Resource Report 2:

Literature review on the financial needs and products available to small scale Landlords and Entrepreneurs from Commercial Banks

A research project sponsored by the National Department of Housing, the Social Housing Foundation, Nedbank and the FinMark Trust

Date: 6 February 2006

Submitted by:

Shisaka Development Management Services (Pty) Ltd

in Association with CSIR Built Environment

Shisaka Development Management Services
Reg.2002/018833/07
PO Box 2601, Saxonwold, 2132
Tel: 011 447 6388; Fax: 011 447 8504
Email: shisaka@shisaka.co.za

CSIR Built Environment
PO Box 395, Pretoria, 0001
Tel: 012 841 2571; Fax: 012 841 3400
Email: mnapier@csir.co.za

This research into Housing Entrepreneurs has been undertaken by Shisaka Development Management Services (Pty) Ltd in association with CSIR Built Environment

Authors of this Report:

Robert McGloughlin

The ideas expressed are based on research undertaken and extensive discussions within the Team.

Project Team:

Team Leaders

Matthew Nell and Ishmael Mkhabela

Project Co-Ordinator

Ros Gordon

Project Members

Judi Hudson, Maurice Makhathini and Mark Napier

Specialists

Otto Holicki, David Gardner, Robert McGloughlin and Kgaogelo Mamabolo

Social Researcher

Progressus

Administration

Kim Foster and Kendel Nordin

Acknowledgements

Funders

The Finmark Trust, the Social Housing Foundation,
Nedbank, and the National Department of Housing

Co-ordinator

Kecia Rust – The Finmark Trust

Thank you to the advisory committee, focus group, interview and survey respondents, as well as specialists and Government Officials who provided their valuable input. A special thank you to NURCHA who provided the Team with access to primary research data.

Reports produced as part of the Housing Entrepreneurs Research Project:

Final Reports:

Research Report: Consolidated analysis of research into Small Scale Landlords and Home Based Entrepreneurs (April 2006)

Small Scale Landlords: Research Findings and Recommendations (3 May 2006)

Home Based Entrepreneurs: Research Findings and Recommendations (to be released in July 2006)

Resource Reports

Literature Review

Resource Report 1: Literature review of Small Scale Landlords (6 February 2006)

Resource Report 2: Literature review on the financial needs and products available to Small Scale Landlords and Entrepreneurs from Commercial Banks. (6 February 2006)

Resource Report 3: Literature review on entrepreneurship, housing and housing finance (6 February 2006)

Resource Report 4: Literature review on Home Based Entrepreneurs (6 February 2006)

Small Scale Landlords

Resource Report 5: Research into Landlords in Inner Cities (6 February 2006)

Resource Report 6: Research into Landlords in Townships (6 February 2006)

Resource Report 7: Research into Successful Landlords (6 February 2006)

Resource Report 8: Research into Service Providers in respect of Small Scale Landlords (6 February 2006)

Resource Report 9: Research into Public Sector Stock (6 February 2006)

Home Based Entrepreneurs

Resource Report 10: Research into Home Based Entrepreneurs (6 February 2006)

Resource Report 11: Research into Successful Entrepreneurs (6 February 2006)

Resource Report 12: Research into Service Providers in respect of Entrepreneurs (6 February 2006)

Contents

List of Tables

1 Introduction

1.1 Background

Finmark Trust, the Social Housing Foundation, Nedbank and the Gauteng Department of Housing have appointed Shisaka Development Management Services in association with the CSIR to undertake research into 'Housing Entrepreneurs'. Housing Entrepreneurs are defined as small scale landlords and entrepreneurs who operate or use their house as part of their business activities.

The purpose of the research is to understand **how housing and housing finance can be used as a tool to promote the emergence and growth of entrepreneurs and small scale landlords**. Specifically the study aims at:

- **Identifying the housing finance interventions** necessary to build an entrepreneurial and small scale landlord sector in low income areas.
- Developing **appropriate information products and tools** to assist emerging entrepreneurs and landlords in their efforts at becoming housing entrepreneurs.
- Focusing on the potential for small scale entrepreneur landlords to be the model for dealing with **difficult to transfer state owned stock**.
- Understanding the key issues which would support a **productive relationship between the landlord and the tenant** in the small scale sector in the mutual interests of both parties.
- Inform policy and strategy directions so as to facilitate **better access to housing investment opportunities for either entrepreneurs or small scale landlords**, such as are already being realised in the middle and upper income sector of South Africa.

This report forms part of Phase 1 of the research and comprises a literature review of the financial needs and products available to small scale Landlords and Entrepreneurs. International and national literature was reviewed through an Internet search, as well as documentation provided by professionals in the development sector.

1.2 Focus of the review

This review focuses on the findings of local and international studies that relate, or have relevance to, the financial needs and the financial products that are available to small scale landlords and entrepreneurs (SLEs).

The document is not intended to be an exhaustive, academic analysis of the topic, but rather to outline key highlights, issues and concerns from the literature.

This document sets out the **issues and current approaches to financing SLEs** that are found internationally and locally. Examples of lending approaches are given and details of the loan products are discussed. The conclusions and findings of these studies are summarised in a concluding section.

1.3 General support of Small Scale Landlords and Entrepreneurs

The small enterprise economy has the potential to contribute to the development goals of stimulating economic growth, reducing unemployment and reducing levels of poverty.

Formal financial institutions have found providing support to SLEs has been risky, costly and unprofitable (Rogerson) (even leading to the demise of a number of local institutions, such as Saambou Bank). As a result **the development of financial products and services to this market has been limited.**

Yet **access to finance remains one of the key hurdles sighted** by SLEs to entering or growing their business, as found by various studies sited by Rogerson.

2 International Experiences/Approaches to Financing SLEs

There is limited literature available documenting the experiences and approaches of foreign providers of credit to SLEs. A summary of these experiences and approaches are set out below.

2.1 Bangladesh Rural Advancement Committee

The Bangladesh Rural Advancement Committee (BRAC) is the largest non-governmental credit provider in Bangladesh. BRAC's approach to lending combines credit and business development services within a few productive market sectors (Pikholz, L. 1999).

According to Pikholz BRAC's success is attributed to:

- focusing on **profitable sectors** (poultry);
- actively **engaging with other producers** in the sector;
- **identifying and removing constraints** at key points in the economic chain;
- **charging for value added services**;
- **maximizing synergies** between financial and non-financial interventions; and
- operating the program support enterprises as a business with skilled staff.

2.2 Shore Bank Corporation

South Shore Bank of Chicago as detailed by Pikholtz has been successful in providing finance to entrepreneurs wishing to rehabilitate apartment buildings.

The success of this product is that:

- the market (the rehabilitation of apartments and the demand for the end product) was well defined and there was a **viable commercial opportunity**;
- the **individuals had the necessary skills** to undertake the work and the **entrepreneurial drive**;
- South Shore Bank **tailored loans to meet the cash flow needs** of the borrower; and

- South Shore Bank took the initiative to ensure that **market information, technical know-how and educational information was shared** amongst borrowers.

The lessons learnt from Shorebank as reported by Seloane, *et al* on their visit to the bank:

- the ability of the applicant to repay the loan from salary is not a crucial factor in real estate lending. The **primary focus in approving the loan should rest on expected cash-flow and character of the applicant**;
- the lending institution should have a **clear and simplified primary focus**. This separates good companies from great companies;
- proximity impact principle, (**know your customers**), should be the foundation of a good lender (the location of an operating office should be amongst the client base), this assures efficient accessibility, more intimate understanding of the client and ensures rendering of quality service;
- it is important for companies to be socially responsible through **positive interaction with its primary customers** (Shorebank turned some of its customers into multi-millionaire landlords), thus, the bank did not only create wealth for itself but to its customers as well;
- any responsible lender should put **client education and counselling** as an integral part of the loan application process, this is a sure route to maintenance of good quality loan portfolio; and
- the bank uses loans to community organizations such as churches as a platform to sell their mission and market their loan and banking products.

2.3 Global Financial Innovations Partnership (GFIP)

A subsidiary of South Shore Bank, Shore Bank Advisory Services has partnered with USAID to launch the Global Financial Innovations Partnership (GFIP). This is an innovative model for leveraging capital and technical assistance resources to benefit 100 million “slum dwellers” by 2020 in disinvested urban communities and developing economies throughout the world.

The GFIP, based on the Shore Bank model, is designed to forge strategic partnerships among government agencies, the donor community and the private sector to catalyze slum-upgrading activities. Implementation by Shore Bank would consist of activities that will increase the access to finance for slum upgrading through private capitalization, strategic partnerships with local financial institutions and capacity building of institutions engaged in housing finance.

In both of these cases BRAC and SSB provided **both credit and support services**, which together contributed substantially to the success of the borrowers.

Pikholz found that in these examples the experience was that **finance, on its own, though useful and necessary, will not increase the productivity of lenders**. It is the provision of **appropriate and affordable business development/support services**, with or without finance that will enable firms to more easily grow.

2.4 Other Lessons Learnt from Lending Programmes Internationally

Seloane, *et al* visited lending operations in Bucharest (Romania), Chicago and Washington DC (USA) to gain a better understanding of the practical experiences encountered by lenders to low income markets. The salient lessons learnt from these operations are highlighted below.

2.4.1 Domenia Credit (Romania)

Domenia was one of the first specialized mortgage institution established in the Romanian market after the collapse of socialist rule in the country. The lessons learnt by Domenia Credit include:

- the **cession of title deeds and an efficient foreclosure process** is crucial for the maintenance of a good quality housing loan book;
- it is crucial for the **eviction process to be swift and cheap**;
- there is need for **special legislation authorizing the lender to surpass long-winded court procedures to effect eviction from property;**
- there is a need to offer **less than 100% housing loan**;

- the maximum monthly premium should be no greater than **35% of total gross household income**;
- it is importance to consider **"grey income"** when dealing with low-to middle-income earners;
- a **comprehensive site inspection report** should form part of the loan application to be submitted to a credit committee;
- **character assessment of the lender** should be given more weight than any other criterion when assessing loan applications;
- **counselling of potential home-owners** should be made compulsory and a condition precedent to processing a housing loan; and
- loan officers should have **negative incentives** when his/her portfolio under-performs.

2.4.2 Alpha Bank

Alpha Bank is one of the largest banks in Greece. It was one of the first to create a branch network and mortgage loan products in post-socialist Romania. Alpha Bank pioneered the mortgage housing market in around 1999. Its focus is on the high-income market. The lessons Alpha Bank learnt include:

- the borrower must make a 25% cash deposit that acts **as collateral on the loan**; and
- monthly premium repayments should **not exceed 35% of gross household income**.

2.4.3 Romanian–American Enterprise Fund (RAEF)

RAEF works as wholesale lender. Its program focuses on providing assistance to young Romanian entrepreneurs so at to create small to medium enterprises. RAEF relies on **NGO networks as the distribution channel of loans**. The NGO personnel act as **loan officers and are responsible for marketing and portfolio monitoring**. Lessons learnt from RAEF are as follows:

- An effective collection system requires **reminders a day or two** before the monthly instalment is due;

- **Continuous contact with the client is beneficial** for maintenance of a good quality loan book;
- The most effective management as a wholesale lender is the creation of a business partnership with reputable community organizations;
- Loan product development should make provision for "NGO activities" in the form of fees that cover all loan origination and loan monitoring expenses
- The quality of community organizations and expertise of loan officers plays a crucial role in the success of repayment by borrowers.

2.4.4 Community Investment Corporation (CIC)

CIC is a community based organization that originates loans as per the community re-investment act and other acts that aim at encouraging affordable housing and neighbourhood revitalization within Chicago City, USA. The institution generally takes the first lien mortgage on the property financed. The majority of its loans are for refurbishment and construction lending. Lessons learnt from CIC are as follows:

- It is prudent to **internalise departments that are responsible to manage quality workmanship on projects**, outsourcing is good only for the initial phase when the cost structure does not allow for an internal department.
- Large commercial banks can meet their social responsibility mandates more efficiently by **risk sharing funding to community-based loan originating institutions** such as CIC.

2.4.5 City First Bank of D.C.

City First Bank of D C offers banking services specifically for the lower- to middle-income earners. These include savings accounts, housing loans, personal loans and enterprise loans. Emphasis is on local community impact. Lessons learnt from this bank highlighted the need to:

- **pre-screen and credit rating** was most efficient;
- an **economic analysis of specific neighbourhoods** offers up-front credit rating of an area; and of the applicants and projects coming from respective neighbourhoods;

- **upfront payment of collateral** has proven to be effective mitigating factor against high default rates;
- **reserves to cover part of loan exposure** should be calculated in accordance with applicant, product and neighbourhood risk rating.

2.4.6 State of Maryland Community Development Agency (MDA

MDA was created and funded by the State of Maryland, USA. It falls under the USA's State Department of Housing and Community Development. The agency's mission is to ensure inhabitants of Maryland "achieve equal housing opportunities". To achieve this objective it acts as both wholesale lender and retail financier. Lessons learnt from MDA are:

- low default rates are attained and managed through c**redit screening and intensive pre-approval counselling**;
- Government created institutions should have their developmental mission as a priority;
- development agencies have to attain sustainability and at the same time be flexible enough to ensure attainment of developmental role; and
- **education, training and information dissemination** to (potential) home-owners.

2.4.7 Manna Mortgage Corporation (MMC)

MMC is a not-for-profit organization established 22 years ago by a church minister as a reaction to a housing shortage for church members and the community in general. MMC sources funds from the federal government and donor agencies to implement its strategies of alleviating housing shortage for low-to-middle income earners. Lessons learnt from MMC are as follows:

- **Collateral is crucial** as a form of commitment irrespective of fact that the lender is an NGO;
- **Educational and rehabilitation programs** often result in better repayment rates than lenders that "cherry pick" on highly rated clients from high income groups; and
- **good quality service to clients** is the best marketing and sales strategy.

2.4.8 Lessons learnt

A summary of the lessons learnt by these international lenders in making loans to low income lenders, as highlighted above, is graphically represented in Table 1 below.

Table 1: Summary of Lessons Learnt by International Lenders

Description of Salient Lessons Learnt	**Domenia Credit (Romania)**	**Alpha Bank**	**Romanian–American Enterprise Fund**	**Shore Bank**	**Community Investment Corporation**	**City First Bank of D.C**	**State of Maryland Community Development Agency**	**Manna Mortgage Corporation (MMC)**
Cession of title Deed	x							
Ability to foreclose	x							
Premium not > 35% of monthly income	x	x						
Consider non-formal income	x			x				
Physical site inspection	x							
Character assessment	x			x			x	
Counselling Services	x			x			x	x
Loan Officers in/de-centivised	x			x				
Collateral - cash deposit		x				x		x
Refurbishment loan term 5 years		x						
Effective Loan System			x	x				
Continuous Contact with Borrowers			x	x			x	
Community organisations involvement			x	x	x			
Trained loan officers			x	x				
Lender to be focused				x				
In-source key lending functions					x			
Pre-screen Clients						x	x	
Consider macro factors of neighbourhoods						x		
Government support prioritized							x	

On the basis of the above table it is evident that the following factors are considered by the Lenders detailed to be of important in respect of providing loan finance to small scale Landlords or Entrepreneurs:

- Character assessment
- Counselling services
- Collateral or cash deposit
- Continuous contact with the Borrower
- Community organisations involvement

2.5 Successful Clusters of Business

Rogerson (1999), in a report on enterprise in Africa for the Centre for Development and Enterprise, links the success of small enterprises to clustering. The core features of the clusters described are:

- **clusters of primary small and medium-sized enterprises** which are spatially concentrated and sectorally specialised;
- **a strong relatively homogenous cultural and social background** linking the economic agents and creating a common and widely accepted behavioural code;
- **an intense set of backward, forward, horizontal and labour linkages**, based on both market and non-market exchanges of goods, services, information and people; and
- **a network of public and private local institutions**, supporting the economic agents in the cluster.

2.6 The Value of Property Rights as a Means to Access Capital

The value of real estate held, but not legally owned, by the poor in the developing world, is at least USD9.3 trillion (ID21 Urban Poverty)

Hernando de Soto argues (in his book 'The Mystery of Capital' – 2000) that the **establishment of property rights of the urban poor** is the key to economic revival in developing countries. He also argues that the world's poor are actually quite rich in terms of land assets. However because of a range of issues the poor have difficulty in transforming their property assets into working capital. If this problem could be resolved this latent wealth could be unleashed to stimulate massive new investment and entrepreneurship among the poor. The key, he argues, to unleashing this potential is to give the poor **title deeds to their property**. The tile deed to the property would allow the poor to provide collateral for loans. According to de Soto, **by facilitating access to credit** it is possible to convert these individuals into successful entrepreneurs.

Alan Gilbert however questions whether property title alone is sufficient to unlock the potential that de Soto believes is possible. Gilbert provides evidence that suggest that sales of properties are sometimes more frequent when people lack legal title. He also suggests that the evidence also points to the fact that **the possession of a title deed does not necessarily improve security of tenure or access to credit**.

2.7 Experiences in Other African Countries

Experiences in other African countries, according to Rakodi, have found that **large traditional loans are not well suited to the incremental needs of the low income market**. For SLEs that are expanding their assets progressively, loan repayment terms and cash flow mismatches occur between the fixed nature of the large traditional loans and the asset.

Rakodi states that households in low-income settlements **construct their housing without formal-sector finance.** She found that, for example, 35% of respondents in Chaani and 27% in Kisauni, two low-income settlements in Mombasa, used rental incomes to help support the consolidation of their dwellings and those informal sources accounted for 72% of all investment in the Dandora sites-and-services project in Nairobi.

In international markets where SLEs are expanding and growing their asset base progressively, a **mix of finance from various sources, such as, savings, loans from family/friends and small loans** was used to overcame the problems associated with longer term formal finance.

3 Lending to SLE's

3.1 Principals for Sustainable Lending to SLEs

Rogerson summarises Webster and Fidler's principals for sustainable lending to SLEs into the following 10 points:

- offer short term loans with frequent repayment periods;
- offer small initial loans;
- concentrate on provision of working capital to enterprises with a proven track record;
- specialise in financial services and diversify loan portfolios;
- simplify services by making the credit programme a customer friendly process;
- localise services and focus on scale;
- shorten turnaround times between loan application and disbursement;
- motivate repayment via group solidarity and joint liability;
- recognise that the poor do save by linking credit programmes to savings; and
- charge full-cost interest rates (factoring in inflation, loan losses, delinquency and cost of loaning funds).

3.2 Obstacles for SLEs

In the literature reviewed a wide range of obstacles for SLEs to become active or to expand their current operations are noted. Below is a summary of these obstacles.

- **Lack of access to formal financial services**: Individuals lack the required security for loans, the loans are not affordable and individuals may be listed on credit bureaus that disqualify them from accessing formal credit.
- **Lack of basic funding to invest**, especially in inner city refurbishment projects.
- The **numbers of financial service providers are restricted**. Limitations include the minimum capital requirements set out in The Banks Act.

- **High levels of unemployment mean that loan repayments are unaffordable**. Individuals may also have temporary employment or irregular employment. **Income is therefore highly volatile.** Existing businesses tend to be subsistence and do not provide excess capital for reinvestment.

- **Formal banks' perceptions are that the lower end of the market is uneconomical**. These banks are not accustomed to working at the lower end of the market where SLEs are active. To compensate for this additional burdens are then placed on these SLEs to price for this perceived or actual risk.

- **Mortgages provided by formal banks are not viable** where the household income is low and erratic.

- **Low income households may be reluctant to take on** debt. The risk of losing a home is greater than the benefits of accessing capital.

- **Lack of security of tenure or tile deed of the property limits the security that can be offered by the individual**. This limits households' ability to leverage capital using existing property as collateral. Another view is that titling may make little difference to the poor in terms of security of tenure or access to finance (see the comments referring to de Soto and Gilbert above).

- **Creating wealth from climbing the housing ladder by moving from small home to larger ones is limited** as there is a low turnover in properties in low income areas. Turnover is also affected by the limited supply of housing stock and end user finance available.

A particular feature of South Africa's affordable housing sector (Smith 2003) is the **dysfunctionality of the secondary market**. This is for a number of reasons including:

- The limited availability of finance given the risks associated with this segment of the population and the housing they occupy.

- The limited availability of estate agents in low income areas.

- Constraints in the process of transferring property.

- Demand issues: the relative newness of new housing construction in this market, given the recent introduction of the housing subsidy scheme. Households residing in these units are not yet ready to put their houses on the market.
- Supply issues: Those that are cannot find other housing in which to move, given the narrow focus of the subsidy scheme on the construction of subsidised houses.

3.3 Typical Capital Needs of SLEs for Construction of Accommodation

The capital/funding requirements of SLEs vary widely depending on the nature of construction. New construction aimed at expanding existing accommodation available for rental on existing properties, which could include expanding existing units or developing additional accommodation units on existing properties, can be constructed for as little as a few thousand rands (for informal backyard accommodation), up to hundreds of thousands of rands (for formal second dwelling units).

The indicative costs, according to Gardner, D., of formally constructed accommodation options suitable for rental accommodation (medium / higher-density accommodation, finished to medium levels of finish) are for new developments R75 000 for a 30m2 unit, conversion from other uses R45 000 for a 30m^2 unit or refurbished units R27 500 for a 30m^2 unit .

Informally developed, formally and informally constructed accommodation range from R480 to R760/m2 for the construction of rooms (at Cato Manor it is much lower R300-R365/m2) and for the construction of shacks R85-R100/m2 (Cato Manor R65/m2).

3.4 Capital/Funding Sources Used by SLEs

It was generally reported in the literature that finance was difficult to obtain for SLEs. The SLEs that had successfully raised finance for their activities generally used the following sources:

- **Savings**: Most informal rental stock constructed by the landlord has been financed via savings. This includes lump-sum capital amounts through retirement and life policy payouts.
- **Loans**: Few informal structures have been constructed using loans.

- **Incremental Construction**: It is likely that many landlords construct dwellings using an incremental process as and when resources (finance or stockpiled materials) are available.

In K. Rust's report of 2004 only 15% of the respondents had accessed finance. 36% of these respondents had loan finance from a bank, 5% had a current mortgage loan. None of the respondents were using mortgage loans to start a business. 3% had a micro loan, 9% had loans from *mashonisas* (informal cash lenders) and 43% had loans from friends and family. The majority of respondents had used their own funds to start business (savings).

3.5 Sources of Capital

Sources of capital most used for the **construction of informal accommodation** include pension payouts, retrenchment payouts, bank loans using the house as collateral, personal savings and ad-hoc money. Existing latent value of building stock is also used. There is a high degree of 'sweat equity' applied to the development of these units, although most are contractor-built or built through the supervision of hired labour. Stockpiled building materials are also a common form of 'equity investment' (Gardner, D. 2005).

Gardner, D. found that limited sources of financing were found to have been used by SLEs. These sources can be summarized as:

- **Debt**: commercial loans, specialist service providers and micro loans.
- **Equity:** pension payouts, retrenchment payouts, personal savings and ad-hoc money
- **Building / stock** (incremental building, donated building materials, collected building materials, stolen materials, relief tents)
- **Guarantees**
- '**Sweat' equity** (SLEs own opportunity cost)

In a report by Wilson, M. (Aug 2005: Finance 24) consumers in South Africa are getting more than **R5bn a year of housing finance through the micro-lending industry**, in small loans of R10 000 or less at a time. The latest figures from the Micro Finance Regulatory Council show that while school fees and other education costs still top the list of reasons for taking out small loans, housing comes a close second.

In the three months from March 2005 to May 2005 the banks, which are the favoured source of micro-loans, made R2.3bn worth of loans - including R685m worth for education, R630m worth for housing and R250m worth for small business funding.

This suggests that the banks alone are now making R2.5bn worth of micro-loans for housing a year. Micro-loans are defined as being amounts of R10 000 or less, and are repayable over 12 to 36 months.

The micro-lending industry as a whole made R5.77bn worth of loans in the three months to end-May, which represents an increase of 30% on the same period in 2004.

The total value of micro-loans made in the 12 months to end May was R22bn, which suggests that **almost R6bn worth of non-mortgage funding is now going into housing annually**.

Reserve Bank figures show that some R94bn worth of new mortgage-linked home loans were made in the 12 months to end-May 2005. **Micro-lending could thus be seen to represent 6% now of all borrowings being made to finance housing needs.**

3.6 SLE Expectations and Experiences of Returns

In considering the economic returns on low-income landlordism, a few important points must be kept in mind:

- Calculating the rate of return on rental properties based on certain assumptions in relation to land values and construction and maintenance costs **might not provide a realistic picture of the economic benefits to be gained by being a low-income landlord**.

  Small landlords, who seek to invest in rental housing for the accumulation and expanded reproduction of capital, are certain to weigh the benefits of **alternative investments and to choose that alternative which provides a better rate of return on capita**l. However, as the literature clearly demonstrates, such as in Rakodi's report on Rental Tenure in the

Cities of Developing Countries, **this form of low-income landlordism is rare and has been seen to occur in only a few cities such as Nairobi.**

- A retrospective econometric analysis of the rate of return on rental properties does not take into consideration the way in which low-income landlords view investment in rental housing. With the majority of landlords operating with the view to supplement income, investment in **rental property may be driven, in the long term, by other considerations such as the purchase of property for children or for sale when land prices rise**.
- Analysing the rate of return on rental properties assumes that the total capital invested in the production of rental housing is available to the landlord at any given point in time. Thus rates of return are subjected to an opportunity-cost argument. In other words, landlords would rather invest in other sectors of production since the returns on investment are higher. However, it is evident that the majority of landlords are involved in the production of rental housing in consolidating self-help settlements. Investments are made over extended periods of time and the construction process is one of gradual consolidation. In such circumstances, **capital is injected in small and varying amounts intermittently.** The amounts are often too small to be invested in other sectors of production. Even if they were to invest in other sectors of production, **the rates of return are not likely to be as high as those that they derive from rental housing.**
- The investment in rental housing **may be made for many other reasons**: accommodation built for self-occupation may be sub-divided and let, in the short and medium term, to provide subsistence incomes; accommodation may be added for the needs of the households, but be rented out in the short or medium term, to pay for such an investment; and, rental accommodation may be produced for transfer to children at a later date.

It can, therefore, be argued that the rate of return may be of concern to those landlords who possess the capital required for the production of a certain quantity and quality of rental housing and are thus likely to consider the opportunity cost of investing in rental housing. For those landlords whose access to capital is limited by savings and whose investment is intermittent, investment in rental housing is more likely to be governed by considerations other than the economic rate of return

Examples of Actual Returns being realised in South Africa is shown in Table 2 below.

Table 2: Typical Returns for Accommodation in Townships

Description of Accommodation	Size of Unit (m^2)	Construction Cost (approximate)	Typical Rental (monthly estimates)
Shack	10	R3,000	R150
Backyard tenement	10	R14,500	R250
Backyard tenement with toilet	17	R24,100	R350
Prefabricated structure	10	R23,500	R200
Prefabricated structure with toilet	17	R38,000	R250

* Source O. Holicki

4 Finance and Lending Products Available to Local SLEs

The literature discusses various financing options that are available to SLEs in South Africa. Many of these finance options or loan products are not necessarily specifically designed for SLEs but have been used by SLEs to further their objectives. The finance and lending products can be categorized into:

- End User Finance Options
- Specific loan types from Financial Service Providers
- Guarantee Products
- Other alternative lending options

Each of these is detailed below.

4.1 End User Financing Options for SLEs

The types of end user finance discussed in the literature that SLEs can access include:

- loans that use pension fund surpluses as collateral;
- loans that use payroll deduction as security;
- membership based savings clubs;
- group lending schemes, where the group is individually and jointly liable for the repayment;
- instalment sale loans (also known as "Rent to Buy" or "Deferred Sale"), such as Nedbank's Buy-to-Let, which uses a portion of the rental income into the affordability calculation of the SLE;
- End-User Mortgage Finance, finance linked to the underlying value of the asset constructed (e.g. how the Perm scheme operated).

A key characteristic of sustainable alternative finance suited to the SLE is a progressive approach. Instead of long term mortgage finance the alternative could be to combine small loans with savings and subsidies.

4.2 Specific loan types from Financial Service Providers

The following specific loans are available from Financial Service Providers:

- The Trust for Urban Housing Finance (TUHF) provides finance to increase the quality and supply of rental housing in South Africa’s inner-cities through small private owners, small private residential landlords and housing developers. TUHF provides bridging finance facilities and longer-term loan facilities.

- The NHFC introduced two products that use securitisation to encourage banks to lend down market, Primary Market Institution (PMI) and their Primary Market Lender (PML) products. The PMI product targets housing units sold by instalment sale and that are secured by pension-provident fund withdrawals benefits. The PML product targets housing bought by using mortgage loans. Both products target individuals who are employed and are earning less than R6,000 per month.

4.3 Alternative Financial Approaches

Alternative financial products improve SLEs access to capital. Examples of such alternative financial approaches are set out below.

- **Guarantee Products**: Guarantee products are designed to cover the lenders’ risk of non-payment by the borrower. Typically guarantee products are designed to cover lenders’ risk on bridging finance or long-term loans and cover a portion of the lender’s risk of non-payment from the borrower. In order for guarantee products to be successful, the following factors must be considered:

  - guarantees must be implemented in tandem with sources of finance for which they are required;
  - cost of guarantee must be competitive;
  - volume of guarantees must ensure overhead costs are covered;
  - there must be a spread of risk across portfolios / geographic areas to limit exposure; and
  - there must be an ability to secure backing for guarantees from other interested parties.

The ideal situation would be to have a single national guarantee fund for facilitating the expansion of the middle and lower-income rental sector to ensure feasible volumes of business. It is assumed that guarantees will facilitate the flow of commercial funding to commerciallyoriented rental operators by reducing the real and perceived risk lenders have regarding this market.

Guarantees should also only be provided as 'last resort' mechanisms, otherwise they have the potential to simply push up the real cost of accessing finance by rental institutions.

- **Credit Schemes:** Certain current building materials initiatives, linked to Nurcha financing programmes, could be used to extend their services for rental accommodation construction. In supporting the role of the emerging builder, bridging finance has been critically important, as such builders haven't the capital to carry the costs of development until they are paid for their services. However, risks associated with any emerging market made it extremely difficult for such builders to access the necessary finance to participate.

  Credit for financing materials and labour for the construction of informal units, which has a small average loan size (less than R10 000, possibly R5 000), could be provided by many small loan institutions. Schemes already exist that could be applied to this market, but few have specifically targeted informal rental and resistance is likely to be experienced in encouraging the flow of such finance into this market. This is probably due to the 'unbankable' complexion of the lenders, on first analysis (low income landlords, some with irregular incomes, low loan sizes) (Gardner, D.).

4.4 A Study into the Constraints Experienced by SLEs Investing in Housing

In Rust, K (2001) a report prepared for Nurcha on investing in rental stock, respondents were either unable to source financing or were not prepared to enter into restrictive agreements with lenders.

In a response to the loans offered by the National Housing Finance Corporation (NHFC) the respondents said that the NHFC was not lending, others questioned if it would be worth their while to approach the NHFC, given the limitations that an agreement with this institution placed on their operations.

The NHFC has been described by lenders as:

- **Unaffordable:** loans issued by the NHFC are all above prime, ranging from ½% to 4% above. This increases costs to the institution, which, if they are also accessing the subsidy, they are less able to cover with rental income.
- **Uncertain:** While the last two loan agreements have been coming in at about prime plus ½%, the NHFC reserves the right to increase the rate after 5 years. This undermines long term planning as the institution will be unable to determine its long term repayment responsibilities.
- **Inflexible**: one respondent noted that the NHFC was seeking rights of first mortgage on his 550 instalment sale units. The agreement would undermine the ability of beneficiaries finding alternative (cheaper) finance at transfer because the NHFC didn't want to convert its one bond for all the units into 550 individual bonds. They wanted to charge a penalty for early termination of the loan.
- **Unreasonable:** One respondent said that while his institution was registered as a primary market institution, it wasn't being remunerated properly for the risk and exposure it was taking on the NHFC's behalf.

One Landlord noted that while the NHFC did provide finance for instalment sale units, it did not provide funding for long term rental in the inner city. While this Landlord was able to access funding from Nurcha's Joint Venture Development Fund, this only covered 70% of development costs. The remaining 30% still had to be found on the open market – a market that was exceedingly hesitant to invest in the sector.

Indeed, constraints are not limited to the NHFC. To date, only one social housing institution has been able to secure private sector, long term finance. The Johannesburg Housing Company secured a R10 million loan at prime less ¼% from ABSA Bank. The loan was for the purchase and upgrading a building close within the vicinity of ABSA's inner city headquarters, and so it was logical for them to invest. Still, the negotiations were arduous, and were only possible once the JHC had demonstrated its track record and growth path to the satisfaction of the lender.

Few affordable rental housing institutions are able to boast a track record like the JHC's, which has been operating with steady growth and reasonable returns for over five years

4.5 Conclusions in respect of local lending

The international experiences of making finance available to SLEs emphasised the benefits of 'credit-plus' lending strategies. These strategies, where finance was coupled together with business support services, reportedly lowered the risk to the lender and improve the position of the borrower.

In the literature under review there were no examples of local lenders using 'credit-plus' strategies. Although there are financial services providers that do employ this strategy there would seem to be a lack of these financial institutions nationally.

There appears also to be a lack of access to specific loan products that are designed with the unique needs of SLEs in mind. This has meant that SLEs that wish to access finance did so by combining various sources of capital, such as savings, borrowings from friends and family, small unsecured 'micro-loans' and in some cases formal loans.

There are many initiatives that have been put in place across a wide range of market participants to try to address the needs of SLEs. It appears from the literature reviewed that these initiatives have had a broad market in mind and have relied on traditional forms of security to give SLEs access to finance.

An opportunity would seem to exist for specific niche financial services providers that provide both credit and support services to be established to service targeted market segments. These niche financial services providers should explore alternative forms of finance and security to extend credit to SLEs.

Non traditional loan products that are aligned to the needs unique needs of the SLEs would appear to reduce the risk to lenders and enable SLEs to expand and become successful. Alternative forms of finance that use, or combine savings, loans, credit and guarantees and that are designed with the specific needs (size, repayment terms and cost) of SLEs may offer a viable alternative for SLEs.

5 Key Findings

This report sets out the **issues and current approaches to financing Housing Entrepreneurs** on the basis of both international and local experience.

(1) **Availability of products**: Formal financial institutions have found providing support to Housing Entrepreneurs has been **risky, costly and unprofitable**. As a result the development of financial products and services to this market has been **limited.** Yet access to finance remains one of the **key hurdles** sighted by Housing Entrepreneurs to entering or growing their business.

(2) **Lending practices and sustainability**: Literature from a range of Lenders providing different forms of finance to Housing Entrepreneurs was reviewed [see Box below]. On the basis of this review the following common factors were identified in respect of lending practices:

- Lending should only occur where there are **profitable and viable markets**.
- Entrepreneurs should have the **necessary skills to undertake the work** and the **entrepreneurial drive**.
- **Engagement with other producers** in the sector should be encouraged
- **Key constraints in the economic chain** should be identified and removed
- **Client education and counselling** should be an integral part of the loan process providing appropriate and affordable business development and support services. Support should be provided by skilled staff who specialise and are knowledgeable of the sector in which the entrepreneur operates. Entrepreneurs should be assisted in sharing market information, technical know how and information.
- Loans should be tailored to meet the **cash flow needs of the borrower**
- Loans should not be made on the basis of the applicants ability to repay the loan from salary, rather the primary focus in approving the loan should rest on expected cash flow and the character of the applicant.

- In order to ensure that the loan is repaid timeously it is important that the Lender ‘knows the customer’. Accordingly an operating office should be located amongst the client base and should have continuous contact with the Borrower. The Lender should have an **intimate understanding of the borrower** and be **focused on assisting the borrower to succeed.**
- **Community organisations can be used as a platform** to sell and market the loan products.
- Borrowers should provide **upfront collateral**.
- For Landlords and Entrepreneurs who are expanding their assets progressively, large traditional loans are **not well suited** to their more incremental needs. A **mix of finance** from various sources such as savings, loans from family and friends and small loans are being used to overcome problems associated with longer term formal finance.

The following **10 points were identified as being principles for sustainable lending**[1]:

- offer short term loans with frequent repayment periods;
- offer small initial loans;
- concentrate on provision of working capital to enterprises with a proven track record;
- specialise in financial services and diversify loan portfolios;
- simplify services by making the credit programme a customer friendly process;
- localise services and focus on scale;
- shorten turnaround times between loan application and disbursement;
- motivate repayment via group solidarity and joint liability;
- recognise that the poor do save by linking credit programmes to savings; and
- charge full-cost interest rates (factoring in inflation, loan losses, delinquency and cost of loaning funds).

[1] C Rogerson, 2005 Reaching out to informal women entrepreneurs in Johannesburg, The case for a market development approach towards spaza retailing unpublished.

Lenders reviewed who are providing finance to Housing Entrepreneurs internationally

The Bangladesh Rural Advancement Committee **which provides credit and business development services within a few productive market sectors.**

Shore Bank Corporation **which provides finance to entrepreneurs to rehabilitate apartment buildings.**

Global Financial Innovations Partnership **which is a mode for leveraging capital and technical assistance resources to 'slum dwellers'.**

Domenia Credit (Romania) **which was one of the first specialised mortgage institutions established in Romania after the collapse of socialist rule in the country.**

Alpha Bank (Greece) **which provides mortgage finance in Romania**

Romanian – American Enterprise Fund **which provides assistance to young Romanian entrepreneurs so as to create small to medium enterprises.**

Community Investment Corporation **which provides loans to encourage affordable housing and neighbourhood revitalization in Chicago, USA.**

City Bank of D.C **which offers banking services specifically for lower to middle income earners in Washington D.C, USA.**

State of Maryland Community Development Agency **(USA) which provides both wholesale and retail finance to achieve equal housing opportunities.**

Manna Mortgage Corporation **(USA) which sources funds from the federal government and donor agencies to address housing shortages for low to middle income earners.**

(3) **Current lending activities in South Africa**: Loan products available to Housing Entrepreneur's in South Africa are listed below. These loans include both specific loans developed specifically for the sector, as well as general loans that are available.

- **Micro loans:** It is estimated that Micro-lending could represent up to 6% of all borrowings being made to finance housing needs. In a report by Wilson, M. (Aug 2005: Finance 24) consumers in South Africa are getting more than R5bn a year of housing finance through the micro-lending industry, in small loans of R10 000 or less at a time.
- **End User Financing** : The types of end user finance discussed in the literature that Home Entrepreneurs can access include:
    - loans that use pension fund surpluses as collateral;

- loans that use payroll deduction as security;
- membership based savings clubs;
- group lending schemes, where the group is individually and jointly liable for the repayment;
- instalment sale loans (also known as “Rent to Buy” or “Deferred Sale”), such as Nedbank’s Buy-to-Let, which uses a portion of the rental income into the affordability calculation of the Home Entrepreneur;
- End-User Mortgage Finance, finance linked to the underlying value of the asset constructed (e.g. how the Perm scheme operated).

- **Specialist loan for Residential Landlords** : The following specific loans are available from Financial Service Providers for Housing Entrepreneurs including for example[2]:
    - **The Trust for Urban Housing Finance** (TUHF) provides finance to increase the quality and supply of rental housing in South Africa’s inner-cities through small private owners, small private residential landlords and housing developers. TUHF provides bridging finance facilities and longer-term loan facilities.
    - **The National Housing Finance Corporation** (NHFC) introduced two products that use securitisation to encourage banks to lend down market, Primary Market Institution (PMI) and their Primary Market Lender (PML) products. The PMI product targets housing units sold by instalment sale and that are secured by pension-provident fund withdrawals benefits. The PML product targets housing bought by using mortgage loans. Both products target individuals who are employed and are earning less than R6,000 per month.

      In addition the NHFC : Alternative Tenure Division offers mortgage book loans to landlords who acquire or develop residential units for rent to lower income households.

- **Alternative Financial Approaches**: Alternative financial products improve Home Entrepreneurs access to capital. Examples of such alternative financial approaches are set out below.

[2] More details on these loans are covered in Resource Report 8

- **Guarantee Products**: Guarantee products are designed to cover the lenders' risk of non-payment by the borrower.
- **Credit Schemes**: Certain current building finance initiatives, linked to Nurcha financing programmes, could be used to extend their services for rental accommodation construction.

In Rust, K (2001) a report prepared for Nurcha on investing in rental stock, respondents indicated that they were either unable to source financing or were not prepared to enter into restrictive agreements with lenders. The following key problems were identified in respect of NHFC finance:

- Unaffordable: loans issued by the NHFC are all above prime, ranging from ½% to 4% above.
- Uncertain: The NHFC reserves the right to increase the rate after 5 years. This undermines long term planning as the institution is unable to determine its long term repayment responsibilities.
- Inflexible: NHFC has set requirements and is not prepared to adjust them to the needs of Borrowers.

Constraints are not limited to the NHFC. To date, only one social housing institution has been able to secure private sector, long term finance. The Johannesburg Housing Company secured a R10 million loan at prime less ¼% from ABSA Bank. The loan was for the purchase and upgrading a building close within the vicinity of ABSA's inner city headquarters, and so it was logical for them to invest. Still, the negotiations were arduous, and were only possible once the JHC had demonstrated its track record and growth path to the satisfaction of the lender. Few affordable rental housing institutions are able to boast a track record like the JHC's, which has been operating with steady growth and reasonable returns for over five years

(4) **Conclusions**: The review concluded the following:

- The international experiences of making finance available to Housing Entrepreneurs emphasises the benefits of '**credit-plus' lending strategies**, where finance is coupled together with business support services on an ongoing basis. In the literature under review there were no examples of local lenders using 'credit plus' strategies, although there are financial service providers in South Africa that do employ this strategy, but generally only in the loan initiation phase.

- There appears to be a **lack of access to specific loan products** that are designed with the unique needs of Housing Entrepreneurs in mind. This has meant that Housing Entrepreneurs that wish to access finance did so by combining various sources of capital, such as savings, borrowings from friends and family, small unsecured 'micro-loans' and in some cases formal loans.
- Loan products that have been developed to address the needs of Housing Entrepreneurs rely on **traditional forms of security** to give Housing Entrepreneurs access to finance. An opportunity exists for specific niche financial services providers that provide both credit and support services to be established or expanded to service targeted market segments. These niche financial services providers should explore alternative forms of finance and security to extend credit to Housing Entrepreneurs. Such alternative forms of finance should use, or combine savings, loans, credit and guarantees and should be designed with the specific needs (size, repayment terms and cost) of Housing Entrepreneurs.
- Finance should only be provided in respect of **profitable sectors**.
- A credit strategy should be designed that is appropriate for the **specific needs** of the Housing Entrepreneurs

6 References

Berry, M. 2000 Investment in Rental Housing in Australia: Small Landlords and Institutional Investors

Coccato, M. 1996 Alternatives to Home Ownership: Rental and Shared Sub-markets in Informal Settlements

Feasibility (Pty) Ltd. Secondary Township Housing Markets: Interim Report

Ferguson, B., Navarrete, J. 2002. New Approaches to Progressive Housing in Latin America: A Key to Habitat Programs and Policy

Gardner, D 2005 NURCHA "Next to Formal" Private Rental Housing & the Role of Informal Rental Housing in South Africa

Gardner, D. 2005 NURCHA Informal Rental Development Programme: Phase 1 Secondary Research

Gardner, D. 2005 NURCHA PROJECT 1: SOUTH AFRICAN RENTAL SECTOR OVERVIEW (Towards Recommendations for a Rental Role for Nurcha)

Gough, K. V., Tipple, A.G., Napier, M 2003. Making a Living in African Cities: The Role of Home-based Enterprises in Accra and Pretoria

Kumar, S. 1996 ***Landlordism*** in third world urban low-income settlements: A case for further research

NURCHA, 2005 Descriptions for Topology Development

Pikholz, L. 1999 Growing Small and Micro Businesses Through A Credit Plus Strategy: Lessons From The International Experience

Rakodi, C. 1995 Rental Tenure in the Cities of Developing Countries. Urban Studies Vol. 32 Issue 4/5 p791, 21p

Roberts, C.D. and Roberts, G.B. Techniques in Entrepreneurial Finance for Practitioners: Helping Micro-entrepreneurs Gain Access to Capital

Robins, S. 2003. Literature Review on the Socio-Cultural Dimensions of Township (Residential) Property Markets

Rust, K. 2004. The Role of Housing in Entrepreneurial Activity in South Africa

Rust, K. 2002 Housing Finance Resource Programme Occasional paper no. 4. "Competition or Co-operation

Rust, K. 2001 Investigation into Constraints on the Delivery of Rental Housing in South Africa

Seloane, M., et al. 2004 Report on the Visit to Bucharest (Romania), Chicago and Washington DC (USA)

Shisaka, 2004 Township Residential Property Markets, Final Report

Smith, D. A. 2003 Affordable Housing Institute: The Affordable Housing Ecosystem: American and Other Creatures

Snijder, F. 2001 Shacks for Shelter, Houses for Sale: Understanding the Informal Housing Market in Two Informal Settlements in Kwazulu-Natal

Wilson, M. 2005 Small Loans for Homes. http://www.finance24.com/articles