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THE RELATIONSHIP BETWEEN MORTGAGE FINANCE AND REAL ESTATE DEVELOPMENT IN KENYA

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Abstract

Real estate investment plays a crucial role in providing employment opportunities, offering shelter to households, enhancing income distribution and alleviating poverty. One of the most important factors in real estate development, world over, is its financing. Unlike the developed countries that use stocks and bonds, financing of real estate developments in Kenya is predominantly through mortgage financing. This study will seek to find out the relationship between mortgage financing and real estate development in Kenya. This study will adopt an explanatory research design by review of the literature.

Keywords: Mortgage Finance, Mortgage Repayment Schedules, Mortgage Interest Rate, Real Estate Development.

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1.0 Introduction

Real estate investment plays crucial role in providing employment opportunities, offering shelter to households, enhancing income distribution and alleviating poverty. Mortgage finance refers to a loan secured by collateral of some specified real estate property that the borrower is obliged to pay back with predetermined set of installments. The loan is usually for the purchase or construction of housing estates by individuals or companies (Krainer, 2009). According to Pittman (2008), obtaining a mortgage in today's mortgage market is a complicated process as it involves many procedures like identifying the best service provider with the best interest rates.

In the last decade, Kenya's real estate has been anything but robust. The construction sector is approximated to have created 82,000 private sector jobs in 2010. Real estate has been one of Kenya's fastest growing sectors over the last decade, fuelled by a burgeoning middle class with higher disposable incomes. Returns on investments in the sector have easily outpaced those of equities and government securities (Oremo, 2012). For instance, in 2012, the value of Nairobi's prime real estate grew by 25% while at the Kenyan coast it went up by 20% outdoing other major cities like Miami (19.1%), London (12.1%), Moscow (9.8%), New York (3.1 %), Shanghai (-3.4%) and Singapore (-4.7%) (Central Bank of Kenya, 2013).

The cost of mortgage loans is out of reach for the majority of middle-class Kenyans and compares poorly with peer countries in Africa, a new report by the Centre for Affordable Housing Finance in Africa (CAHF) has showed. The Africa Housing Finance Yearbook 2012 by CAHF, a non-governmental organisation, says that "owning a house is still a pipe dream for a majority of middle class Kenyans. Only about 11 per cent of Kenyans earn enough to support a mortgage. This means that most middle-income earners cannot afford an average mortgage necessary to buy an entry-level house," says the report. Despite the boom in Kenya's real estate sector, however, mortgage finance is still accessible to only a small majority of the Kenyan population, adversely affecting real estate development in the country (Walley, 2011).

1.2 Objectives of the study

The objectives of the study will be:

i) To determine the extent to which mortgage financing affect real estate development in Kenya

ii) To evaluate the effect of mortgage repayment schedules on the real estate development in Kenya

2.0 Literature review

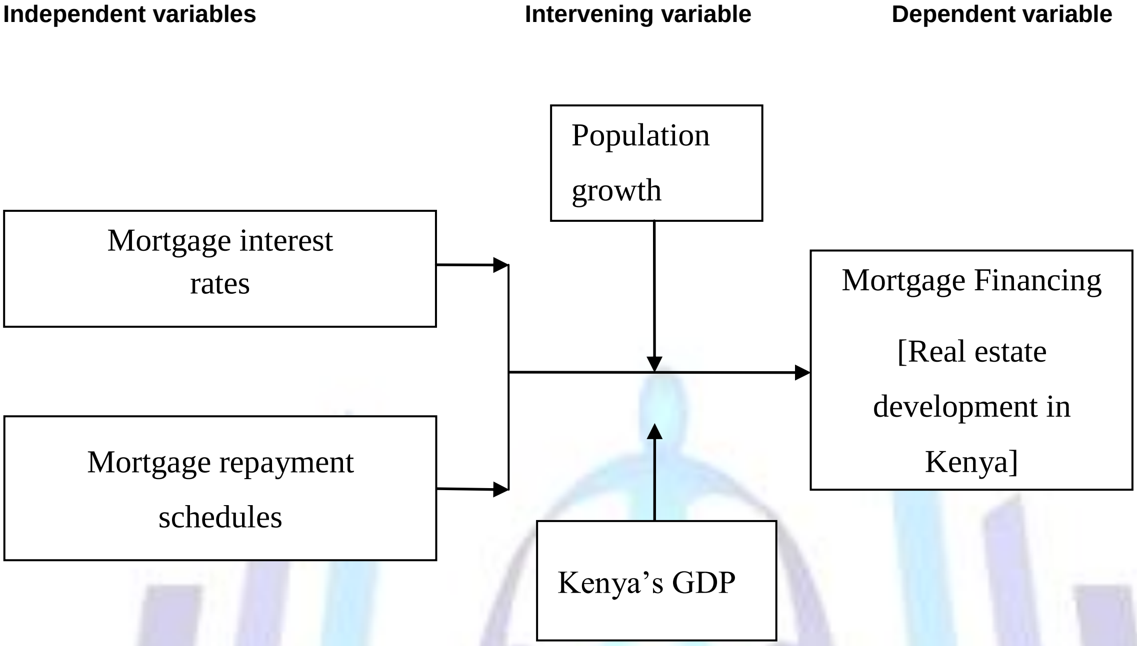
2.1 Theoretical review

The study will be based on 3 theories namely Theory of Price, Interest Rates Theory and Theory of Financial Intermediation. These theories assert that the market price reflects interaction between two opposing considerations. They contend that the price for any specific good/service is the relationship between the forces of supply and demand. On one side are demand considerations based on marginal utility, while on the other side are supply considerations based on marginal cost. An equilibrium price is supposed to be at once equal to marginal utility from the buyer's side and marginal cost from the seller's side (Kuttner, 2012). According to Hahn (1982), changes in interest rates affect the overall expense of borrowing and thus expenditures undertaken with the borrowed funds. Higher interest rates tend to decrease expenditures and lower interest rates lead to an increase in expenditures. The expense of borrowing these funds depends on interest rates. Higher interest rates can add to the overall cost of these expenditures. Lower interest rates can reduce the overall cost of these expenditures. This means that changes in interest rates can induce changes in consumption and investment spending, and thus aggregate demand. The main reason for the existence of financial intermediaries is risk management, liquidity and credit evaluation. They act as a link between suppliers of funds (the depositors) and borrowers of mortgage loans. They also help distribute funds in a nation by transferring funds from those parts that have surplus to the areas that need to borrow (Coles & Boleat, 2012).

2.2 Conceptual framework

The dependent variable in this study will be real estate development in Kenya. The real estate development in Kenya is influenced by several factors that constitute the study's independent variables. Based on the literature review, the independent variables of the study will include; mortgage interest rates and mortgage repayment schedules. The study's intervening variables will be the country's GDP and population growth.

Fig 1 Conceptual Framework



2.3 Empirical review

2.3.1 Mortgage interest rates and real estate development

The Central Bank of Kenya (CBK) uses its power to change certain key interest rates as a way of controlling economic growth. When the CBK raises the prime rate, often to curb inflation and slow the growth of the economy, mortgage rates rise as a result. On the other hand, when the CBK slashes interest rates to stimulate growth, mortgage rates have a tendency to drop, making them more affordable to investors, thus increasing investment (Walley, 2011). According to Doms, Furlong & Krainer (2007), "interest rates are the single most critical factor in driving the mortgage market and access to more middle income housing." By influencing the interest rate structure that prevails in Kenya's financial system, changes in monetary policy therefore affect the interest rates that prevail in the mortgage market. Lenders are able to blend funds and partly use their deposit bases, capital and other funding sources to achieve a lower cost of funds, but over the long term the net interest margin will have to reduce if access to mortgage finance is to improve.

Leah (2012) cites funding as one of the major cost driver for the developers of houses who in turn have to recoup the same from the final buyers of the houses by charging high prices. Memon (2010) supported this finding and stated that in house development, availability and cost of long term funding, as reflected through mortgage interest rates, has a major influence on the final cost of the house. AfDB (2013) research findings supported this position in the Kenyan context by confirming that there are only a handful of private developers in Kenya that can afford to finance medium to large scale developments of 200 units and above for middle to low income segments. Financing cost is therefore one of the key obstacles for the development of large scale real estate developments and forms part of the final cost of the house. Interest rates chargeable on mortgages influence the mortgage quality in that the higher the interest the more expensive the mortgage product becomes, and the more susceptible to defaults due to high repayment costs. Low interest rates on the other hand encourage compliance and prompt repayment thus guaranteeing quality products.

According to Omengo (2012), high interest rates in Kenya are hurting real estate investment. Interest is a cost to the developer of real estate as it is to the end buyer. He noted that over the years, the Central Bank of Kenya (CBK) has increased the Central Bank Rate (CBR) from 7% to 18% in an effort to tame runaway inflation and stabilise the weakening shilling. Consequently commercial banks have increased their lending rates from as low as 11% to between 20%-25%. High interest rates in Kenya mean that ongoing projects will cost more when finally delivered. This will be due to higher costs of material, labour and most importantly the cost of construction money. Halting or delaying work in progress would only escalate the costs further. Developers usually pass the increased costs to buyers in the form of higher prices. Should they fail to do so, they will have to do with drastically reduced profits or suffer loses. Since, high interest rates also translate into expensive mortgages; new investors are likely to shy away from real estate investment resulting in low investment.

Interest rates have a major impact on the real estate markets. Changes in interest rates can greatly influence a person's ability to purchase a residential property. That is because as the interest rates fall, the cost to obtain a mortgage to buy a home decreases, which creates a higher demand for real estate, which pushes prices up. Conversely, as interest rates rise, the cost to obtain a mortgage increases, thus lowering demand and prices of real estate. However, when looking at the impact of interest rates on an equity investment such as a real estate investment trust (REIT), rather than on residential real estate, the relationship can be thought of as similar to a bond's relationship with interest rates. When interest rates decline, the value of a bond goes up because its coupon rate becomes more desirable, and when interest rates increase, the value of bonds decrease. Similarly, when the interest rate decreases in the market, REITs' high yields become more attractive and their value goes up. When interest rates increase, the yield on an REITs becomes less attractive and it pushes their value down (Nguyen, 2011).

2.3.2 Mortgage repayment schedules and real estate development

According to McDonald & Thornton (2008) mortgage repayment is simply how the loan is to be repaid over a given period of time. The loan is repaid in fixed periodic payments usually monthly. The repayment period usually varies from country to country. For example in the USA; it could be between 15-30 years, UK can be between 15-20 years. The mode of paying back the mortgage can be scheduled mortgage payment, prepaying through refinancing or resale, delinquency, and foreclosure (McCarthy & Peach, 2002). In Kenya one of the most important factors considered in appraising viability of a mortgage application is the capability of the borrower to repay their mortgage.

According to Ball (2003), while there are many aspects to the housing market, he argued that the provision of housing finance is a binding constraint that must be addressed before the market can sustainably provide adequate housing. He noted that even in the best of environments, housing is a major purchase-average home prices typically range from 4 times annual income in developed countries to 8 times annual income in emerging economies-that is affordable only when payments can be spread out over time. He therefore asserted that longer repayment periods of mortgage finance allow the investors time to recoup their investment, which promotes the growth of the real estate sector.

According to the Central Bank of Kenya Mortgage Finance Survey (2010), mortgage by its very nature is a long term investment that will involve credit agreements spanning from 5 years to 30 years. To be able to properly finance such contractual agreements, Mortgage Finance Institutions (MFIs) need ready market to provide them with longer term funds that they can in turn use to invest in properties and provide the market with mortgage products. Lack of long-term finance implies that the institutions will not be in a position to finance construction of new properties and thus the mortgage market will reduce or shrink as the providers of funds will not be in a position to offer the public long term finance if they are unable to access it. According to Adjonyoh (2007) in Ghana, lack of access to long term capital is a major barrier to real estate delivery. Even though the government policies recognizes the private sector's dominant role in housing provision, the banks have short term funding and unable to lend on medium or long-term bases, thus crippling the real estate industry.

2.4 Summary of literature

Topic	**Objective**	**Findings and Recommendations**
The effect of financing sources on real estate development in Kenya by Joseph Kamau Mwathi (2013)	To establish the source of financing real estate in Kenya	The study found out that mortgage financing is the most used source of financing, with equity and venture capital being the least source of financing used. The study recommended that further research should be carried out on the effects of sources of financing in unsuitable economic conditions, political instability and a global economic crisis and on the internal and external factors that affect the decision on sources of financing for real estate firms in Kenya
The effect of real estate finance on financial performance of commercial banks listed on the Nairobi Securities Exchange by Linet Anne Akinyi Ojiambo (2014)	to determine the effect of real estate finance on financial Performance of commercial banks listed on the Nairobi Securities Exchange	The major finding of the study was that mortgage finance had a strong negative effect on the financial performance of listed commercial banks in Kenya The study recommended that a study should be conducted to examine how mortgage finance can be used to improve the financial performance of banks in Kenya
Factors influencing performance of mortgage financing among commercial banks in Kisii town, Kenya by Jared Ondong'i Makori (2015)	to examine the factors influencing performance of mortgage financing among commercial banks In Kisii town, Kenya	The study established that employment status of clients affected mortgage financing among banks. The study recommendation was that banks should seek ways to identify

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		various risks they face in lending to the borrower; this would help them to determine their interest rates
Determinants of house construction cost in Kenya: a case of Nairobi County by Samuel K. Moko and Prof. Washington H.A. Olima (2014)	to establish the determinants of house construction cost in Nairobi County	The study found out that land, building materials and infrastructure had the most influence on the housing cost in Nairobi Kenya The study recommended that the government should offer incentives and create an enabling regulatory and business environment to private sector participation and adoption of new alternatives in building technologies by the professionals in the housing sector
The effect of interest rates volatility on the growth of real estate market in Kenya by Nelson Murage Muriuki (2013)	to establish the effect of interest rates on growth of real estate market in Kenya	The study found out that the interest market has experienced low volatility. Thus, volatility in the interest market is predictable, at least in the short run. It recommended that investors should consider investing in the real estate market despite the erratic interest rates
Strategies for financing real estate development in Ghana by Benjamin Appia-gyei Nkyi (2012)	To contribute to a better understanding of the financial practices and problems on the growth of real estate firms in Ghana	The major study finding was that the major financial sources of real estate finance in Ghana are retained profits and advance deposits with former as the main finance acquisition pattern In its recommendation, it noted that substantial progress could be made if policies are made to ensure the establishment of more diverse lending institutions, publicly or privately to encourage healthy competitions to make the scheme more accessible
The Role of Secondary Mortgage Facility in expanding the availability of funds for Mortgage Finance in Nigeria by Ayodele Olubunmi Ojo (2009)	To review the role secondary markets can play in expanding the availability of funds for housing in Nigeria	The study established that building and owning a home in Nigeria has become increasingly difficult over the years as a result of prohibitive terms of credit facilities offered by banks and the limitation on loan-able funds available from the apex mortgage banking institution In its recommendation, the study noted that the existence of a viable primary market is indispensable to the development of an effective mortgage finance industry
Financing alternatives for small real estate developers in China: A case study of Guangzhou by Min Liu (2011)	To explore some new financing options for the small and medium commercial real estate developed in China	The study found out that native bank loans, self-funded option and stock right cooperation are the main financing options for small and medium commercial real estate companies in China The study recommended mezzanine financing as a good choice for commercial real estate financing

2.4.1 Conclusion and Recommendation

From the studies conducted, it is evident that mortgage financing is the most used source of financing for real estate development in majority of the countries. However, there is mixed evidence from the various studies about the effect of

ISSN 2321-1091

mortgage financing on the performance of real estate investment. Few researches have been conducted on the area of mortgage financing especially on real estate development in Kenya and mostly have showed mixed findings on the nature of relationship between interest rate and loan repayment terms and the real estate development. It is paramount for mortgage financiers, investors, the government and researchers to understand how mortgage financing affects the real estate development. Hence, further research is required on the subject. This study thus will seek to establish the relationship between mortgage financing and real estate development in Kenya.

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