

The background of the page is a collage of various international coins, including Jordanian Dinar, Mozambican Meticals, Kenyan Shillings, and others, scattered across the page.

How to build a resilient housing finance ecosystem through local currency financing?

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INTRODUCTION

As Africa begins to emerge from the most severe pandemic phases, the long-term social and economic impacts remain ahead as other crises occur—the Russia-Ukrainian war and the monkeypox outbreak. One sector that has experienced significant disruptions from COVID-19 is construction, including housing experiencing a shortfall in revenue collection by US\$ 658 million.¹ Some major disruptions include a decline in project finance, a halt in public housing projects, low uptake of houses in 2020, and a significant drop in revenue among modest-income households.²

Moreover, housing has become even less affordable with decreasing risk appetite of banks, shorter tenors, and rising prices relative to the USD base.³ The consequences are most severe for households with informal/irregular sources of income, although the pandemic has highlighted how the lack of decent housing can impact all of us. Therefore, the housing finance sector will play a central role in the post-crisis recovery by providing adequate long-term finance to support access to decent and affordable housing. Investment in this sector becomes crucial to boost the economy and generate sustainable growth for the African States amid and post-COVID-19.

The Centre for Affordable Housing Finance in Africa (CAHF) published its 2021 yearbook that provides a state of play for the affordable housing sector. The focus is on the affordability of the property and its financing: it is of great importance to take a different point of view and to talk about the de-risking of currency risk, particularly about local currency financing and/or mortgages in the housing sector. There have been numerous discussions about currency risk and debt sustainability, but we rarely discussed the issue of currency risk for consumer protection.

Therefore, this article discusses foreign currency mortgages and their adverse impacts on African countries' consumer protection laws. The main objective is to raise awareness among all key housing finance stakeholders to grasp the challenges posed by foreign-denominated mortgages (FDM) to the African States already in a weak monetary and economic position. Second, to stress the need to finance and develop cutting-edge research to offer disaggregated data on foreign currency loans and provide an in-depth understanding of key concerns around FDMs' designing and underwriting. Also, to critically assess FDMs and their risks on borrower's protection in the African States. Finally, this article should offer some recommendations to prevent a further crisis that might erupt from a possible overreliance on FDM.

¹ Which represented with the construction sector about 20.5% of Africa GDP in 2020. See 'The impact of covid-19 pandemic on real estate investment in sub-Saharan African region' Sakariyau J. K, Esv O. et al https://www.researchgate.net/publication/352121019_THE_IMPACT_OF_COVID-19_PANDEMIC_ON_REAL_ESTATE_INVESTMENT_IN_SUB-SAHARA_AFRICAN_REGION pg. 198-199.

² 'The impact of covid-19 pandemic on real estate investment in sub-Saharan African region' Sakariyau J. K, Esv O. et al https://www.researchgate.net/publication/352121019_THE_IMPACT_OF_COVID-19_PANDEMIC_ON_REAL_ESTATE_INVESTMENT_IN_SUB-SAHARA_AFRICAN_REGION

³ CAHF (2020). Housing finance yearbook 2020. <https://housingfinanceafrica.org/documents/2020-housing-finance-in-africa-yearbook-11th-edition/>

AN OVERVIEW OF THE AFRICAN MORTGAGE MARKET

The African mortgage market has considerably evolved regarding the number of players and depth, although these remain insufficient compared to other regions. Today, in addition to the traditional state-owned housing bank, several private commercial banks, microfinance institutions (MFIs), housing cooperatives, and savings and credit cooperatives (SACCOs) are operating in that segment. In 2021, the total value of residential mortgages outstanding in South Africa was US\$70.3B⁴ (vs. US\$9.1B in 2014). However, except for South Africa, the value recorded for that same indicator in some African countries was slightly above US\$2B, thus indicating a smaller-size mortgage market in the rest of the continent. For instance, the total value of residential mortgages was US\$2.1B⁵ (vs. US\$1.6B in 2014) in Kenya, US\$2.2B in Morocco,⁶ and \$2.1B⁷ (vs. US\$1.4B in 2011) in Nigeria.⁸

Despite these encouraging figures showing growth in the sector over the last decade, the mortgage market remains shallow in most African countries, thus having a limited impact on stimulating economic growth. As a result, the ratio of mortgage to GDP in most countries is below 2%. In 2021, this indicator was above 5% in Seychelles (8.30%), Botswana (8.70%), and Mauritius (7.92%).⁹ Cabo Verde (23.40%) and South Africa (23.30%) were the only African countries with a ratio above 20%.

Furthermore, with over half of African countries having suffered negative GDP growth in 2020, these trends show a relative resilience of the mortgage market amid COVID-19. The figures recorded between 2020 and 2021 did not record a negative performance in that segment. Two years into the pandemic, the mortgage market is far from collapsing. However, its penetration remains enormously far from the reach of many African consumers, as suggested by these indicators above.

PROBLEM STATEMENT

Are FDMs popular in the African mortgage market? And if so, why?

Despite the ongoing development of local financial markets and progress in inflation control before the pandemic, foreign currency lending remains an essential financial structure in some African countries. For instance, according to the IMF's latest Financial Soundness Indicators, foreign-currency-denominated loans to total loans were, on average, 30% in countries like Kenya, 28.3% (Q1 2022), Nigeria 32.9% (Q3 2021), Zambia 32% (Q4 2021), and Ghana 25.5% (Q4 2021).¹⁰ While this proportion is already non-negligible considering the critical economic role of these countries within their region, it is remarkably higher (over 50%) in other key African economies like Mauritius, 57.8% (Q1 2022) and Djibouti, 56.5% (Q4 2021). But some Southern African countries record less important rates, at below

⁴ Centre for Affordable Housing Finance 'Yearbook 2021', <https://housingfinanceafrica.org/app/uploads/2021/11/2021-cahf-yearbook.pdf> pg 221.

⁵ Centre for Affordable Housing Finance 'Yearbook 2021', <https://housingfinanceafrica.org/app/uploads/2021/11/2021-cahf-yearbook.pdf> pg 141.

⁶ Centre for Affordable Housing Finance 'Yearbook 2021', <https://housingfinanceafrica.org/app/uploads/2021/11/2021-cahf-yearbook.pdf> pg 177.

⁷ Centre for Affordable Housing Finance 'Yearbook 2021', <https://housingfinanceafrica.org/app/uploads/2021/11/2021-cahf-yearbook.pdf> pg 193.

⁸ African Development Group 'Housing markets dynamics in Africa' El Hadj M. Bah et al (2018), <https://housingfinanceafrica.org/app/uploads/HOUSING-MARKET-DYNAMICS-IN-AFRICA.pdf> Pg 59-64.

⁹ See country profiles of all 54 African countries and their key figures. Centre for Affordable Housing Finance 'Yearbook 2021', <https://housingfinanceafrica.org/app/uploads/2021/11/2021-cahf-yearbook.pdf>

¹⁰ International Monetary Fund 'Financial Soundness Indicators' <https://data.imf.org/regular.aspx?key=63174545>

10% — South Africa, 7.5%; Botswana, 3.9% and Namibia, 0.1%.¹¹ Moreover, several research and papers in the context of international debt vindicated this overreliance on foreign currency borrowing as the 'original sin,' i.e., "the inability of emerging economies to borrow internationally in its own currency."¹²

Given the absence of disaggregated data, it is hard to indicate whether currency substitution in Africa (in particular), emerging economies, and developing countries (in general) is prevalent among households and primarily related to housing finance.

Nevertheless, according to Kingsley Muwowo from Shelter Afrique: "Despite the lack of structured data on those countries offering hard currency mortgages in Africa, we observe – on the ground and subject to respective countries Central Bank regulations – that in East and Southern African countries some financial institutions do offer mortgages in hard currency (USD majorly), whereas the other regions offer average or limited mortgages in hard currency. This results into these institutions being exposed to currency mismatch"

Many housing finance schemes in Africa might be based on or impacted by foreign currencies. But the absence of in-depth research and disaggregated data on foreign currency loans does not inform the rationale explaining their usage in African mortgage markets. Housing finance providers in Africa traditionally relied on short-term local funding and long term foreign denominated funding to finance long-term mortgages, exposing themselves to liquidity, currency, and interest rate mismatch risk. In Central and East Europe (CEE), according to a 2021 IMF working paper, FDMs are heavily present too.¹³ However, unlike in Africa, existing research highlighted the reasons for such lending practices. One of the primary rationales explaining the strong presence of FDMs in the CEE region is the debt limit channel (DLC). The DLC refers to whenever the exchange rate is expected to depreciate, credit-constrained agents are allowed to backload the real payment on their loans (i.e., effectively hold more debt over the loan duration) if they choose to borrow in foreign currency.¹⁴

In economies recipients of FDMs, this situation creates a currency mismatch and generates the so-called FX risk that needs to be appropriately managed. This risk is usually located in the mortgage providers' balance sheets, who then offer their products denominated in or indexed to the same foreign currency¹⁵, thereby shoving the risk down to the average consumer. It is crucial to remember that the latter is the main target for affordable housing in Africa.

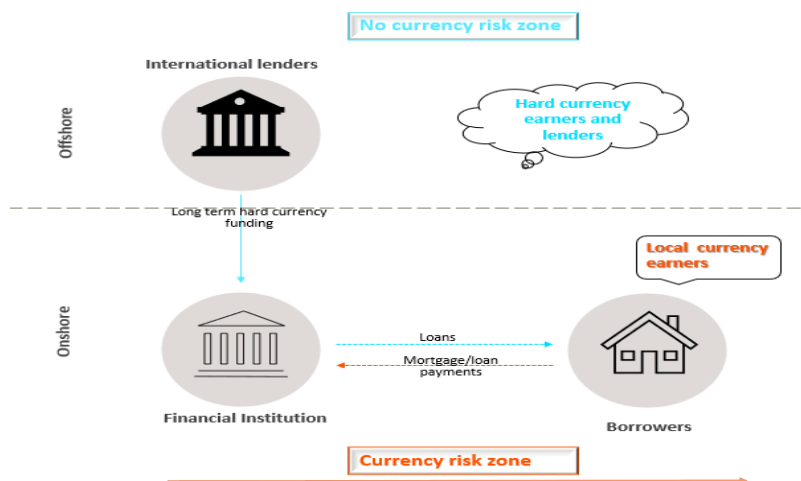
¹¹ International Monetary Fund 'Financial Soundness Indicators' <https://data.imf.org/regular.aspx?key=63174545>

¹² International Monetary Fund 'Equilibrium Foreign Currency Mortgages' Marcin Kolasa (2021), pg 2.

¹³ International Monetary Fund 'Equilibrium Foreign Currency Mortgages' Marcin Kolasa (2021), pg 2.

¹⁴ International Monetary Fund 'Equilibrium Foreign Currency Mortgages' Marcin Kolasa (2021), pg 2.

¹⁵ Assuming that the mortgage provider/FI does not have access to adequate long term FX hedging instruments which is generally the case.



The 2008 subprime crisis has demonstrated how such an uncontrolled system could (1) trigger a credit risk event associated with negative externalities and (2) damage local or global financial stability. Subsequently, when domestic currencies depreciate, mortgage obligations are exacerbated. This causes distress and sometimes foreclosures, as it did for some homeowners in Ghana, where the Cedi devalued from around 1 to 6 vs. the US\$ between 2008 and 2018. Because of the several constraints that affected the mortgage market in Ghana,¹⁶ the housing finance providers' portfolios were in US\$, and they transferred the currency risk to the end consumers. As a result, mortgage payment amounts were multiplied by or indexed to US\$, and defaults or foreclosures occurred. For instance, if a homeowner had signed a USD-linked loan paying 250 USD mortgage equivalent, which was 250 GHS in 2008, this same amount in USD would have become 1500 GHS in 2018. Thus, half a dozen times higher in only ten years. These scenarios are unacceptable and totally avoidable.

Also, in Europe, decades ago, attracted by perceived low-interest rates, several Eastern European home buyers massively took on mortgages in the Swiss franc, Japanese Yen, and other foreign currencies (e.g., 700k owners in Poland up to an amount of USD 40 billion). In Hungary, by 2008, more than 70 percent of loans were denominated in foreign currencies, and more than 85 percent in Latvia (Mak and Pales 2009, Blanchard et al. 2013: 333). Foreign currency loans were misleadingly attractive to consumers because of the lower interest rates. However, they were not informed about the risk related to potential currency depreciation. As a rule, softer currencies like the Zloty or Forint and African currencies tend to depreciate versus currencies like the Swiss franc, Euro, and USD.

In Poland, most mortgages were concluded when the Swiss Franc was below 2 Zloty. But in 2015, the Swiss franc, abandoning its currency ceiling against the Euro, soared to five Zloty, more than doubling mortgage holders' debts. So the Polish consumers went to the European Court of Justice, which ruled in their favor in 2019 under the Unfair Terms in Consumer Contracts directive.

Following this issue, the [EU Parliament](#) published a study about the miss-selling of financial products in the mortgage sector. It stated that "households' over-indebtedness became a major social problem, which resulted in a strong deterioration of the confidence in the financial intermediary system." In

¹⁶ Several constraints such as high and volatile inflation, high-interest rates, excessive exchange rate movements, etc.; and the hard currencies long term funding coming from international lenders.

conclusion, "banks should prioritize their customers' interests in the sale of mortgage loans. Furthermore, conflicts of interest must be identified and managed."

In December last year, the Polish banking regulator proposed to finally solve the mortgage issue by converting the Swiss franc mortgages into Zloty at the exchange rate prevailing at the signing date of the loan. However, this would cost the Polish banking system an expected 40 billion Zloty, or three times the industries' 2019 profits.

What are the other threats linked to foreign currency risk faced by FDMs to consumer protection in Africa?

Foreign currency loan interest rates can be floating (three-or-six-month Libor or Euribor rates) but may also be reviewable at the lender's discretion thus creating Interest rate policy risk (IRPR). They can change anytime and independently of any domestic macro developments. Other risk includes interest rate variability (IRVR). It refers to lower monthly installments for an introductory period that increase later in the loan cycle or interest grace period. These favor room for higher lender's fees and potentially higher LTV ratios, unlike local currency mortgages.

Finally, is the transparency risk. A low level of financial literacy on the borrower's end and the complexity of FDMs may lead to hidden charges. In addition, practice showed that the products are often packaged with low initial payments that may change rapidly in the loan repayment cycle.¹⁷ In already poor African economies where consumer protection is constantly challenged and somehow breached, such risks become heavier. They could easily exacerbate African borrowers' risk position if they are not well mitigated with adequate tools.

RELEVANCE OF THIS ARTICLE

In summary, currency, interest rate, and transparency are some significant risks that are poorly understood and should not be used to miss-sell products to non-accredited consumers as it is improper practice and weaken confidence in the entire ecosystem. Therefore (i) mortgages should be in the functional currency of the homeowners' revenues, and (ii) this risk should be managed in the financial sector sides.

To minimize such risks, these institutions could resort to the capital market to access long-term funding, but very few markets in our region have the depth to do so. Because access to long-term domestic currency funding is scarce, mortgage providers opt for long-term financing from international lenders in foreign currencies whereas they could obtain long term local currency funding or hedge it.

One sector recognizing the importance of protecting its customers against external shocks and building a resilient ecosystem (*i.e., fewer non-performing loans or defaults due to currency risk issues*) is

¹⁷ The World Bank 'Regulation of foreign currency mortgage loans: the case of transition countries in central and eastern Europe', Hans-Joachim Dübels, Simon Walley, Finpolconsult (2010), <https://openknowledge.worldbank.org/bitstream/handle/10986/12943/693820RSCOP1130tgage0loans0Jan02011.pdf?sequence=1&isAllowed=y> pgs 13-14.



the MFI sector. It is time for other financial sector actors, especially mortgage providers, to foster financial stability and sustainably protect Africa's core engine and middle class.

Furthermore, it is difficult to see why these principles of fairness could not be applied in consumer contracts, financial education, and incentives for good behavior in Africa. For example, could loans in their own currencies protect homeowners and sustainably stabilize the ecosystem against currency depreciation shocks?

SOME RECOMMENDATIONS

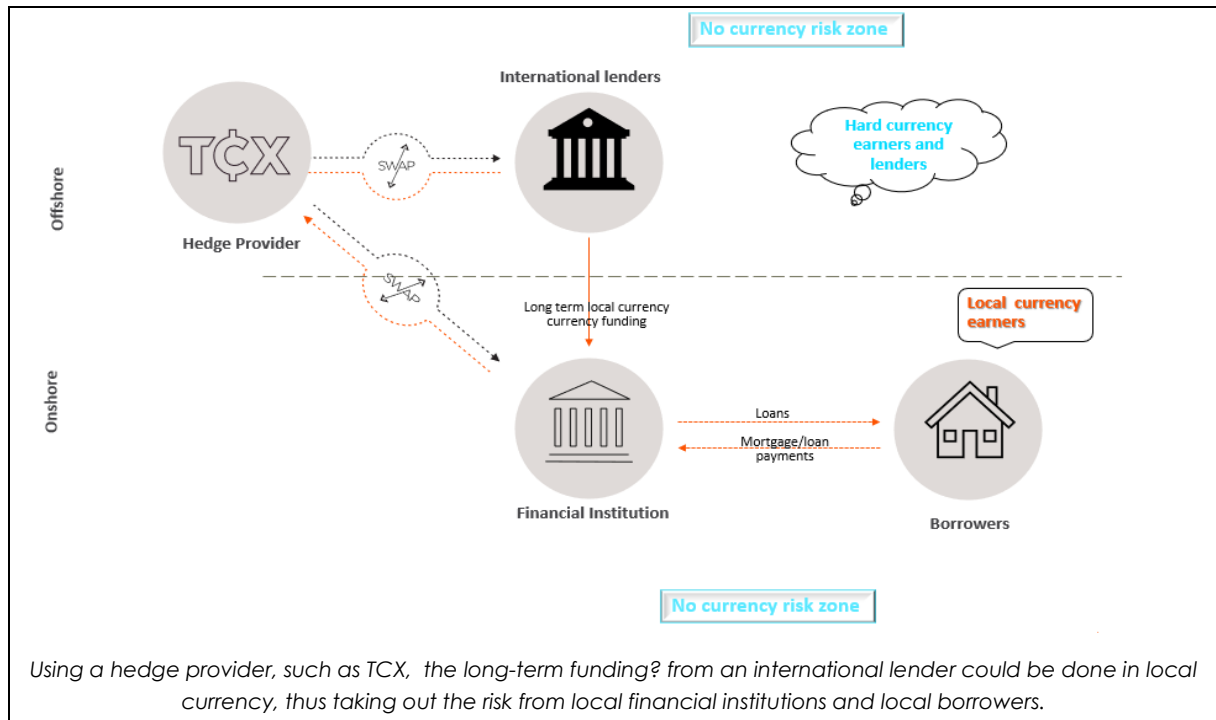
Applying the logic of converting all the current mortgages at the signing date also in Africa might create instability (losses) in the financial sector in a post-covid world. But there may be other solutions to a threatening situation that encourage the creation of a sustainable ecosystem.

We argue that there is a need for discussions about the best way to solve these situations and build a resilient and sustainable housing finance ecosystem. It might be:

- (i) To set up incentives for domestic funding providers to lend to banks and mortgage providers. But any efforts in domestic currency onshore capital market developments and risk management enhancement are medium to long-term actions. In the meantime, local banks and mortgage providers can work with hedging providers to offer local currency products and set up specialized vehicles like mortgage refinancing companies. The latter have proven their value by providing onshore and offshore local currency long-term resources at affordable interest rates. (E.g., the latest local currency bond issued by KMRC¹⁸ showcased that this solution can work and that now, local investors can build upon that.)
- (ii) The international lenders could commit to actively providing local currency funding to the local financial sector and work with hedging providers. In addition, international lenders' credit facilities should continue (1) to incentivize the use of funds dedicated to specific end-beneficiaries (e.g., revenues per tranche, house prices) and (2) to be aligned with the FI housing strategy.

Blended finance instruments play a crucial role in tackling at the same time the pandemic effect and climate adaptation needs for more resilient housing programs. As part of the incentives mentioned above, performance-based subsidy schemes should unlock market potential by meeting supply and demand at affordable prices and thus exponentially increasing resilience.

¹⁸ <https://kmrc.co.ke/press-release/>



(iii) Regulation is critical to prevent further crises. One example is to set a target that all mortgages should be in local currency (not based on nor indexed in hard currencies) with at least the same tenors or longer as the current mortgages/financing offers. A first step could be to rule that all mortgages below a specific amount should be denominated in their domestic currency, thereby protecting the middle class while giving the financial sector time to adjust. Besides, the scope of the FX open exposure ratio should be extended to indirect exposure embedded within loan portfolios.

Another example of regulatory currency risk mitigation could draw from earlier Central and Eastern European countries (CEE), which implemented stricter measures around foreign currency lending. For instance, in 2013, the financial supervision authority in Poland recommended that banks be against offering foreign currency lending mortgages to households that do not earn in that currency, thus ending the origination of this type of lending. In addition, in 2014, in Hungary, foreign currency housing loans were converted to domestic currency.¹⁹

Solving this issue is not just a matter of consumer protection but an essential step in building a resilient middle class and a sustainable and stable housing ecosystem toward the SDG 11 "sustainable cities and communities."

¹⁹ International Monetary Fund 'Equilibrium Foreign Currency Mortgages' Marcin Kolasa (2021), pg 16-17.



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