# Alternative Options to Mortgages in Ghana

by Noah Kofi Karley

## INTRODUCTION

The standard and quality of a large proportion of houses in Ghana is below the minimum for a country. It is not uncommon to see families living in conditions that could simply be described as homelessness and a significant number of households living in overcrowded homes. Conditions around many neighborhoods are also poor. Standards across the nation are more or less the same.

One surprising observation is that rural areas have relatively "decent" buildings and better environmental conditions. But urban areas are generally overcrowded with uncontrolled urban sprawl. This is not to say that we do not have high standard houses in the country. In fact, there are good houses, which are comparable or even better than some Western homes. But how many of such homes are we talking about? Only a few! In general, the majority of key workers, such as teachers, nurses, and civil servants, who reside in urban areas, live in substandard homes.

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It is important for us to know that housing contributes immensely to human life and dignity and, therefore, investment in housing should be regarded as investment in a secure and stabilized future. While many understand the need for a decent home and are prepared to invest in homeownership, most do not have adequate resources to do so.

Nowadays, it appears that the general public is aware that national resources are drained by decades of mismanagement. People no longer think it is necessary to agitate for government intervention to provide homes for the masses. Rather, people are now turning to financial institutions and becoming angry with such institutions for failing to provide the needed finance to achieve homeownership aspirations.

People feel that financial institutions have the potential to provide the needed financial resources to support programs that could lead to the development of adequate housing for many of the key workers in the country. But the common impression is that banks and other lenders in the formal sector are not sympathetic to the ordinary people and are reluctant to provide financial assistance for them to build or purchase decent homes.

While I would not agree or disagree that lenders are unsympathetic to certain potential borrowers, this article highlights some of the requirements that have to be satisfied for bank lending. It also assesses whether conditions in Ghana and the situation of most potential borrowers are conducive for lending. If not, what alternative mechanisms could enhance decent homeownership aspirations of Ghanaians?

## LENDING REQUIREMENTS

Banks in Ghana are mainly portfolio lenders whose general objective as mortgage lenders is to run a low-cost and low-risk business where mortgage lending fits well in relation to other investment activities. Although government policies back private sector participation in the housing sector, the banks have short-term funding and are unable to lend on a medium- or long-term basis, thus crippling the housing industry. However, few banks endeavor to provide needed funds for long-term housing investment. But in order to survive, the banks must make a profit. To thrive, the return must warrant the investment of capital, and to grow the bank must accumulate retained earnings to support asset growth.

Therefore, for lending to take place, financial institutions would generally want to establish that certain basic requirements are met. I would categorize these into five requirements and call them the five C's of lending decision, namely: character, capacity, collateral, capital and condition. These requirements relate to the circumstances of the potential borrower, the property and the environment in which lending occurs. The lender normally makes sure these basic requirements are fulfilled before lending. There may be other requirements to fulfill, but in this article we limit ourselves to the five C's against which we determine whether or not it is viable to lend in Ghana.

## CHARACTER

The lender wishes to transact business with someone who will respect the contract and observe the terms. The bank would ignore any potential borrower who is perceived as capable of repudiating the loan. Therefore, an attempt is made to establish whether or not the potential borrower is a person of good character and respect. In general, character is assessed by obtaining references from people who know the borrower, by examining the regularity of their bill payments, previous credit record, source and stability of income and other personal attributes necessary.

While banks in developed economies may be able to evaluate character of the borrower with sufficient certainty it may not be so easy in Ghana. The impression gained at the first meeting with a lender is the starting point of the assessment, and while it is possible to obtain references on borrowers in Ghana credibility may not be assured.

In Ghana many people are not accustomed to buying on credit, most have no credit records or bank accounts and there are no established credit bureau to keep records of bill payments. So the character assessment or credit performance of these people is unpredictable or cannot be completed. In Ghana, lenders have developed several methods of assessing the character of the potential borrowers. For example, they use employers, community members, and pastors for character references, and sometimes gather other information on personal habits, contacts and actual sources of income for each applicant. But because such information is qualitative, the risk cannot be actually measured and, therefore, it is often hard to avoid adverse selection of borrowers.

## CAPACITY

Determining the borrower's financial ability and buying power is a critical aspect of the evaluation process. Typically, capacity is evaluated using the ratio that expresses the percentage of an applicant's income needed to cover monthly debt obligations, including the mortgage payment, the house-debt-to-income ratio. This focuses on housing-related payments and is calculated as the ratio between monthly mortgage payments (including taxes and insurance) and gross monthly income. The total-debt-to-income ratio, which includes non-housing debt such as car payment and consumer installment debt, is also often considered.

Assessment of financial capacity in Ghana is problematic. First, accurate income data are hard to obtain because, besides formal employment, most people derive additional incomes from the informal sector. Moreover, because most people receive salaries in cash they cannot prove their income. Even if sources of income are verifiable, wages are very low. The average cost of a decent low-income family house in Ghana (about 50 million cedis) is more than ten times the average annual salary of most key workers in Ghana. Based on this example, the housing debt-to-income ratio shows that most Ghanaians simply cannot afford decent housing. Only a few relatively rich people able to prove that their monthly loan repayment will take less than 35% cent of their official monthly income would probably be provided with housing funds. It is therefore not surprising that most mortgagors in Ghana are mainly employees of private institutions and Ghanaians living and working abroad.

## COLLATERAL

The value of the property is an important asset upon which the loan is offered. The lender determines whether, in the worst-case scenario, such as repossession on default, the property can be sold to pay off the debt. Lending is normally against the value of the property based on the expert opinion of an attorney and appraiser. Suitability of the property for mortgage is assessed on the basis of the legal status of the property, location, structure, and the market value. The appraiser uses cost, income, and market approaches to estimate the property value. Attorneys, acting on behalf of lenders, ascertain the existence of the property and ownership from the deed office to ensure that no other claim is imposed on it. Freehold properties are preferred because then the buyer owns the land so that the future prospects of selling will not be hampered.

In Ghana the situation with collateral risk is complicated. For example, the law is such that foreclosure proceedings are not straightforward. In the case of default, it is difficult to evict a borrower, especially if they have children. Also, because land is mostly communally owned, lenders would find it difficult to register mortgages on properties that are not freehold. It is also not possible for individuals to use land as collateral against a bank loan because they do not own the land themselves. Another problem concerns the structural aspect of the property. Unsuitable materials in housing construction offer inadequate security to lenders. The common complaint in the housing construction industry is that of the use of unsuitable materials and the lack of basic infrastructure and amenities detracts from the value of property. Finally, the value of a property is often based on the sale prices of similar properties in the neighborhoods, but the presence of uncontrolled settlements in most neighborhoods is a potential source of problems for lenders in Ghana.

**CAPITAL**

Because housing finance usually requires long-term loans, which are often characterized by uncertain returns, it is generally regarded as a risky investment. Therefore, the lender usually requires the potential borrower to demonstrate their wealth by making a financial stake in the property in the form of a downpayment (deposit) towards the loan. It is believed that such a financial stake in the property motivates borrowers to make regular mortgage payments and keep the property in good condition. Normally an 80% loan-to-value ratio (LTV) is set as regulatory benchmark. But depending on the type of borrower, the downpayment requirement in Ghana is between 20% and 50% of the value of the property.

The deposit requirement is a big problem for many people because of the lack of savings. Although Ghanaians often participate in various saving programs through informal and formal mechanisms, many people who deposit money in their bank accounts often withdraw the money after short periods to meet the daily cost of living. For example, rough estimates show that over 90% of key workers whose salaries are paid through a certain bank in Accra, withdraw over 90% of their money by the next pay day. This implies that it would be difficult or take a very long time for such people to raise the minimum deposit required for a bank loan through savings. However, to overcome the deposit requirement some banks have developed schemes with certain private sector employers to provide guarantees to their employees. But such guarantees are usually valid only while the company employs the borrower. Moreover, most key workers are public servants and they do not have such schemes from the government.

**CONDITIONS**

The nature of the lending environment is an important factor that affects the evaluation of mortgages. The state of development of the mortgage market depends in large part on the degree of macroeconomic stability, the legal system, and government policies in general. Government policies determine the competitive environment in which the mortgage is done and, therefore, affect the elements of the credit evaluation process. Economic conditions may subject the market to risk in diverse ways. For instance, changes in inflation and interest rate could change the value of the mortgage. This risk is high in Ghana, as it is in all volatile economies with double-figure inflation rates.[1] A high level of inflation implies a low expected return and therefore a high risk to the lender funding long-term loans. The borrower also suffers through diminished real income during inflation and high mortgage rates, which make it difficult for regular mortgage payments.

To mitigate the risk of inflation, most lending institutions, such as Home Finance Company in Ghana, prefer collecting monthly payments in U.S. dollars. But it is difficult to rely on payments in hard currencies if mortgagors are based in Ghana, given the depreciating trend of the value of the Ghana currency, the cedi, against the U.S. dollar.

It may be suggested that lending institutions in Ghana could eliminate the effect of inflation by linking payments to the rate of inflation or developing dual-indexed mortgage mechanisms, first introduced in Mexico in the 1980s. These mechanisms are complex, especially for people with no borrowing experience, and it is doubtful that they can be used in Ghana.

The above assessment of lending decisions and viability of conditions in Ghana shows that lenders will generally provide loans if they perceive the potential borrower has the capacity and willingness to pay back the capital and interest as agreed. The few mortgage lenders in Ghana operate on market principles. They are naturally risk averse and therefore reluctant to offer loans to potential borrowers given that the financial, legal, and economic systems do not possess adequate measures to support the mortgage lending process. So what should be done to create opportunities for the ordinary people to afford decent homes? Perhaps we should go back to the basics.

**ALTERNATIVE MEASURES**

The above discussions suggest that the main obstacles to access institutional funding for housing in Ghana relate to the underdeveloped financial and legal system and unsophisticated nature of the economy. Thus, the need to concentrate effort on strengthening the legal system, developing the financial system in general and housing finance in particular, and fixing the fundamental economic problems cannot be overemphasized. Several alternative measures from simple to sophisticated mechanisms may be taken to ensure that potential borrowers meet the basic lender requirements for mortgage provision.

The success of any method will certainly depend on how well it is adapted to local conditions. Given the stage of economic and financial infrastructure and the generally low-income of many people in Ghana, it appears that community development initiatives in the form of local mutual associations could create opportunities for decent homeownership for the masses. Well-established mutual associations could operate very well in Ghana to overcome most, if not all, of the obstacles that prevent institutions from financing certain potential mortgage borrowers. That is to say, the principles underlying operations of mutual associations could be well adapted to address the main problems associated with the basic requirements (the five C's) discussed above.

A mutual association is one based on the commitment of the local community to help itself. It is often developed through community initiatives, reflecting community ideals of cooperation, self-help, savings and home-ownership. The concept is not new in Ghana. Several mutual associations can be cited, including susu groups, building societies and credit unions, most common with local market traders, tradesmen, and even some professionals and certain key workers in cities. Unfortunately, most of these associations were not able to realize their full potential. They needed support in the form of initial capital and infrastructure, like adequate office spaces and equipment, as well as some form of technical assistance to set up a sustainable institution. The lack of resources, coupled with mismanagement and corruption, led to failure of most of these associations and/or activities of some being taken over by well-established financial institutions. The enthusiasm that followed the establishment of building societies in the 1970s to 1980s died out too soon for lack of support.

### THE BEST POSSIBLE ALTERNATIVE

Mutual associations could help achieve the basic lending requirements and provide successful social structure for building home-ownership in lower-income communities if they were supported. For instance, well-established mutual associations could be helped by the government investing on a matching basis by the purchase of preferred shares in an amount up to the equivalent of the investment raised locally. Local associations would be motivated to increase their contributions and savings if they believed that the government support would depend on their own contributions. At the point of credit evaluation, the assessment of the ability and willingness to pay back loans would be much easier for mutual associations compared to high street banks.

First, because mutual associations are local organizations for the local people, community members are likely to take better care of the savings. In most cases, management of the association is local and, therefore, has a very good knowledge of the character of potential borrowers. Unlike the bank, which assesses the credit reputation based on the person's credit history, the potential borrower should be well known to the association, and so credible character reference is guaranteed. Moreover, the community acts as a watchdog so that no borrower would like to be known in the community as failing to repay a loan.

With respect to the assessment of financial capacity of potential borrowers, association managers are clearly aware of the economic activities of potential borrowers because they are local people. Thus, the problem of income verification would be less. Also, they can assess the ability to pay by considering both formal and informal incomes of the borrower. Income from extended family members in a household could be included as part of the family income, thus increasing the amount the household qualifies to borrow. These opportunities are usually not often available to borrowers when high street lenders evaluate the loan.

As I have seen, Ghanaians naturally have the spirit of self-help initiative. Therefore, mutual associations can capitalize on this community initiative to develop programs that incorporate self-help activities where borrowers can contribute their own labor towards house building. By so doing, debt-to-income ratio and, therefore, the loan required will be such that the borrower would be able to afford to buy, even with the low income.

As discussed earlier, "freehold tenure" in Ghana is not common because of communal land ownership. The current legislation is also not clear about how long it will take to foreclose on defaulted property even if it were possible to do so. This makes collateral risk complicated for banks. But where mutual institutions offer loans to local people to acquire houses built on communal land, there may be alternative ways to ensure collateral security.

For example, if activities of mutual associations are undertaken with the full participation and agreement of local communities and their leaders being custodians of the land, they could effectively negotiate funding and collateral terms with associations. The parties could agree on some form of share equity/ownership. The mutual association would make funds available to qualified members to build houses on the portion of community land (to which members of the community are entitled anyway) in return for partial ownership and/or to share equity on the property. In that way, mutual associations would not have to worry about the lack of freehold tenure where land is communally held, as the house is effectively owned by the member and the association until the loan is paid up. In that case, the community does not guarantee the loan to the institution, but the association is part owner and equity shareholder of the property. The property itself becomes the first collateral security for the loan to the extent that in the event of repayment default, the property could be taken over by the association.

Moreover, because both owners and the community participate in the building process, they would be able to undertake adequate checks to ensure that unsuitable work is not done. Hence, the value underlying mortgage security for the lender is maintained. Also, the community could make land available to the association and then, through self-help programs, houses may be completed for beneficiaries. Habitat for Humanity in Ghana successfully developed similar programs that helped to provide affordable houses for certain low-income households in the early 1990s. However, follow-up on this initiative did not happen, probably because of the lack of government support.

In addition to personal savings contributed by potential borrowers into mutual association programs, they can contribute their own labor, especially into self-help programs developed by the association, which can be regarded as capital investment in the property. In this case, the loan-to-value ratio may not be large, and therefore monthly loan payments could be affordable.

Finally, we suggest that the risk associated with the state of the economy could be left for the government to deal with because it has the powers and instruments to implement appropriate policies and also support mutual associations. Nevertheless, mutual associations could make significant contributions in the quest for sustainable homeownership for key workers in Ghana as they are meant to be self-sustaining economic organizations. The credit policies of mutual associations would be sound as they are based on the commitment of the local community geographically close to the association and thus known to its management. But it must be noted that events may not be easy in practice as described above. In any case, a number of variations on the theme may need to be considered if success is to be achieved.

## NOTES

[1] As of August 2002 the Central Bank maintained its rediscount rate at about 25%. The 91-day Treasury Bill discount rate for example was 24.5% through August 2002. The commercial banks' borrowing rates were also generally stable throughout the year. Rates for savings deposits moved up slightly from 20%–25% cent to 20%–27% and the range for call money from 20%–27% to 20%–30% per annum. As of August 2002, the typical mortgage rate quoted by most lenders, especially Home Finance Company, was 12.5% per annum. But where it is quoted in the Ghana cedi, the mortgage rate is usually between 20% and 25% per cent per annum.