Why are interest rates on housing finance so high in Africa?

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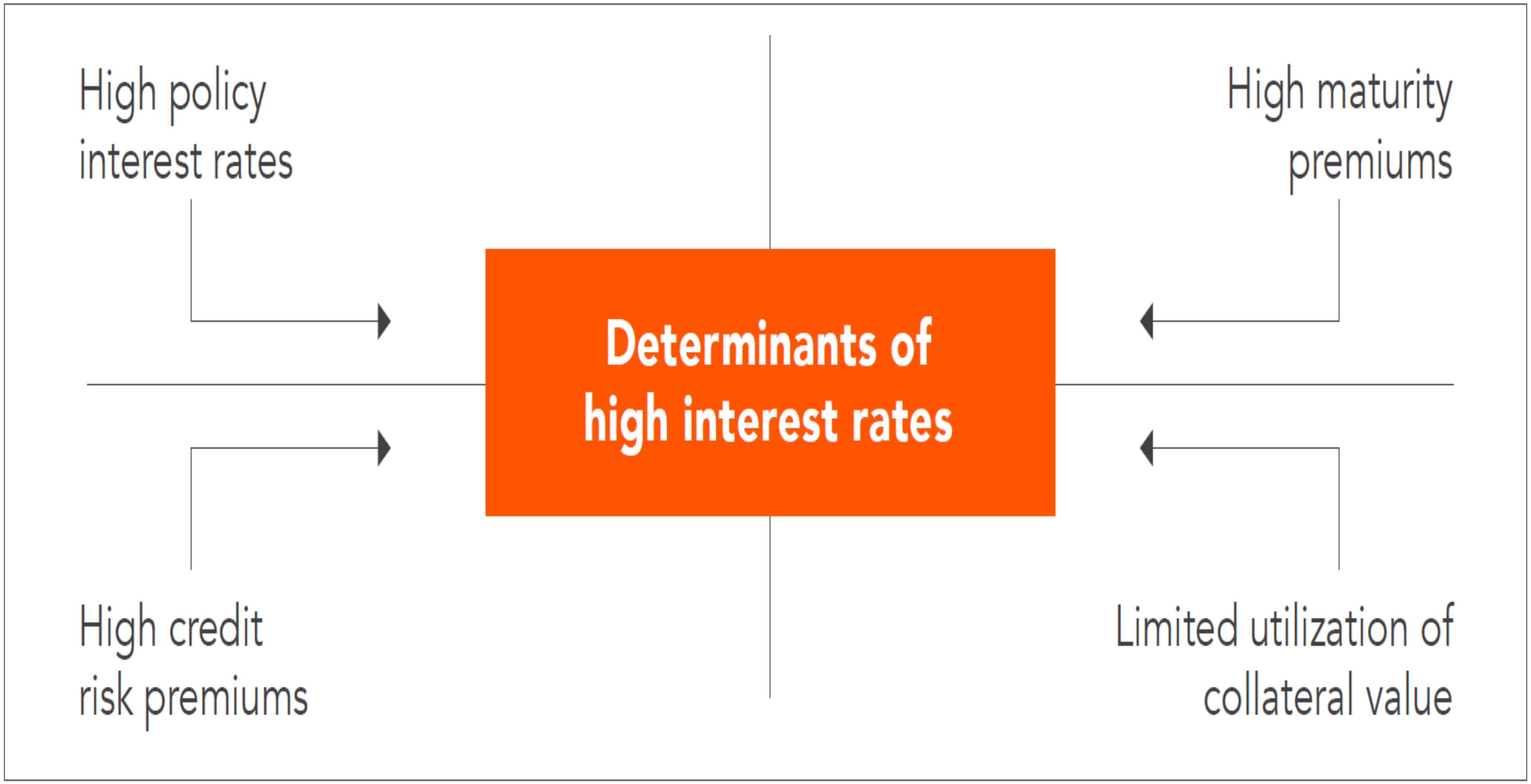
Determinants of high interest rates

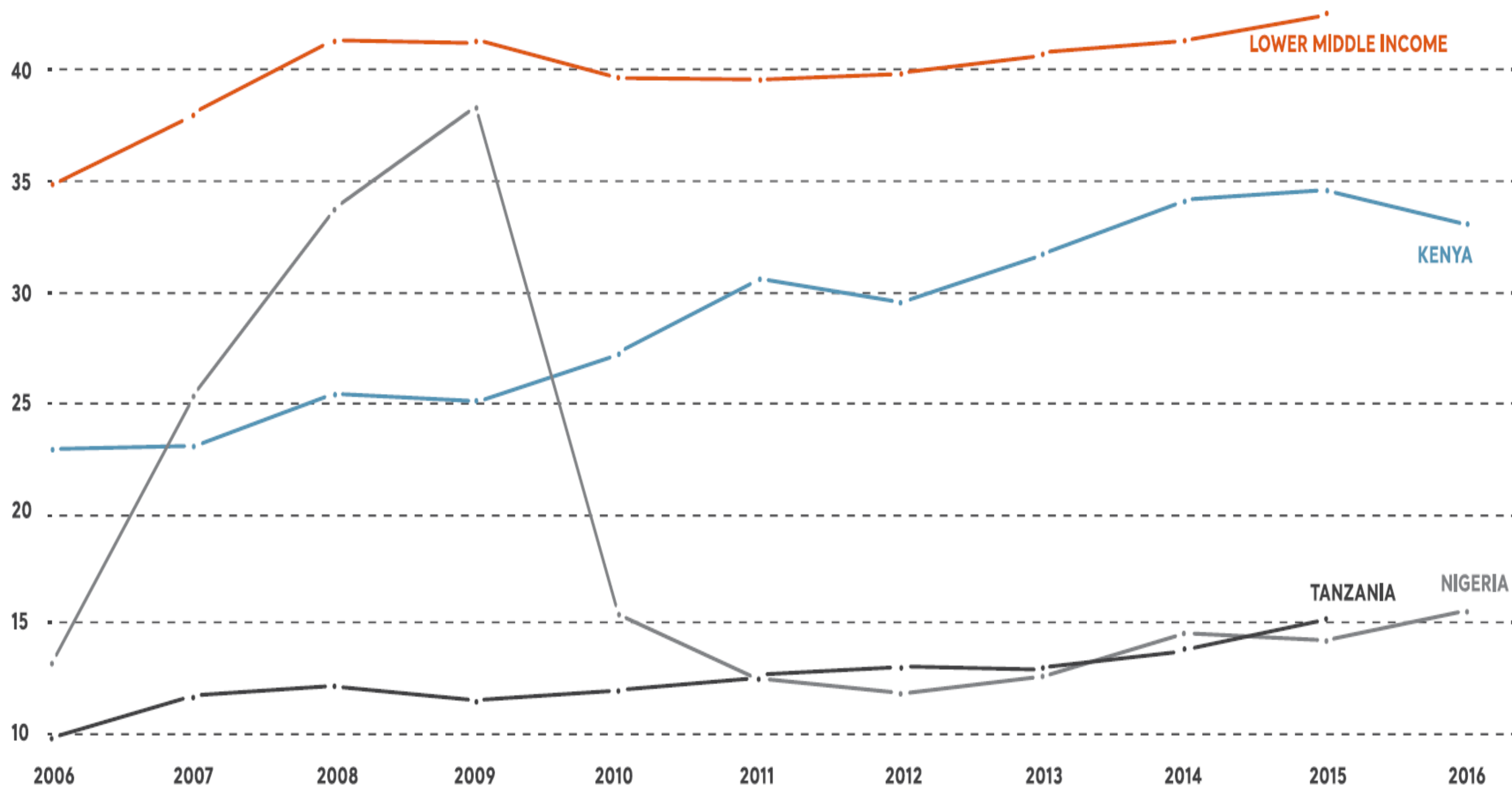


1. Channels determining high interest rates

High policy interest rates:

1. Shallow financial markets & volatile “risk-free” government borrowing rate
2. Fiscal dominance due to a narrow tax base; over-reliance on commodity exports as a source of fiscal revenues; high government borrowing required to finance domestic investments squeezing out domestic lending
3. Placing greater reliance on private sector funding depends on maintaining macroeconomic stability

Shallow financial systems: credit to the private sector as % of GDP

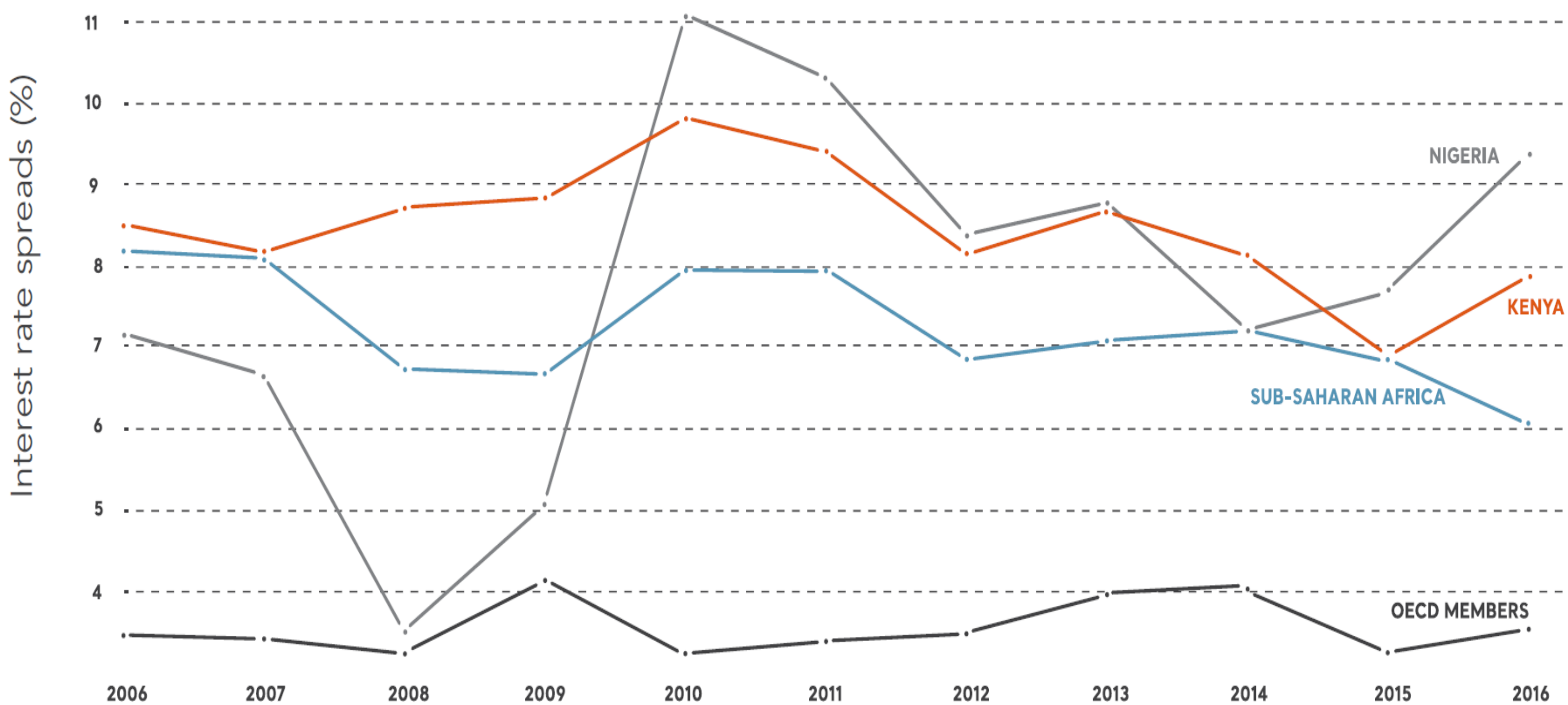


2. Channels determining high interest rates

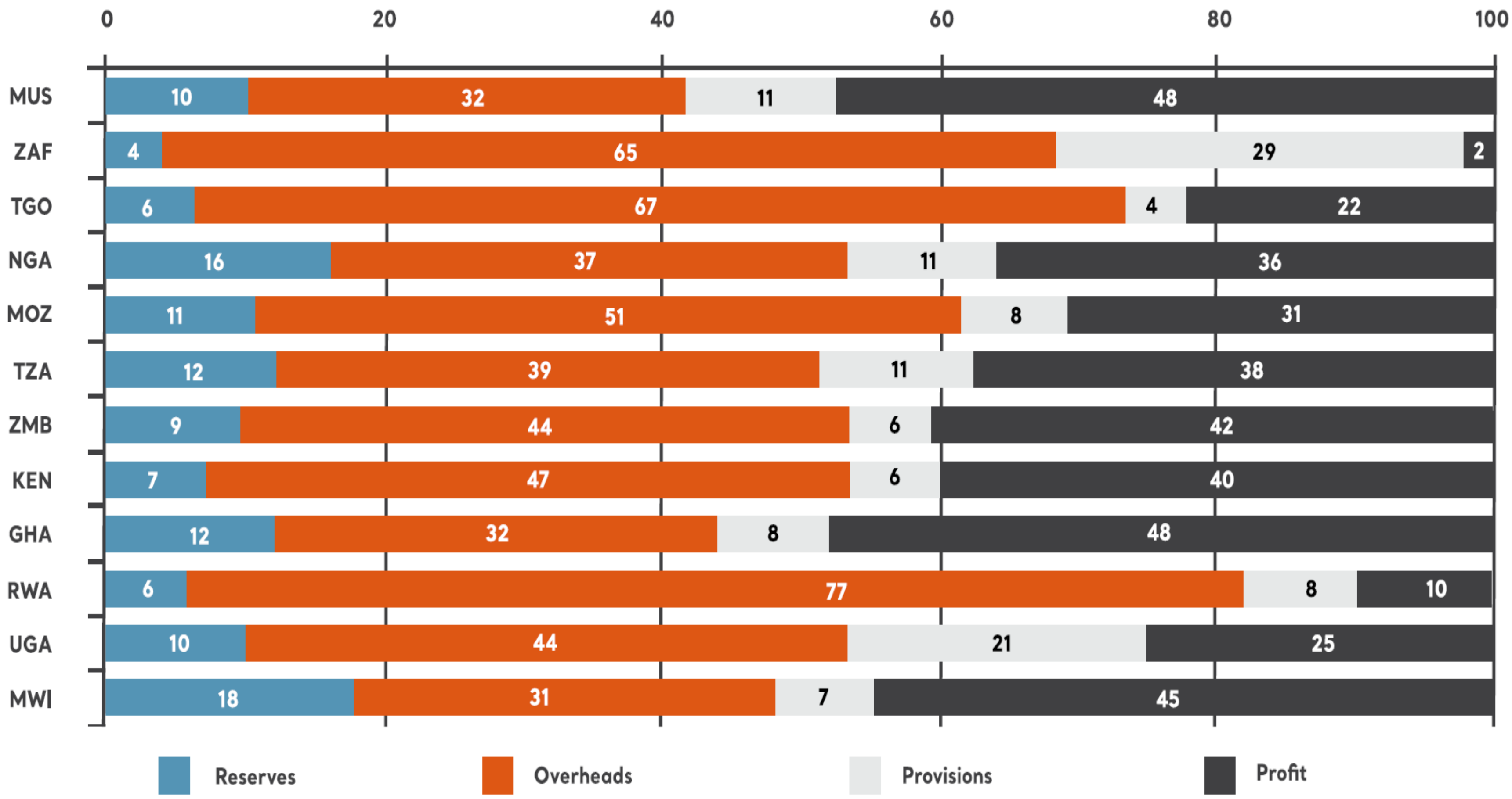
High credit risk premiums:

1. Small size and fragmentation of financial systems reduces benefits associated with economies of scale
2. High overheads costs associated with high operational and regulatory costs
3. Dominance of a few large banks, and limited competition and internal inefficiencies
4. Limited innovation and lack of familiarity with mortgage markets due to: crowding out by government borrowing; lack of reliable credit information; weak contractual environment

High interest rates spreads



Decomposition of interest rate spreads



Spreads may be particularly high for mortgage loans

- **Cost of equity**: risk-weighting applied to mortgage loans may be higher than 35% required by Basel 2 (not recognizing mortgage collateral value)
- **Credit risk**: considered high due to weak credit information and enforcement environment
- **High operational costs**: setting up and running mortgage business
- **Funding cost**: regulatory liquidity ratios limit bank maturity mismatch and scarce sources of long-term financing

3. Channels determining high interest rates

The maturity of mortgage financing (rather than the interest rate paid) determines its affordability

High maturity premiums:

1. Mismatch between long-term borrowing needs and available short-term funding
2. Shallow and illiquid domestic financial markets
3. Absence of liquid government security yield-curve to be used as benchmark for debt funding
4. Institutional investors are absent from investment in the mortgage sector

4. Channels determining high interest rates

Limited utilization of collateral value:

1. High risk premiums reflecting assessment of operating environment specific to different countries, regions and even localities
2. The cost and time taken in registration and conveyancing of titles.
3. Weak contractual frameworks, and weak legal recourse in realizing collateral value in case of borrower default
4. Lack of familiarity and untested markets for the resale of collateral

1. Recommendations and their impact

Reducing policy interest rates:

A. Strengthen macroeconomic management and reduces government borrowing**:** *Uncertain due to policy challenges*

B. Enhance efficiency of domestic debt management policies: *Important in setting a benchmark for private sector debt issuance*

C. Place greater reliance on government borrowing abroad to reduce crowding: *Could be beneficial in short-term, but likely to further increase government indebtedness*

D. Direct interventions to control bank lending rates or spread between bank deposit and lending rates: *Controls lead to reduced credit provision and reduced competition*

E. Interest rate subsidies Impact: *Fiscally costly, inefficient, difficult to administer on a targeted basis, and impacted by weak repayment culture (moral hazard)*

2. Recommendations and their impact

Lowering credit risk premiums:

A. Strengthening banking supervision, implementing timely corrective actions and where needed bank resolution: *Reduction of bank spreads and increased competition that encourages sustainable financial deepening; reduce # of banks and overcrowding*

B. Strengthening sharing of credit information: *Potentially significant contribution to reducing bank lending premiums*

C. Enhance deposit insurance coverage: *Strengthened competition through more level playing field among banks*

3. Recommendations and their impact

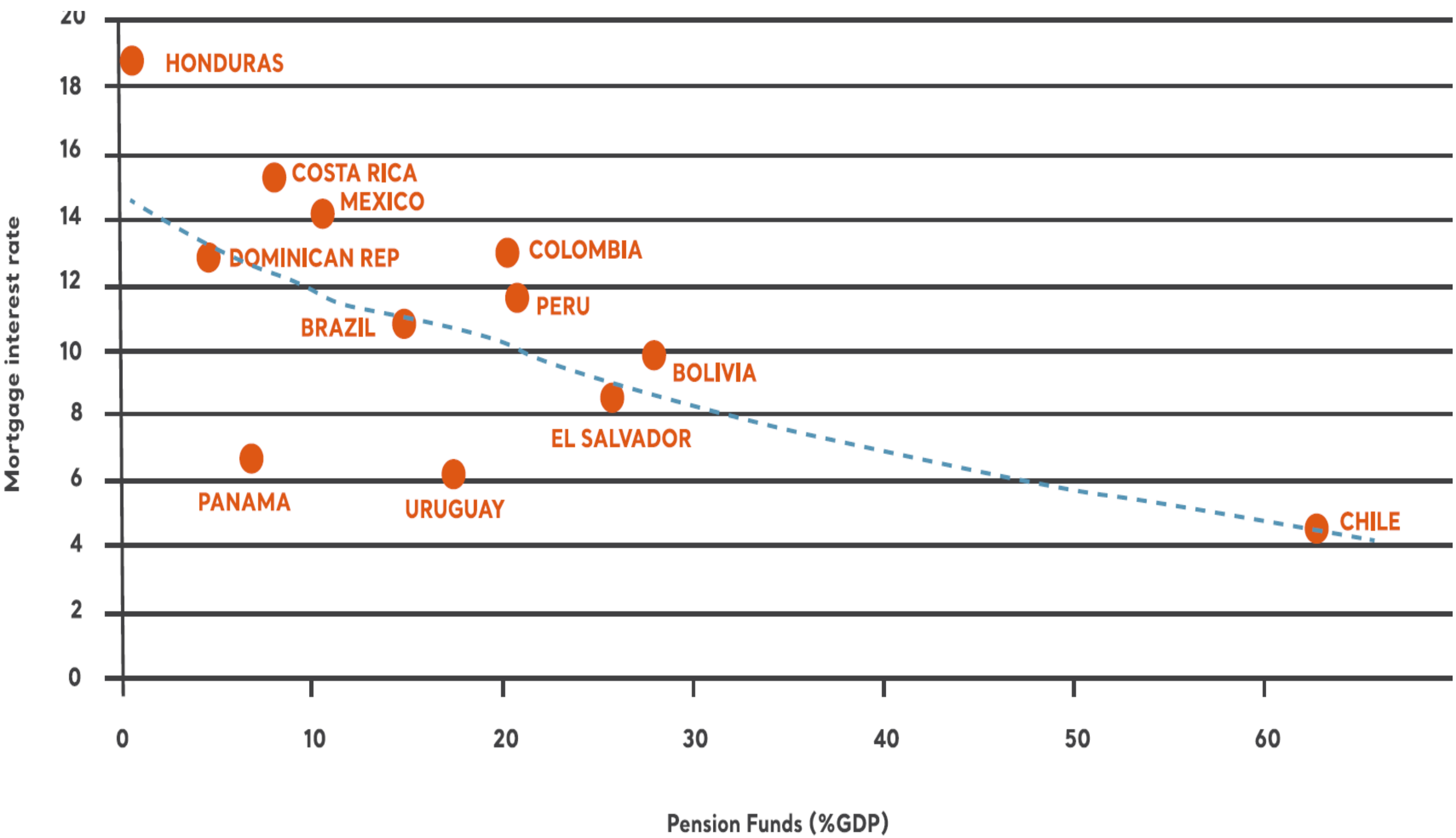
Lowering maturity premiums:

A. Increase the availability of long-term funding through mortgage liquidity facilities: *Significant, particularly in terms of incentivizing bank lending for housing*
B. Introduce a market for covered bonds: *Potentially significant, but depends on prior institutional reforms*
C. Develop a sound benchmark government security yield curve Impact: *Fundamental to the pricing of long-term funding*
D. Investment by institutional investors may put downward pressure on interest rates: *Dependent on pension reforms (not least governance) and availability of investment vehicles that diversify risk (e.g. bonds issued by liquidity facility or covered bonds)*

Mortgage liquidity facilities: fundamentals

- Relieves banks of maturity mismatch
- One centralized bond issuer
- Mortgages provided as collateral on a recourse basis. Credit risk remains with banks, and borrowers still burdened with high bank spreads
- Banks obliged to replace non-performing loans with performing loans
- Promote prudent, standardized lending processes

The size of pension fund assets and the level of mortgage interest rates



4. Recommendations and their impact

Leveraging utilization of collateral value:

A. Strengthen property and collateral registration, foreclosure mechanisms, and credit information-sharing: *Significant but medium term*

B. Use incentives, such as installment sales and partial credit guarantees**:** *Encouraging innovation in bank mortgage lending to enter frontier markets*

C. Pension-secured housing loans: *Depends on ability to realize value from forced sales*

D. Improve affordability through innovative mortgage instrument design: adjustable interest rates, foreign currency or using index-linked borrowing: *Exposes borrower to risks (of higher interest rates, currency devaluation and price-index uncertainty)*

Mortgage design and affordability

- Keep things relatively simple
- Fixed-rate mortgages provide comfort to consumers (known repayment burden, and gradually falling repayment in real terms)
- Affordability depends more on maturity of the mortgage than the interest rate paid
- Consumer protection considerations

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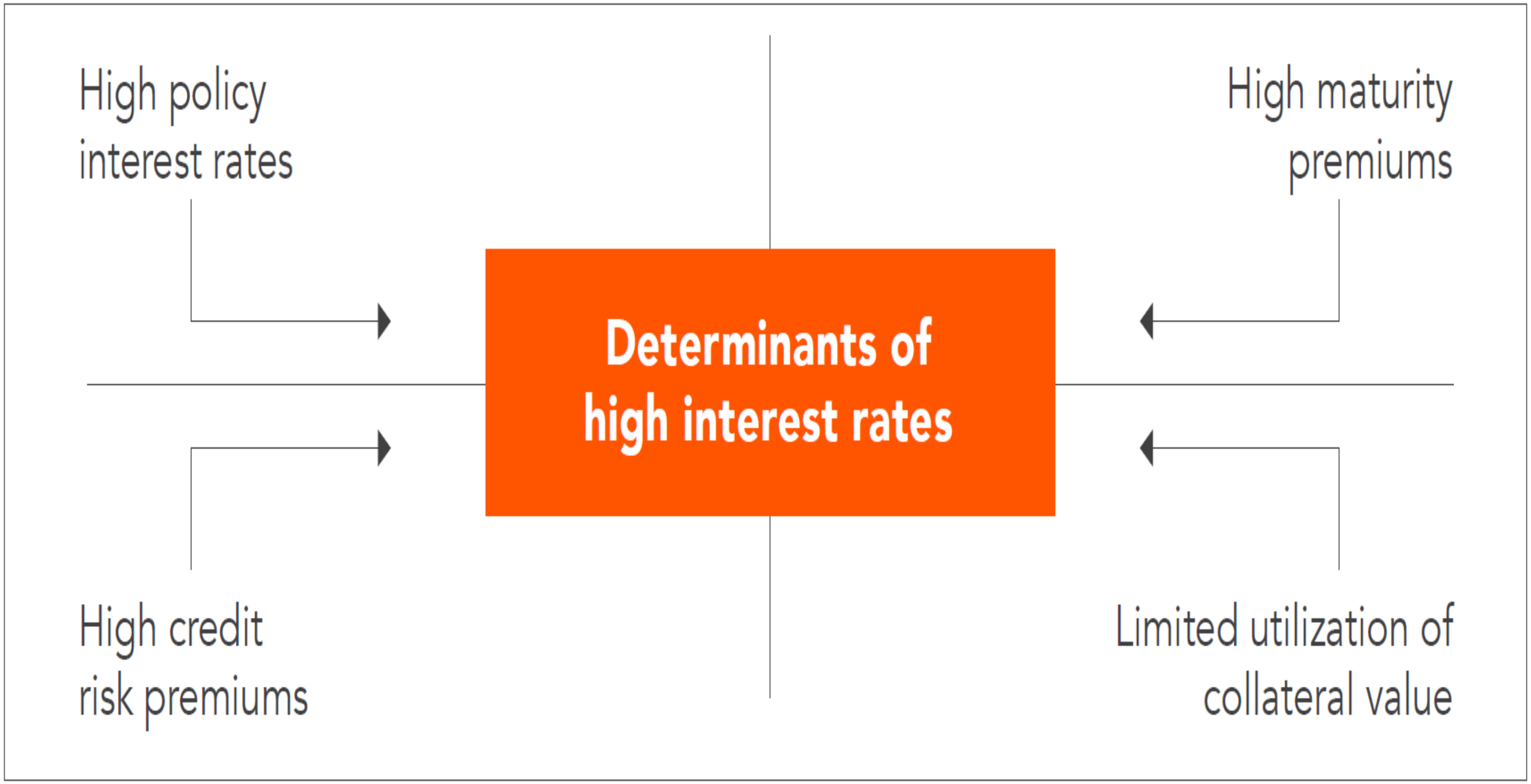

Annex: Factors contributing to the accumulation of public debt