Uganda are on a par with those in the comparator

countries. The table also illustrates the strong correlation between the interest rate spread and the wealth of a country. Other data shows a similar position.

Interest rates, spreads and margins

	Real lending rate %	Real deposit rate %	Interest spread %	Overheads %	Interest margin %
Kenya	16.5	3.5	13.0	6.1	9.1
Uganda	19.4	5.9	13.5	7.9	12.7
Tanzania	12.0	-1.2	13.1	6.9	7.5
Zambia				9.8	13.1
Malawi				7.9	12.7
Sub-Saharan Africa	9.9	-1.5	11.5		8.1
Low-income countries	10.8	-1.6	12.4		7.8
OECD countries	4.6	0.5	4.1		3.6

Source: Beck and Fuchs (2004) and World Bank Financial Structure Database.

Real lending (deposit) interest rates are the difference between average lending (deposit) interest rates for 2002 and the log of CPI inflation for 2002. The interest spread is the difference between deposit and lending rates. The net interest margins is the net interest revenue relative to total earning assets; data are from the World Bank Financial Structure Database based on raw data from Bankscope, for 2001.

Uganda scores very well in respect of legal requirements. The following table relates to the business climate but is indicative of the position generally.

Cost of doing business

	Informal economy (% of GNI)	**Cost of registering property (% of property per capita)**	**Cost to create collateral (% of income per capita)**	**Cost of enforcing contracts (% of debt)**
Uganda	43.1	5.5	11.9	22.3
Kenya	34.3	4.0	3.3	41.3
Tanzania	58.3	12.6	21.3	35.3
Ghana	38.4	4.1	37.9	14.4
Zambia	48.9	9.2	19.2	28.7
Sub-Saharan Africa	42.3	13.2	41.8	43.0

Source: *Doing Business*, World Bank, 2004.

Uwe Lohse, in a 2002 paper for UN-Habitat, commented on the shared characteristics of housing finance markets in Sub-Saharan Africa –

> "In many countries public sector housing finance institutions have been established as instruments of national housing policy. Often their declared purpose was to finance housing developments for the lower income groups, in most cases those specialised institutions were excluded from other finance intermediation services, that is, were not able to take deposits, but depended on government funding for their financial resources. Some were able to issue bonds – with government guarantees and sometimes with special tax exemption.
>
> Economic stabilisation programmes to reduce budget deficits lead to the reduction of subsidies to housing finance institutions, which in some countries closed down, eg Tanzania's National Housing Bank.
>
> In many of the former British colonies in Africa the housing finance system was based on the building society model. These still form an important part of the housing finance systems in Kenya, Zambia and Zimbabwe."

Lohse also makes the point that housing development corporations have offered limited long term mortgage loans for buyers of their own developments and that commercial banks and other finance companies have sometimes "ventured into offering mortgage lending, however, have not found it lucrative and have, in many cases restricted, housing loans to good customers and to employees".

Kenya
The Housing Finance Company of Kenya (generally known as Housing Finance) is the largest specialist lender in Kenya. It has a housebuilding subsidiary – the Kenya Building Society. It was established in 1965. It is a public company; CDC has 30.4% of the shares, private investors 62.3% and the government 7.3%.

HFCK will make loans for house purchase of up to 80% of valuation for up to 15 years. Where loans are made to companies then all the directors must provide a guarantee. Loans for the purchase of a plot are for a maximum of 50% of valuation and are repayable over 2 years.

The accounts for 30 June 2004 show total assets of £s10.3bn ($127m) of which loans account for £s6.8bn ($84m). Customer deposits total £s9.5bn ($118m). The accounts seem to show non-performing loans of £s4.2bn ($52m).

Zambia
There are three specialist housing institutions in Zambia, all building societies, with the Zambia National Building Society having the bulk of the business. However, in total they are very small with just 1,500 active accounts. Between 1985 and 2000 the mortgage rate varied from 20% to 90%.

Ghana
The First Ghana Building Society has taken a declining share of overall business. The dominant lender is the Home Finance Company (HFC), which has succeeded in reaching

lower income borrowers to some extent through devices such as graduated payment mortgage and incremental mortgages. HFC was originally conceived to operate as a secondary mortgage institution that would be a catalyst to stimulate primary mortgage lending by banks the government taking up to 90% of the default risk. In practice, however, the market has not worked like this. Rather it has become a primary lender and also has a mortgage origination and servicing role. It provides construction finance as well as finance to home buyers. The company is listed on the Ghana Stock Exchange.

The bank assets to GDP ratio was 39% at end-2002. The level of financial intermediation in the economy was low by the standards of Sub-Saharan Africa. M2 as a share of GDP was 19% in 2002. At the end of 2002, commercial banks accounted for 73% of financial sector assets; insurance companies for 18%, and for other non-bank financial institutions 6%. The two building societies with eight branches had financial assets of just 11 billion cedi, 0.7% of financial sector assets, while the Home Finance Company had assets of 345 billion cedi, 1.3% of financial sector assets.

It is worth quoting the IMF Ghana Financial System Stability Assessment Update 2003 in respect of housing finance –

> "Most lenders have shied away from providing housing finance, leaving Home Finance Company (HFC) as practically the only financial institution supplying mortgages. Discussions with stakeholders suggest that the reluctance of banks and other lenders to engage in housing finance reflects: (i) the poor macroeconomic policy environment, which has led many lenders to invest instead in high-yielding treasury bills; (ii) a weak property title system and inefficient foreclosure processes; (iii) weak institutional arrangements, with six ill-coordinated, yet interdependent agencies, and the effective absence of the dispute resolution bodies provided by the law; and (iv) poor management by the government of the land it owns or manages as a fiduciary agent of customary owners. The authorities were encouraged to extend the favourable legal framework that governs HFC's lending to other potential mortgage lenders, such as banks, to encourage more lending to this sector, and to reduce import duties on construction goods to lower the cost of building housing."

Tanzania

The Tanzania Housing Bank was created in 1973 and became the sole source of formal housing finance. Notwithstanding the intention, it was able to lend only to a marginal extent to low income groups and its activities declined over the years as building costs and interest rates increased. The Bank was liquidated in 1995. There is currently no formal finance for housing in Tanzania.

The IMF Financial System Stability Assessment August 2003 comments on the banking system in Tanzania. It is noted that credit to the private sector remains very small and mostly short term, interest rate spreads are high and banks accumulate extensive holdings of government paper and sizeable offshore dollar placements. However, the banks are liquid, well capitalised and resilient to most shocks. It is suggested that banks would be able to endure a significant reduction of interest spread.

Banks account for about 80% of the financial system's assets but bank deposits are only 14% of GDP and bank credit to the private sector at about 6% of GDP is among the lowest is Sun-Saharan Africa. The spread between bank lending and deposit rates is around 11-12%.

Only 6.4% of the population has a savings or a current account, down from 18% a decade earlier.

The report concludes that the Tanzanian financial sector performs only a very limited role in the economy even by Sub-Saharan African standards and suggests an urgent need to strengthen market foundations. It is noted that a Land Act was introduced in 1999 and while it contained significant advances it was flawed in respect of the availability of mortgage based finance. The report comments: "Because of bankers' caution, as well as the collateralisation requirements of the BOT, mortgages remain important in Tanzanian banking, even where the main assurance of creditworthiness is the expected cash flow of the business. The Land Act 1999 altered the position with regard to mortgages in several important ways, which impede the development of mortgage lending. It appears, however, that most of the main problems are technical and can be resolved without compromising other (social) goals."

The report interestingly is silent on housing finance reflecting the lack of any formal housing finance system in the economy.

The report includes a useful analysis of a survey showing how households and enterprises make extensive use of informal mechanisms. The vast majority of households hold savings in some form. Awareness of the use of bank deposit services is higher than in comparable countries, larger because of the extensive networks of TPB and NMB. Physical forms of saving dominate the asset portfolios of households. The survey points to deficiencies in bank deposit services such as negative real returns and poor service. The proliferation of microfinance programmes has improved access to formal credit. Access to credit however remains limited.

Appendix 4

The project

The terms of reference of the project were –

- To examine the current state of housing finance mechanisms in Uganda and evaluate them against a benchmark of a fully functioning housing finance system.
- To identify constraints and impediments to the development of a modern day system.
- To make recommendations for a proper housing finance policy that will eliminate or minimize the effects of these impediments and provide a comprehensive solution that will reduce government involvement, cause the private sector to increase its investment and involvement in this area, and introduce international standards of practice and transparency.

Methodology

The project was undertaken as follows –

- A review of literature on housing finance markets in emerging economies and relevant developments in Uganda.
- A visit to Kampala from 1 – 6 September 2004 which included meetings with a wide range of relevant people from government departments, the Bank of Uganda, the National Social Security Fund, commercial banks, developers and real estate agents.
- Preparation of the report taking into account comments and reactions of interested parties.

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Appendix 6

The author

Mark Boleat has over 25 years' experience in trade associations in the housing and finance sectors in the United Kingdom. Between 1986 and 1993 he was Director General of the Building Societies Association. During this time he was responsible for a demerger which created the Council of Mortgage Lenders, of which he was also Director General, and he was Secretary General of the International Housing Finance Union and Managing Director of the European Federation of Building Societies from 1986 to 1989. From 1993 to 1999 he was Director General of the Association of British Insurers, the largest trade association in Britain.

He has chaired one of the largest housing associations (organisations which provide subsidized rental housing) in Britain and for five years was a member of the Board of the Housing Corporation, which funds and regulates housing associations.

Mark Boleat is the author of the first ever study of housing finance at the international level *National Housing Finance Systems: A Comparative Study* (1986) and he was the founder editor of *Housing Finance International* (1986 – 89). He has undertaken consultancy work on housing finance for the World Bank, the International Finance Corporation, the OECD, the United Nations, the Government of Jersey and major banking institutions.

He has also published a number of books on trade associations including *Trade Association Strategy and Management* (1996) and *Managing Trade Associations* (2003) and has undertaken consultancy projects for British and European associations.

Mark Boleat is a director of Countryside Properties (a large British housebuilder and developer) and the Comino Group (a software company) and has previously been a director of three life insurance companies. He is also a member of the Gibraltar Financial Services Commission, the British National Consumer Council and the Court of Common Council of the City of London.

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