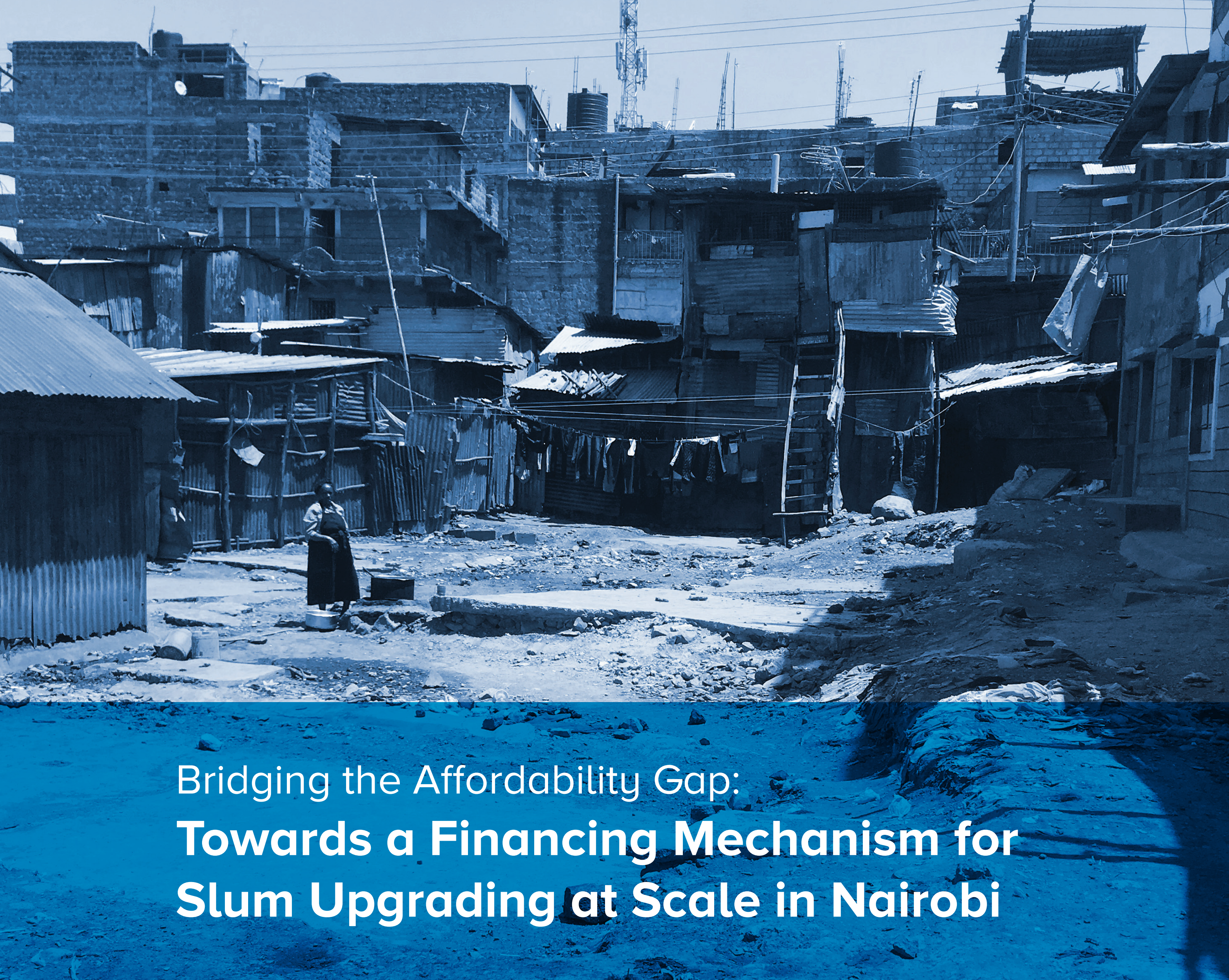

Bridging the Affordability Gap:
Towards a Financing Mechanism for Slum Upgrading at Scale in Nairobi

International Institute for Environment and Development

Slum Dwellers International

UN HABITAT
FOR A BETTER URBAN FUTURE

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Abbreviations and Acronyms

ADB	African Development Bank
AFD	Agence Française de Dévelopement
AGF	African Guarantee Fund
AHFP	Affordable Housing Finance Project
AHP	Affordable Housing Programme
AMCHUD	African Ministerial Conference of Housing and Urban Development
AMT	Akiba Mashinani Trust
AO	Al Omrane
CBK	Central Bank of Kenya
CBR	Central Bank of Kenya Base Rate
COTU	Central Organisation of Trade Unions
CURI	Centre for Urban Research and Innovation
DFI	Development Finance Institution
ELRC	Employment and Labour Relations Court
FY	Financial Year
HF	Housing Fund
ICT	Information and Communication Technology
IIED	International Institute for Environment and Development
IPDU	Integrated Project Delivery Unit
ISDF	Informal Settlements Development Fund (Egypt)
JV	Joint Venture
KAHFP	Kenya Affordable Housing Finance Project
KENSUP	Kenya National Slum Upgrading Project
KES	Kenyan Shilling
KISIP	Kenya Informal Settlements Improvement Project
KPDA	Kenya Property Developers Association
KMRC	Kenya Mortgage Refinance Company
KURA	Kenya Urban Roads Authority
KUSCCO	Kenya Union of Savings and Credit Cooperatives
KWFT	Kenya Women Finance Trust
L.N.	Legal Notice
LPDP	Local Physical Development Plan
MFI	Microfinance Institution
MRC	Mortgage Refinance Company
MW	Megawatt
NACHU	National Cooperative Housing Union
NaMSIP	Nairobi Metropolitan Services Improvement Project
NMT	Non-Motorised Transport
NCA	National Construction Authority
NCIF	Nairobi Community Infrastructure Fund

NEMA	National Environmental Management Agency
NGO	Non-Governmental Organization
NHC	National Housing Corporation
NWSC	Nairobi Water and Sewerage Company
OBA	Output-Based Aid
PFMA	Public Finance Management Act
PML	Primary Mortgage Lender
PPA	Physical Planning Act
PLUPA	Physical and Land Use Planning Act
PPP	Public-Private Partnership
SACCO	Savings and Credit Cooperative
SDHUD	State Department of Housing and Urban Development
SDI	Shack/Slum Dwellers International
SDG	Sustainable Development Goal
SIDA	Swedish International Development Agency
SII	Social Impact Investor
SME	Small and Medium Enterprise
SPA	Special Planning Area
SPARC	Society for the Promotion of Area Resource Centres
SRA	Slum Rehabilitation Authority
TDR	Transfer of Development Right
TP	Tenant Purchase
UN-Habitat	United Nations Human Settlements Programme
UNOPS	United Nations Office for project Services
USAID	United States Agency for International Development
USD	United States Dollar
VSB	Villes Sans Bidonvilles (Cities without Slums)
WASH	Water, Sanitation and Hygiene

List of Legislation and Policies

1. Central Bank Act, Cap 491
2. Central Bank of Kenya (Mortgage Refinance Companies) Regulations, 2019
3. Constitution of Kenya, 2010
4. County Governments Act, No. 17 of 2012
5. Employment Act, No. 11 of 2007
6. Environmental Management and Co-ordination Act, No. 8 of 1999
7. Energy Act, No. 1 of 2019
8. Housing Act, Cap 117
9. Housing Fund Regulations, 2018
10. Income Tax Act, Cap 470
11. Kenya Revenue Authority Act, No. 2 of 1995
12. Land Act, No. 6 of 2012
13. Physical Planning Act, No. 6 of 1996 (repealed)
14. Physical and Land Use Planning Act, No. 13 of 2019
15. Public Finance Management Act, No. 18 of 2012
16. Public Private Partnerships Act, No. 15 of 2013
17. Public Procurement and Asset Disposal Act, No. 33 of 2015
18. Public Roads and Roads of Access Act, No. 3 of 1951
19. Stamp Duty Act, Cap 480
20. Urban Areas and Cities Act, No. 13 of 2011

EXECUTIVE SUMMARY

In 2017, the County Government of Nairobi declared Mukuru to be a Special Planning Area (SPA), paving the way for the preparation of an integrated Local Physical Development Plan (LPDP) for this large informal settlement in collaboration with its residents and partner organizations.

The SPA covers Mukuru Kwa Njenga, Mukuru Kwa Reuben and Viwandani which together accommodate around 300,000 low-income residents, many of them living in extreme income poverty. The County Government, supported by the Muungano Alliance (Muungano wa Wanavijiji, AMT and SDI-Kenya), is leading a participatory planning process that will result in a multi-sectoral LPDP that reflects the priorities of the population in the SPA, besides being consistent with the planning norms of an inclusive and sustainable city.

Implementing this ambitious integrated plan will require finance for a wide range of infrastructure services and affordable housing as well as complementary financial interventions to support micro- and small enterprises.

This publication sets out a financing mechanism for the envisaged upgrading investments in informal settlements in Nairobi, pejoratively called "slums". Mobilizing the vast amounts of capital required will face critical challenges, with affordability and land tenure at the forefront. As never before, however, the political climate is ripe for expanding the supply of housing for low-income households. Government has designated affordable housing as one of its four pillars of development and an Affordable Housing Project (AHP) has already started. Three slum upgrading projects in Nairobi, already in the pipeline, as well as similar investments in other towns testify to the determination of government to include upgrading in the AHP.

As part of this housing agenda, substantial work has gone into operationalizing a Housing Fund (HF) to support the delivery of 500,000 affordable houses during the term of the current government, and the associated regulatory and institutional changes are underway.

The government's central role will be to facilitate the unlocking of private capital for purposes of funding the AHP besides taking the responsibility for financing bulk infrastructure (water, sewage, power, access roads) with the assistance of development partners and other sources.

Most recently, the Government's efforts have received support from development partners in the form of programmes such as the World Bank US$250 Million Kenya Affordable Housing Finance Project (KAHFP). Housing Fund Regulations issued under the Housing Act, and Development Framework Guidelines on how the Fund will operate, have been prepared by the national government's State Department of Housing and Urban Development (SDHUD).

An important aspect of this report is how the upgrading of Mukuru and other informal settlements in Nairobi could be linked to these institutional innovations which seek to deliver infrastructure services and affordable housing at scale.

International experience on slum upgrading finance is examined early in the report in order to draw out general trends that provide a useful backdrop for Nairobi. The cases of India, Morocco and Egypt are set out and a general approach to slum upgrading finance presented.

This approach argues that since infrastructure is a public good, its funding should be the primary responsibility of the public sector but with complementary private financing wherever possible. In contrast, house construction is a private good whose funding should be left to the private sector but with publicly funded subsidies for the lowest-income households. Finance for micro-enterprises is also a private responsibility but micro-finance agencies may require government assistance to capitalize their loan funds.

An examination of Kenya's housing finance landscape shows that in spite of growing financial inclusion, the vast majority of urban residents do not have access to affordable, long-term finance for housing.

In this regard, the key features of the regulatory framework are reviewed, with a view to providing a better understanding of the laws that have a bearing on slum upgrading finance. In view of recent institutional and regulatory innovations in the wider housing finance sector, the likely trajectory of slum upgrading finance in Kenya is highlighted.

After this broad investigation of finance for slum upgrading, attention turns to the particular circumstances of the SPA, with specific reference to infrastructure and how its financing could be linked to the HF and its subsidies.

Funding mechanisms and their institutional channels are investigated with a focus on the different types of upgrading investments. In particular, it is recommended that the County Government establish a Nairobi Community Infrastructure Fund (NCIF).

NCIF would be a public corporation created under the Public Finance Management Act and would serve as the focal point for financing infrastructure services in all city slums within the county. It would draw its capital, including loans and grants, from a wide range of sources, both domestic and international, as permitted in law.

In particular, it would seek assistance from the HF as well as from pipeline infrastructure services projects financed by development finance institutions and other organizations in Nairobi's informal settlements and the surrounding areas. NCIF's remit would be restricted to project appraisal and funding, with no project implementation role, so as to avoid duplicating the functions of executive departments of the County Government and other public-sector utilities.

Because housing is primarily a private good, it is recommended that the efforts of the County Government should not be expended towards the establishment of a special housing fund, but rather, the financing of housing in Nairobi slums should be linked to the HF whose capitalisation will come primarily from statutory payroll deductions, allocations by the National Treasury, development partners, voluntary contributions by the self-employed, and private capital. Regardless of the sources of finance, it is evident from the analysis below that capital as well as interest rate subsidies are required for upgrading to be affordable to the lowest-income households.

Private capital has the potential to play a critically important role in slum upgrading, if supported with adequate public subsidies. Some of this capital could be drawn from social impact investors who seek social benefits alongside financial returns. Evidence shows that Nairobi leads other cities in the region in attracting social impact investments, some of which have supported housing development. There is a need for the Country Government and relevant national agencies to work closely with AMT and other non-state and state actors to design subsidy or cross-subsidy mechanisms to test out ways in which low-income households could be included equitably within the improvement of Nairobi slums. It is evident that existing models for the provision of housing are inadequate to the challenge of SDG 11. Slum upgrading in the city, therefore, needs to embrace innovative funding to enable new approaches to be tested.

To illustrate how the proposed funding mechanisms could gain traction, the report sets out the practical steps to be taken by the County Government, alongside other partners:

County Government:

- Pass a resolution to establish the NCIF as a public corporation under the Public Finance Management Act;
- Prepare a draft bill setting out details on: (a) the objects of the NCIF; (b) the Fund's governance structure as well as representation of slum residents organizations on the board; (c) appointment of senior staff; (d) utilization of the resources of the Fund; and (e) financial reporting and auditing;
- Ensure the draft bill is prepared having due regard to the mandate of the national Housing Fund with a view to avoiding duplication of effort by both funds;
- Ensure that the bill is subjected to public participation ahead of its enactment in compliance with the County Governments Act;
- Agree with the National Government on how NCIF will play its rightful role in prioritizing slum infrastructure projects financed by international financial institutions since such projects fall within the devolved functions in the Constitution;
- Negotiate with SDHUD to ensure that Mukuru upgrading is listed as a priority project, commencing with the sites within the SPA that are publicly owned;
- Negotiate with SDHUD so that both bulk and on-site infrastructure in Mukuru are prioritized for World Bank funding during the next round of projects under preparation;
- Negotiate with the SDHUD so that for slum areas, loans from the national Housing Fund will be available at a concessionary rate substantially below the 7% annual interest recommended in the Housing Regulations;
- Jointly with SDHUD, engage with the National Treasury to negotiate with the World Bank for the inclusion in the KAHFP of a risk sharing facility for social housing designed to enable small property developers to secure bridging finance for their social housing projects from commercial banks;

Partners

- Work with residents in informal settlements, commencing with the residents within the SPA, to agree on the sequencing of upgrading investments;
- With the assistance of other organizations, such as SDI, UN-Habitat and SIDA, negotiate funding agreements with financial institutions interested in financing on-site infrastructure services and on-plot connections;
- Sensitize residents in informal settlements about the AHP and encourage them to register as members; and
- Organize the residents into cooperatives or other appropriate collectives so that they can start saving for infrastructure connections and other neighbourhood improvements.

The final section in the report draws attention to seven key takeaway messages, namely:

Financing mechanisms for slum upgrading are heavily influenced by a country's political context, and its financial and legal infrastructure

The prominence given to affordable urban housing in Kenya's development agenda is both recent and unprecedented in the country's history. The establishment of the AHP and development of the KAHFP are a reflection of the political will to introduce institutional reforms in the housing sector and to mobilize the resources needed for programme implementation. In parallel with these changes, devolution has given County Governments the power to legislate, providing them with legal tools to create new institutional funding channels where these are merited. The financing terms for social housing embedded in the AHP, including subsidized interest rates and supply-side subsidies, would not have been possible only a few years ago.

Moreover, Kenya has over previous decades created a well-functioning financial system and deepened its capital market. This financial infrastructure has in turn raised the prospects of mobilizing private capital to support slum upgrading. This is the broad context that has influenced the financing mechanisms proposed in this report.

Funding of infrastructure services should be led by the public sector but mechanisms are needed to mobilize complementary resources from the private sector

Infrastructure in Nairobi's informal settlements, and bulk infrastructure in particular, is a public good whose funding responsibility rests primarily on the public sector. Many sources of capital exist to meet this mandate, including budgetary sources, loans and grants from multilateral and bilateral organizations, social impact investors, and NGOs. In the near-term, the County Government will likely not have the policy levers to unlock private funding on a scale commensurate with demand.

Although land value capture is potentially an important means of raising capital for infrastructure, alongside other land-based financing, it will take time for this source to become feasible. In the interim, imposing a levy on developers who benefit from publicly funded infrastructure would be a more practical alternative.

A dedicated institutional channel is needed for financing infrastructure in Nairobi's Informal Settlements

A Nairobi Community Infrastructure Fund should be created to act as the financing focal point for all infrastructure investments in Nairobi's informal settlements, starting with the SPA. It would be established as a public corporation under the Public Finance Management Act. As already pointed out, its mandate would be restricted to project appraisal and funding, with no project implementation role, so as to avoid duplicating the functions of executive departments of the County Government and other public-sector utilities.

Capital funds for house construction should be the responsibility of the private sector -- financial institutions, Savings and Credit Cooperatives (SACCOs), developers and households -- a role that should be fostered by means of appropriate risk sharing facilities as well as fiscal and non-fiscal incentives. However, low-income households need additional support from state subsidies for housing to be affordable. Incremental development approaches improve affordability and scale.

The AHP has established a framework for attracting private capital for house construction and a city-specific housing fund is, therefore, not a priority. At any rate, finance for house construction should be the responsibility of the private sector. However, commercial finance for house ownership is not affordable unless it is blended with concessionary funds and other subsidies from the public sector.

The main incentive in the AHP is the offtake agreement which assures developers that the affordable houses they build, including in slum areas, will be bought by the HF if they do not sell quickly. Other incentives include the financing of off-site infrastructure by the public sector as well as a range of fiscal and non-fiscal incentives.

There is a need for financial support to be available for low-income housing -- and particularly to community-led housing initiatives -- as well as support for higher-income private housing developments. Support for housing is an important component of poverty reduction, while support for compact cities helps to secure a low-carbon development trajectory. Support for community-led housing developments helps to reduce vulnerabilities through strengthening social capital. This is particularly valuable if housing-related debt increases household vulnerability.

Sequencing of investments matters, with infrastructure taking precedence over other improvements in slum areas in line with the priorities of the residents

The preference of slum residents, in general, is to have infrastructure investments precede other improvements. In Mukuru, for instance, investments in on-site infrastructure are immediately feasible in neighborhoods with clear and unobstructed wayleaves.

The LPDP will reveal which infrastructure investments can proceed immediately as well as those that will require funding in the medium-term and beyond in step with the resolution of issues surrounding wayleaves and road reserves. The sequencing of investments needs to take into account the need for new innovations to assist in the development of models to secure inclusive upgrading at scale.

Optimizing land use in strategically located slum settlements, to ensure high social and economic returns, is a critical element in determining the appropriate upgrading strategy

In the future, land values in slums in strategic locations will likely be very high relative to house building costs. This fact, and the imperative to promote a compact city, provides a compelling case for building apartments to high densities based on cultural preferences and appropriate building regulations. Only in this way can social and economic returns be maximized.

When determining appropriate regulations it will be important that thought be given to the ability of low-income households to maintain project facilities, such as lifts in high rise buildings. Cost savings stemming from economies of scale and the subsidies available under the AHP, especially low-interest rates, would substantially enhance affordability.

Support to micro-enterprises should be an integral part of slum upgrading

There is an active community of micro-enterprises in Kenya's informal settlements, receiving financial and capacity building support from a wide range of organizations: government, commercial banks, microfinance institutions and NGOs. There is a strong case for believing that microenterprises help low-income people (but not the lowest income) increase their incomes and thus their ability to pay for better infrastructure services and housing. Support should be offered through the capitalization of micro-finance agencies able to offer affordable loans, and through the development of mixed-use neighborhoods with workshops and units for retail trade and local services.

1. INTRODUCTION

On 1st August 2017, the County Government of Nairobi declared Mukuru Kwa Njenga, Mukuru Kwa Reuben and Viwandani as a Special Planning Area (SPA).[1] Consequentially, all developments in the area were suspended for a period of not more than two (2) years from the date of the notice. The declaration signalled the County Government's objective to upgrade one of the largest informal settlements in collaboration with partner organizations and the residents.

The defunct Physical Planning Act (PPA) defined a special planning area as an area that cuts across the boundaries of two or more local authorities and which has spatial or physical development problems and is declared as a SPA. The newly enacted Physical and Land Use Planning Act (PLUPA), which has replaced the PPA under which the SPA was declared, provides a broader definition of the SPA under Section 52 and the conditions under which a SPA may be declared by a County Government.

These include where (i) the area has unique development, natural resources, environmental potential or challenges; (ii) the area has been identified as suitable for intensive and specialized development activity; (iii) the development of that area might have significant effect beyond that area's immediate locality; (iv) the development of that area raises significant urban design and environmental challenges; or the declaration is meant to guide the implementation of strategic national projects; or guide the management of internationally shared resources.

The SPA covers a geographical area measuring approximately 550 acres and is home to over 300,000 low-income residents as at 2017, many of them living in extreme poverty. The County Government is leading a multi-stakeholder participatory planning process that will culminate in an integrated Local Physical Development Plan (LPDP) which will contain both sectoral and spatial elements. Legislation empowers the County Government to, among other things, prohibit or control the use and development of land and buildings in the interests of proper and orderly development of its area for a period not exceeding two years during the planning period; and ensure the proper execution and implementation of approved physical development plans.[2]

It is anticipated that the LPDP should include a survey in respect of the area to which the plan relates and such maps and description as may be necessary to indicate the manner in which the land in the area may be used. The LPDP will be used for the general purpose of guiding and coordinating development of infrastructural facilities and services for the SPA.

The bulk of the land within the SPA is owned privately but despite the transfer of land titles to private developers more than 30 years ago, the land has remained largely undeveloped, attracting squatters. Long-term urban residents and rural migrants have been drawn to jobs in the neighbouring industrial area.

The resultant densification of the SPA has seen the built-up area double in size over the last 15 years covering approximately 95% of the settlement with little or no provision for open and accessible public and green spaces. There are significant mobility barriers including dangerous unpaved roads littered with solid waste and refuse, lack of bridges and flooded footpaths due to non-existent storm-water drainage systems.

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1 Declaration was made Mr. Christopher Khaemba, the then County Executive Committee Member - Land and Urban Planning pursuant to Section 23(1), (2) and (3) of the Physical Planning Act, 1996, vide publication under Gazette Notice No. 7654 of August 11th, 2017.

2 The Physical and Land Use Planning Act, 2019 describes the minimum contents for a Special Area Plan (which replaces the Physical Development Plan under the old Act) to include, amongst others, the infrastructure needs of the SPA, a detailed assessment of the social, environmental and economic conditions of the SPA as well as how innovative approaches will be used in the planning and implementation process.

It is estimated that only 1% of residents within the SPA have access to a private or individual water source or private toilets with an average of 547 households sharing one public toilet.[3] Lack of waste management contributes to odours, disease, clogged drains and flooding and informal electricity connections continue to pose a danger to residents through electrocution and fires.[4]

The County Governments Act obliges county governments to plan for the area within their jurisdiction and requires that county plans be based on the functions of the county governments as specified in the Fourth Schedule of the Constitution of Kenya. The financial viability of development programmes is also required. Part 2 of the Fourth Schedule of the Constitution outlines the functions that are devolved to the County Government including, amongst others:

(i) refuse removal and solid waste disposal;

(ii) County transport (includes county roads, street lighting, traffic and parking, and public road transport);

(iii) electricity and gas reticulation and energy regulation;

(iv) County public works and services (storm water management systems in built-up areas, water and sanitation services); and

(v) Firefighting services and disaster management.

The County Governments Act further outlines the manner in which county governments may provide the services and perform the functions enumerated in the Fourth Schedule while the Public Finance Management Act, 2012, prescribes the manner in which public finances may be planned and expended. County functions are discharged through, among others, the provision and operation of infrastructure, including external infrastructure.

The current status of the SPA indicates that implementing the PDP will require significant financial resources and innovative financing mechanisms in order to ensure, not just access to the immediate capital expenditure for roll-out of the necessary infrastructure, but also affordable longer-term finance for the continued operation and maintenance of the infrastructure to ensure that the facilities do not degenerate over the years.

This report explores financing mechanisms for the envisaged infrastructure upgrading investments in the SPA. Mobilizing the vast amounts of capital required will face critical challenges, with affordability and land tenure at the forefront. While various national housing development programmes have historically attempted to address the issue of housing for low-income households, the current government has prioritized affordable housing, including social housing for the lowest-income members of the society, as part of its Big Four Agenda.

As part of AHP, various settlements have been identified across the country including social housing projects in Nairobi, and other towns. Moreover, substantial work has already gone into operationalizing the national Housing Fund established under the Housing Act to support the delivery of 500,000 affordable homes by 2022, and the associated regulatory and institutional changes are underway. To this end, the Housing Fund Regulations, 2018[5] were issued under the Housing Act and the State Department of Housing and Urban Development has published Development Framework Guidelines on how the Fund and AHP will operate.[6]

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3 Mukuru Settlement, 2017 Situation Analysis: Mukuru Kwa Njenga, Kwa Reuben & Viwandani, University of California, Berkeley et al at p34

4 Mukuru Situation Analysis Report, at pp 42-44

5 Kenya Gazette Supplement No. 154, Legal Notice No. 238 of December 18, 2018 developed pursuant to section 57(1) of the Central Bank Act. The Regulations are intended to provide a clear framework for licensing, capital adequacy, liquidity management, corporate governance, risk management, and reporting requirements of MRCs.

6 http://www.housingandurban.go.ke/wp-content/uploads/2018/11/Development-Framework-Guidelines-Release-Version.pdf

Further, the Kenya Mortgage Refinance Company (KMRC) has already been established, whose primary business includes, amongst other things, the refinancing of eligible mortgage loans and extending finance to primary mortgage lenders (PMLs) for financing of eligible mortgages.[7] KMRC will refinance PMLs, such as commercial banks, microfinance banks and Savings and Credit Cooperatives (SACCOs), using funds from the capital market so as to provide affordable mortgages to eligible members of the public.

An important aspect of this report is how slum upgrading in Nairobi could be linked to these institutional innovations under the AHP which seek to deliver infrastructure services and affordable housing at scale, with funding primarily from the national payroll, voluntary contributions by the self-employed, private capital and donor resources.

This Report is organized in eight sections. The next Section (Section two) provides a comparative analysis of various jurisdictions in order to draw out general trends and lessons in financing infrastructure and housing within informal settlements and slums. The cases of India, Morocco and Egypt are examined in some detail for their useful insights on the subject. It concludes by setting out a general approach to slum upgrading finance.

Section 3 turns to Kenya's affordable housing finance landscape, seeking to capture its main features and product offerings against a backdrop of very low incomes for the vast majority of urban residents, especially within slum areas. The Report delves into a review of the key features of the legal and regulatory framework for the financial sector in the housing space. Drawing on international experience, the chapter concludes by projecting the likely pathway for slum upgrading finance in Kenya.

Section 4 describes the financing needs of slum upgrading in Mukuru with specific reference to infrastructure. It takes into account the particular needs of this settlement with a focus on upgrading the appalling standards of on-site infrastructure services and addressing "deficits" in off-site infrastructure. An important element is how to optimize the use of the high-value land in Mukuru and other informal settlements, and link upgrading to the national Housing Fund and its subsidies.

Section 5 discusses various funding mechanisms and their institutional channels, with a focus on the different types of upgrading investments. How to catalyse private capital is the topic of Section 6. The need for credit enhancement instruments as well as current and proposed fiscal and non-fiscal incentives is also examined in this Section.

Section 7 examines how the various proposed financing mechanisms will be rolled out. It highlights the practical steps that would need to be taken, especially by the County Government and its partners to give effect to these mechanisms. Finally, Section 8 summarises the seven key takeaway messages of this report.

7 Section 3, Central Bank of Kenya (Mortgage Refinance Companies) Regulations, 2019

2. INTERNATIONAL PERSPECTIVES ON FINANCE FOR SLUM UPGRADING AT SCALE

It is estimated that one quarter of the world's urban population lives in informal settlements and these exist in nearly all regions and countries, including in highly developed countries.[8] However, almost without exception, countries around the world have singularly failed to implement upgrading of informal settlements at scale.[9]

With over 200 Million people in sub-Saharan Africa -- 62% of Africa's urban population -- living in informal settlements, it has become necessary to prioritise the provision of infrastructure and tenure security for the urban poor. In Nairobi, it is estimated that over 60% of the population live in informal settlements with little or no infrastructure – both social and engineered infrastructure.

UN Habitat has previously defined informal settlements as residential areas where:[10]

(i) Inhabitants have no security of tenure in the land or dwellings they inhabit, with modalities ranging from squatting to informal rental housing;

(ii) Neighbourhoods usually lack, or are cut off from, basic services and city infrastructure; and

(iii) Housing may not comply with current planning and building regulations and is often situated in geographically and environmentally hazardous areas.

Further, informal settlements are characterised by poverty and large clusters of dilapidated housing. They are often located on hazardous urban land with no public spaces and green areas and are constantly exposed to eviction, disease and violence.

Some countries have classified their informal settlements based on the danger posed to their residents. Egypt, for instance, has categorised informal settlements into Unsafe Areas and Unplanned Areas[11]. Unsafe Areas are further categorised into four grades according to the severity and type of risk they pose to inhabitants in light of surrounding conditions. These conditions include environmental and geological factors (Grade One); unsuitable shelters or areas unsuitable for building (Grade Two); areas exposed to industrial pollution, under high-voltage power cables or lacking access to clean drinking water (Grade Three); and areas of unstable tenure that include houses developed on state land or on the territory of the Ministry of Religious Endowments (Grade Four).

An estimated 61 % of urban households in Kenya live in informal settlements compared to 50 % in Nigeria and 23 % in South Africa.[12] In urban centres, 56 % of households are estimated to live in single rooms, and only 19 % own their home.[13]

8 See UN Habitat III Issue Papers – 22 - Informal Settlements, New York, 31 May 2015, p. 3

9 Freire, M. E. (2013) "Slum Upgrading". In Bahl, R. W., Linn J. F. and Wetzel, D. L. (eds) Financing Metropolitan Governments in Developing Countries. Lincoln Institute of Land Policy. Pp. 367-392

10 Urban Planning for City Leaders: A Handbook for Kenya, United Nations Human Settlements Programme, 2018, p ix

11 Mohammed Ezz, How Egypt Deals with Informal Areas, https://timep.org/commentary/analysis/how-egypt-deals-with-informal-areas/, The Tahir Institute of Middle East Policy, April 12, 2018

12 World Bank, Kenya Urbanisation review (2016); Kenya Economic Update, (April 2017)

13 Kenya National Bureau of Statistics, 2018

Nairobi County has, in its Policy for the Nairobi Special Housing Fund, distinguished four broad categories of land occupied by informal settlements:

(i) Settlements on public lands that are not fit for human habitation (e.g. settlements that occupy lands under high-voltage power lines or flood prone riparian reserves);

(ii) Settlements on public lands that are fit for human habitation but have an overriding public use (e.g. lands required for the expansion of roads and rail infrastructure);

(iii) Settlements located on lands that are fit for human habitation and where the designated land use can be changed to accommodate housing development for poverty alleviation; and

(iv) Settlements on public lands that have been designated for upgrading and title regulations (e.g. Huruma, Kahawa Soweto, Korogocho).

The SPA qualifies as both a slum and an informal settlement based on the above categorisation by the Nairobi County Government as well as UN-Habitat's characterization of such settlements.

The Constitution of Kenya enshrines the fundamental right to housing and provides that every person has the right to, amongst others, "...accessible and adequate housing ... and to reasonable standards of sanitation and to clean and safe water in adequate quantities..." In its planning, a County Government is required to develop an integrated development plan which provides clear input, output and outcome performance indicators, including the percentage of households with access to basic services contemplated under the Bill of Rights of the Constitution.

The obligation to plan for future generations of the county is emphasised in the County Governments Act, which provides that the principles of planning and development facilitation in a county shall protect the right to self-fulfilment within the county communities and with responsibility to future generations.

The Act further identifies one of the objectives of county planning as being to *"... facilitate the development of a well-balanced system of settlements and ensure productive use of scarce land, water and other resources for economic, social, ecological and other functions across a county...and maintain a viable system of green and open spaces for a functioning eco-system".*

The County Governments Act obliges county governments and their agencies to deliver services within their designated area of jurisdiction and, in doing so, these services are to be delivered while observing the principles of equity, efficiency, accessibility, non-discrimination, transparency, accountability, sharing of data and information, and subsidiarity. Finally, the county governments are also empowered to differentiate between different categories of users, service providers, services, service standards, geographical areas and other matters as long as the differentiation does not amount to unfair discrimination.

By declaring Mukuru as a Special Planning Area, the County Government of Nairobi gives effect to its powers under the enabling legislation to ensure the development of well-balanced settlements within its jurisdiction through the provision of adequate infrastructure and housing.

Provision of infrastructure is an essential part of any housing development and the financing of infrastructure in informal settlements has been the subject of various case studies in the past. One of the major problems with the provision of infrastructure is its financing.

The Society for the Promotion of Area Resource Centres (SPARC) in India has identified several key obstacles hampering effective and efficient upgrading of informal settlements to include lack of area-wide (metropolitan) strategies and planning for land use and slums, lack of community mobilization capacity, lack of participation of developers in low-income housing projects, lack of housing finance for low-income households, failure to leverage subsidies and household loans, and lack of participation of commercial banks in construction finance in slum projects.[14] These issues are cross-cutting in most emerging economies struggling to improve the living conditions of their citizens within informal settlements, and ring true for Kenya as well.

However, there are a few bright spots on this stark implementation landscape. India, Morocco and Egypt have made considerable progress in upgrading slums and these cases are illustrated below to help distil financing lessons for Kenya. In particular, these countries demonstrate, in their own different ways, how private capital can be incentivized to complement public sector funding and thus make upgrading at scale a reality.

India

India has made significant strides over the past 30 years in expanding private housing investments that benefit low-income households in slums. In Mumbai, for instance, the extremely high land values, relative to construction costs, have provided an avenue for leveraging private capital for housing development.

The Government has offered high value public land to developers, at no cost, enabling them to build a specified number of apartments for low-income households and realize an acceptable return on investment. The apartments are allocated to identified and verified slum dwellers for free (Box 1).

14 Merryl, S. and Ajay S. (2007). “Low income shelter finance in slum upgrading”. Washington, DC: Urban Institute. Cited in Freire, M. E. (2013)

Box 1: Financing of Upgrading in Mumbai

From 1995, the state government began an in-situ slum upgrading programme in Mumbai where more than half the slum population lives on land owned by the state. The Slum Rehabilitation Authority (SRA) was set up as the coordinating authority. There would be multiple executing agencies such as private sector developers, public bodies, NGOs and cooperative housing societies of slum dwellers.

The SRA was made the planning authority for slum areas, and the municipal and state legislation was amended to give power to make changes to the development plan of the city and to provide building permissions.

The SRA designed a mechanism to attract private developers to slum upgrading, ensuring that they would make a profit and low-income households would get improved living conditions. This approach uses Transfer of Development Rights (TDRs) which work in the following way. Developers were allowed to build flats (apartments) in slum areas for higher-income groups and make a corresponding profit on them. However, they would be obliged to build flats for a specific number of the low-income slum dwellers too, at no cost to them. If a developer was willing to build flats for slum dwellers beyond the minimum, he would receive a TDR certificate. A TDR can be used either for construction in another part of the city or sold on to other developers. A floor space index that varies inversely with the price of land was introduced to incentivise upgrading in all sites irrespective of their land value. This means that developers in high priced sites closer to the city centre would get lower TDRs than developers of the same area of land in more peripheral sites.

Any developer who undertook a slum rehabilitation scheme also had to contribute Rupees 20,000 (approximately USD400 as at March 2012 exchange rates) per family to a central fund. The interest from the fund was used to help cover monthly maintenance costs and municipal taxes.

The new middle and low-income apartments would put pressure on the existing water mains, sewers, treatment systems and storm water drains, so the developer was also expected to pay Rupees 840 (USD17) per square foot of built area to fund the needed expansion in infrastructure capacity.

Source: Based on UN-Habitat (2014) and Burra, S. (2005)

Morocco

The development of social housing at scale through private developers is rare in Africa. Indeed, the formal developer market is generally weak even for middle and upper market segments, with few firms manage an output of more than 100 houses annually. But Morocco and South Africa buck the trend as they have a strong private developer industry that has produced social housing in large numbers. Morocco, in particular, offers useful lessons for governments that wish to enable their private developers to invest in slum upgrading.

The Morocco Government's holding corporation, Al Omrane (AO), is the main driver of the *Villes Sans Bidonvilles*[15] (VSB) programme whose focus is the phasing out of slums through social housing. AO's development of social housing, and even new towns, is complemented by private developers who obtain free land from government and local authorities. Such developers are then expected to procure construction finance and build social housing.

The VSB has attracted funding from international donors such as the European Investment Bank, *Agence Francaise de Developpement* [16] and the European Union. Moreover, government is reported to have set aside substantial resources to support low-income housing. Although the targeted production of 170,000 units annually has not been met, progress has been impressive.

A central plank of government policy is to stimulate residential property development through tax incentives that exempt developers of social housing from corporation tax, land registration fees, cement taxes and value added tax. Tax breaks were originally restricted to large property developers, but recent reforms have seen these incentives extended to small and medium sized enterprises. This was achieved by lowering from 500 to 150, the number of social houses over five years that a developer must build to qualify. Tax incentives were introduced as a part of the VSB programme and have given substantial impetus to the private developer industry. Eight key lessons can be drawn from Morocco's experience (Box 2).

15 Cities without Slums.

16 French Development Agency

Box 2: The Developer Industry: Eight Key Lessons from Morocco's Experience

- Institutional reforms and fiscal incentives can give substantial impetus to the property development market, but these must be supported by appropriate legislation to be effective;
- Incentives should be offered to a broad spectrum of developers to ensure competition in the market;
- Developers will avoid market segments that do not allow them to optimize profits. Therefore, incentives should be designed in a way that counters this behaviour, ensuring that they are not skewed;
- Direct interventions by the public sector should focus on delivering serviced land, not house building. The latter should be left to private developers;
- Programme design should promote product diversity to foster the development of more socially inclusive neighbourhoods;
- A facility to provide partial guarantees to those with low incomes is an essential piece of the financial architecture as it encourages lenders to go down market;
- Aligning housing delivery with affordability is a complex process with no easy or quick fixes, pointing to the need for regular programme evaluation and adaptation;
- In the absence of substantial subsidies, there is no easy method of reaching households at the bottom of the income pyramid with housing delivered by formal developers.

Source: Mutero, J. (2014)

Egypt

In 2014, the Egyptian government embarked on an ambitious plan to eradicate slums through increased efforts of the Informal Settlements Development Fund established in 2008 by Presidential Decree No.305 of 2008. Egypt contains 32 cities over 417,000 acres of which 160,000 acres are unplanned areas which shape 40% of Egypt. These areas lack infrastructure like roads, sewerage systems, and all kinds of utilities whose implementation is estimated at EGP 350 Billion (USD 20 Billion) to develop it completely by 2030.

With an estimated 40 million informal settlement dwellers in Egypt out of a national population of some 90 million, this translated to close to 50% of the total population living in slums, with 60% of these living in Greater Cairo. Of these, around 1 million live in Level 1 Informal Settlements - dangerous slums - which are considered unsafe areas, at risk of hazards such as floods and landslides.

In the short-term, the ISDF's Strategy and Policy for the Development of Informal Settlements envisioned an Egypt with no unsafe zones by 2019, the development of unplanned areas in the medium term and in the long term, the development of a comprehensive urban development to stop rural migration to cities and prevent the emergence of new informal areas. The Fund's policies are based on the realisation of social justice and guaranteeing the citizen's right to secure housing, improving living and economic conditions through the relocation of inhabitants of the slums in the same locations or in the nearest neighbourhood, implementation of the principles of partnership with the people in the development of informal settlements, activating partnerships with donors to implement the country's priorities for the development of unsafe areas and the integration of unplanned area development programmes with unsafe areas[17]

Following a promise by President Al Sisi in 2016 to move all those living in slums to new flats over three years, the government launched a landmark project to develop 1,100 slum areas by 2022.

The ISDF and the Tahya Misr (Long Live Egypt) Fund were established by Presidential Decree for purposes of achieving social justice and to ensure citizens' rights to adequate, safe housing and developing their economic status.[18] The ISDF has historically been capitalised through allocations from the general state budget. However, in 2016, President Al Sisi issued a decree to consider the New Urban Communities Authority's budget surplus as a new source of financing for the ISDF's projects effective in FY2016/17. Chaired by the Minister of Investment and International Cooperation and under the direct supervision of the President the Tahya Misr Fund collaborates with, and receives donations from, various state agencies, private sector businesses and financial institutions, the Egyptian diaspora, civil society and NGOs.

A further EGP 1 billion (USD58 Million) has been contributed by the Tahya Misr Fund with various other contributions made by the National Bank of Egypt, private businesses, the Ma'an Foundation, amongst others. As at the FY 2018/2019, the Fund has spent over EGP 15 Billion (USD860 Million) of the estimated EGP 20 Billion (USD1.2 Billion) with the period between 2014 -2018 associated with expenditures on development of safe living areas at 20 times what had been spent between 2008 – 2014.

As at December 2018, the ISDF had completed 102,000 housing units and a further 93,000 were under construction. The completed developments include buildings, green areas, public spaces, roads and pedestrian footpaths. A further four concessions were inaugurated in the first quarter of 2019 and Port Said Province was declared officially slum-free in December 2018 having successfully completed the construction 44 residential buildings within a four-year period to replace the random housing that was rampant in the province. The project is located on an area of 16 acres and includes 880 apartments, a social hall, schools and other public amenities.

The Tahya Misr Fund further announced that by December 2018, it had completed the rehabilitation of 7,264 dilapidated houses in 232 villages for an estimated 36,500 residents, rehabilitation of 213 dilapidated houses in Shubra area, establishment of 12,000 housing units in Alexandria serving 60,000 residents, all at a total cost of EGP 890 Million (USD 50 Million). A further EGP 2 Billion (USD 115 Million) has been allocated towards the continued provision of appropriate housing for more than 250,000 residents from slums and poorer villages.

The success of the ISDF over the last few years is attributed to the strong political will demonstrated by the head of state to this sector and his instructions to all concerned entities to offer all facilities towards the attainment of a slum-free Egypt by 2019. Previous attempts to address slum upgrading were ad hoc and associated with disaster management efforts and forced evictions and there was no integrated strategic plan with specific deliverables.[19]

17 ISDF Strategy and Policies for the Development of Informal Settlements, http://www.isdf.gov.eg/AboutGov.aspx?about=6

18 Mohammed Ezz, How Egypt Deals with Informal Areas, https://timep.org/commentary/analysis/how-egypt-deals-with-informal-areas/, The Tahir Institute of Middle East Policy, April 12, 2018

19 Doaa A Moneam, "Egypt Informal Settlement Free by 2019, Quelling it Fully by 2030: Executive Director of ISDF Khaled Seddiq",

Further support for the Government's efforts under the ISDF has been received from multilateral and bilateral agencies including the African Development Bank's Middle-Income Countries Fund which has been providing technical assistance since 2017. The programme has resulted in the completion of six studies in preparation for future informal settlement development projects in Cairo.

Other support has come from UN Agencies including UN Habitat through its 5-Year Participatory City-wide Urban Upgrading Project which provides technical support to the ISDF and aligns with national urban and housing policies to direct and integrate efforts towards improving living conditions in informal settlements in Egypt.

Box 3: Key Success Factors for Egypt's Slum Free Initiative

- Strong political will, ambitious commitment and direction from the head of state ensuring the success of the ISDF;
- Centralised institutional structures through the ISDF to develop the strategy and implement its mandate to achieve a slum-free Egypt;
- Ownership by the state of the capitalisation of the ISDF to ensure sufficient budgetary allocation in billions of dollars from the national government together with investments from other state corporations and private sector to ensure adequate capitalisation of the ISDF and the Tahya Misr Fund;
- Proper urban planning for the designated areas together with a coherent implementation strategy;
- Participatory involvement of the affected communities;
- Design and development of the new residences in the same areas, or as near as possible to the slum areas, to avoid disruption of the working life of the affected communities;
- Incorporation of economic activities within the residential areas – businesses, shops, new markets, to ensure the continued vibrant economy within the new residential areas;
- Incorporation of social infrastructure including social halls, schools, hospitals and parks to ensure a holistic living environment for the residents; and
- Collaboration with development partners for technical support in the design and implementation of the programme.

Source: Mary Chege, UN Habitat

International experience on the sharing of funding responsibilities is probably best summarized by Freire (2013) who puts forward a financing strategy for slum upgrading based on a distinction between public and private goods as defined in the public finance literature. In the event, public goods should be financed primarily by the public sector and private goods by the private sector. This leads to the generic financing scheme set out below:

Table 1: Slum Upgrading Finance Options[20]

Financing			
Services/programs	**Characteristics**	**In Theory**	**In Practice**
Basic services: trunk infrastructure	Public good	Public sector (with donor help), central and local	Donors, all levels of urban government, help from community-based organisations, federal and state funds
Basic services, individual connections	Private good	Households through tariffs	Subsidies, tariffs, community savings
Land titling	Private / Public good	Private: purchase of title Public: land title programmes	Public for large programmes
Home improvement	Private good	Household savings	With help from up-front subsidies, microfinancing, community savings
Economic opportunities/micro-enterprise development	Private good	Microfinance, Community savings	Comprehensive upgrading programmes
Home purchasing	Private good	Bank credit	With subsidies for those in need
Reproduced from Freire (2013)			

Table 1 clearly shows that a combination of financing sources is critical for slum upgrading and should include public sector financing -- by both national and subnational governments, community savings, bank credit, microfinance and funding from development partners. It also points to the importance of subsidies for those in need. To this end, county governments in Kenya are authorised in law to provide subsidies and apply differential tariffs to poor households when providing basic services, provided that such differentiation does not amount to unfair discrimination. These measures can be effected through, amongst others, tariffs that cover only operating and maintenance costs, special tariffs or life line tariffs for low levels of use or consumption of services or for basic levels of services as well as other direct or indirect methods of subsidies or tariffs for poor households.[21] Tariffs for water in Nairobi are in line with this policy of differential pricing.

20 This is a generic guide and does not apply in its entirety to specific country contexts.

21 Section 120 of the County Governments Act.

3. THE FINANCIAL LANDSCAPE IN KENYA AND ITS LEGAL AND REGULATORY FRAMEWORK

This section examines Kenya's financial landscape seeking to capture its main features and product offerings against a backdrop of very low incomes for the vast majority of urban residents. It describes the sources of finance for housing, infrastructure, and microenterprises, besides reviewing the key features of the legal and regulatory framework for the financial sector. The section concludes by projecting the likely trajectory of slum upgrading finance in the country, based on international experience and recent domestic innovations in housing finance.

3.1 Housing Finance

Formal housing finance, typically in the form of secured loans, is provided by one mortgage finance company and several of the 42 active banks in the country. These financial institutions cater primarily for those in formal employment and the more affluent, and thus exclude the vast majority of the population. Although financial access has increased over the last decade, especially through the use of mobile banking, only high-income households in the formal sector are generally able to obtain long-term housing loans from commercial banks.

Banks also provide credit of short maturity to individuals, usually taken out as personal loans. These loans find their way into the housing value chain where they are used to buy plots and building materials, and to pay for construction labour.

However, the value of loans diverted to housing is unknown as there are no published statistics. Individuals and small developers blend this type of credit with their own savings to build permanent houses, often taking many years to do so.

Multi-storey tenements are a common typology, generally built without formal approval as they do not meet the building standards set by the County Government. In many cases, these buildings are built in a stop-go fashion, with construction gathering pace when finance becomes available and stopping when funds run out. Tenements typically comprise one-roomed dwelling units which are generally affordable by low-income households.

The bulk of housing affordable by those at the bottom of the income pyramid is found in slum areas and is financed informally. The vast majority of the residents in these settlements are tenants. Structure owners are in most cases absentee "slumlords" who often do not own the land and cannot, therefore, use their property to secure borrowing. The main sources of credit for these informal suppliers of housing are relatives, friends, *chamas*[22], and Savings and Credit Cooperatives.

The main sources of finance are described below in two categories: established sources and new sources that seek to innovate and thus have the potential to make a difference in the future.

A. Established Sources

SACCOs

Savings and Credit Co-operatives are estimated to provide almost 90% of the total housing finance but they are highly constrained by the short-term nature of their deposit liabilities. Although their interest rates, at 12% per year, are lower than those of commercial banks, their loan tenors do not generally exceed 5 years in contrast to loans of 15 years or more from commercial banks.[23]

22 Informal merry-go-rounds

23 World Bank (2017) "Housing: Unavailable and Unaffordable" in Kenya Economic Update, Edition No. 15

The conduct of the deposit-taking business of SACCOs is regulated by the SACCO Societies Regulatory Authority[24] with the sector having assets of KES 393 billion (USD 3.9 billion) as at the end of 2016, and a membership of nearly 3.5 million people spread across 175 licensed and regulated deposit taking institutions.[25]

Capping of interest rates, since September 2016,[26] substantially narrowed the difference between the cost of SACCO and commercial bank loans. Capping forced banks to lend at a maximum of four percent above the Central Bank of Kenya (CBK) base rate, known as the Central Bank Rate (CBR). The interest rate charged on mortgages in 2017, on average, was 13.6% as compared to an average of 18.7% in 2016.

This decline was mainly due to interest rate capping. However, rates might diverge once again in the future as a judicial ruling in March of 2019 declared interest rate caps to be inconsistent with the constitution.[27] In the event, the effect will be to make SACCO loans even more attractive to the general public. A recent innovation by a group of 35 SACCOs allows members to obtain interest free loans repaid as "rent" instalments over a 20-year period.[28]

Most of the housing credit from SACCOs is not secured by a lien on property as collateral substitutes are accepted, such as personal guarantors, a member's deposits, motor vehicles and various other forms of tangible assets.

Housing Microfinance

Nearly one-third of microfinance institutions offer housing loans in one form or another.[29] There are 13 microfinance banks which are deposit taking institutions regulated and supervised by the Central Bank. These institutions have substantially expanded financial inclusion. A case in point is Rafiki Microfinance Bank which had the fourth largest market share (7.7%) a few years ago. This bank is reported to have offered "housing microfinance loans for those with no deeds (maximum amount KES 1 million[30] for a two-year term), lot purchase and incremental housing (maximum KES 1.5 million for a three year term), mortgage loans (maximum KES 5 million, for a 20-year term), and multifamily housing (maximum KES 7.5 million a five-year term)".[31]

There is a large number of smaller microfinance institutions which only take deposits from their own members since they are not licensed to accept public deposits. These institutions extend small housing loans to their members, with lending constrained by inadequate capital and affordability. The National Cooperative Housing Union (NACHU) serves as an example of a micro-lender that has sought capital from the banking sector in order to expand its lending. Box 4 summarises NACHU's past experience, illustrating how high interest rates constrained its drawdown of a commercial loan.

24 SACCO Societies Act, No.14 of 2008

25 Centre for Affordable Housing Finance in Africa (2018) "2018 Housing Finance Yearbook"

26 Central Bank of Kenya, Bank Supervision Annual Report, 2017

27 The courts asked Parliament to amend, within one year, the legislation that introduced capping.

28 Centre for Affordable Housing Finance (2018) "2018 Housing Finance Yearbook"

29 World Bank (2016) "Kenya Urbanization Review" Report No: AUS8099 p. 75

30 KES 100 = USD 1.

31 World Bank (2016). Ibid. p. 75.

Box 4: NACHU's Experience with Capital Raising from the Banking Sector

The National Cooperative Housing Union (NACHU) in Kenya is an apex organization made up of primary housing cooperatives. It started operations in the early 1980's and began piloting housing microloans in the early 1990's. Since then, it has become an important provider of such loans to member cooperatives. NACHU has other product offerings, such as education loans, besides providing capacity building and technical support services to its members. It has staff in all major regions of the country.

For many years, NACHU's lending programme relied almost entirely on small donor grants and limited savings by its primary cooperatives, and this severely limited portfolio growth. In 2010, NACHU was able to secure a loan facility of nearly $2.5 million from a local commercial bank, for microlending to residents of slum areas and owners of housing plots in green sites. The wholesale commercial loan was secured in part by an off-shore guarantee and partly by savings deposits by NACHU's members.

To access private capital NACHU had to ensure that its financial performance indicators were sound. In particular, it was important for the portfolio-at-risk to be within acceptable limits. After loan closing, rising interest rates restrained NACHU from drawing down the whole facility. However, this deal with a commercial bank and an offshore guarantor generated spin-off benefits. First, it put pressure on NACHU to raise its prudential standards, especially with regard to loan recovery. Second, it signalled to potential financiers that NACHU was creditworthy, raising its institutional reputation. Indeed, on the strength of its improved financial record, NACHU was able to secure a low-interest loan in local currency from an off-shore financier in 2011. This loan facility was initially capped at around USD 3.5 million but with the flexibility for additional resources to fund a bigger pipeline of projects. The loan enabled NACHU to increase its housing microfinance portfolio more than ten-fold.

Source: Mutero (2014)

Developer Finance

Developer finance for formal construction has two main sources. The first consists of commercial banks, such as Kenya Commercial Bank, and the HF Group (formerly the Housing Finance Company (K) Limited), the only specialized mortgage finance institution in the country.[32] Shelter Afrique, a regional financial institution, also provides bridging loans to some of the bigger property developers.

Many of the small and medium-sized firms which borrow from these financial institutions have limited equity capital. As a result, they have very high debt to equity ratios because construction of even small projects is capital intensive besides having lumpy cashflows. This high leveraging is not healthy but would decline if these firms grew to the point where they qualified for listing at the stock exchange or had access to private equity funds.

Providers of bridging finance protect themselves against the high risk of lending by: (i) requiring the developer to pre-finance a significant proportion of the cost of construction; (ii) releasing loans directly to building contractors in instalments that match construction progress; and (iii) requiring a legal charge, in their favour, on the financed property.

32 The HF Group is an integrated property and financial solutions provider and is registered as a non-operating holding company under the Banking Act, Cap 488 and regulated by the Central Bank of Kenya. Although it is a mortgage finance institution, Housing Finance Company provides developer finance as a way of originating new mortgages and thus expanding its business.

Off-plan financing has also become popular over the years as formal developers seek to reduce their costs of borrowing, arising from interest charges and loan closing fees. A second aim is to reduce the substantial hidden costs associated with protracted delays at the land registry responsible for registering titles and mortgage security documents. In the typical off-plan deal, buyers are offered attractive prices and given manageable payment plans.

The benefit for the buyer is the capital gain that accrues during construction, but this comes with the risk of the developer failing to complete the project.

Mortgage Finance

Mortgage finance from the banking sector is affordable only by the highest income households, typically the top 5% on the income distribution. This type of finance has traditionally been provided by the major commercial banks, most notably by the Kenya Commercial Bank and the Housing Finance Company of Kenya.

Despite being one of the most densely-served African countries, with 42 banks for a population of just under 50 million, commercial banks have only 26,000 mortgage loans outstanding of an average amount of USD 110,000.[33] There were slightly over 26,000 mortgage loans in the market in December 2017 up from 24,000 in December 2016 which represented an increase of 8.8 %.

The average mortgage loan size also increased from USD 90,000 in 2016 to USD110,000 in 2017 due to increased property prices. The average maturity of loans from commercial banks as at December 2017 was 11.9 years with a minimum of 5 years and a maximum of 25 years.[34]

High interest rates in the past have deterred most people from taking out mortgage loans. Loan demand has not grown in step with the recent capping of interest rates since banks have responded to this price control by reducing loan tenors.[35] In the wider banking sector, the growth of credit to the private sector averaged 3.3% in 2018, far lower than the five-year average (2014-2018) of 11.8%.[36]

Against this background of unfavourable lending conditions, some of the large employers have placed deposits with financial institutions for purposes of funding low-interest mortgages for their staff. Indeed, a sizeable part of the mortgage loan book is accounted for by this type of lending.[37] The cooperative sector, through the Kenya Union of Savings and Credit Cooperatives (KUSCCO), also issues mortgage loans at interest rates below market and has a loan book estimated at 10,000[38] mortgages. Notably, this source accounts for the bulk of the entire mortgage portfolio in the country.[39]

While mortgage lending has had a very limited impact, the National Government is working with development partners to expand this market segment through the AHP and the establishment of the Kenya Mortgage Refinance Company. The KMRC is to be capitalised through an initial credit line of USD240 million under the KAHFP with USD50 million going towards its establishment and operationalisation and a further USD190 million to enable it to extend loans to banks and SACCOs that meet specified criteria.

33 As at December 31, 2017, the Kenyan banking sector comprised the Central Bank of Kenya (CBK), as the regulatory authority, 43 banking institutions (42 commercial banks and 1 mortgage finance company), 9 representative offices of foreign banks, 13 Microfinance Banks (MFBs), 3 Credit Reference Bureaus (CRBs), 19 Money Remittance Providers (MRPs), 8 non-operating bank holding companies and 73 foreign exchange (forex) bureaus

34 Central Bank of Kenya, Bank Supervision Annual Report, 2017

35 Cerutti, C. (2018) "Kenya Mortage Refinance Company to Support Affordable Housing Finance". Presentation at the Innovative Housing Finance Workshop organized by KPDA, March 27, 2018 at Park Inn Nairobi.

36 Cytonn (2019) "Cytonn Weekly Report No. 11 of 2019", see https://cytonnreport.com/research/ruaka-real-estate-investment-opportunity-cytonn-weekly-11-2019#focus-of-the-week .

37 Centre for Affordable Housing Finance (2018)

38 World Bank (2017) ibid.

39 Centre for Affordable Housing Finance in Africa (2018) "2018 Housing Finance Yearbook"

Consistent with the Government's strategy, the focus will be on loan values below KES3 million (approximately USD30,000) or KES4 million (USD40,000) within the Nairobi Metropolitan Area with target households being those earning up to KES150,000 (USD1,500).[40]

The Affordable Housing Regulations, 2018, define an affordable housing scheme to include "social housing designated for monthly income earners earning up to KES 19,999".[41] A study of over 800 residents within the SPA categorised income groups into low (KES 4,800 per month), median (KES 9,000 per month) and high (KES14,500 per month) constituting 30%, 56% and 14% of the population, respectively.[42] Based on these average incomes, the residents of the SPA would be classified as being eligible for social housing under the AHP although the vast majority would require substantial subsidies to afford even this type of housing.

B. New Sources

The Housing Fund

In an ambitious plan to tackle the acute urban housing problem, the national government has introduced the Housing Fund Regulations, 2018, to operationalise the Housing Fund which was established over four decades ago under the Housing Act.[43] The Housing Fund is to be capitalized primarily by statutory payroll deductions of 1.5% of the monthly basic salary and a matching contribution from employers, subject to a maximum of KES 5,000 per month.[44] Voluntary contributions from self-employed persons are also permitted under the Housing Fund Regulations with minimum contributions set at KES 200 per month.[45]

The Housing Act provides for other sources of capital, including appropriations by Parliament and borrowings of the Fund from time to time. It is envisaged that these borrowings will include finance from pension funds and insurance companies as well as capital markets through specific housing bonds issued by the Fund.

The mobilized resources will finance the AHP which seeks to provide 500,000 affordable homes by the year 2022, of which around 20% will be social houses targeting those with incomes below KES 20,000 a month.[46] While no breakdown of affordability below this income level has been given, it is clear that the lowest-priced unit, at KES 600,000, will not be affordable by the lowest income households unless larger subsidies than those envisaged in the AHP are made available. Besides greenfield sites, the project includes slum upgrading settlements and three have so far been identified in Nairobi comprised of Kibera, Mariguini and Kiambiu, all of which are located on publicly owned land, unlike the SPA.

40 According to the KAHFP Project Appraisal Document, PAD2889, dated April 2019, given that this is an unexplored market segment, it is envisaged that in case of insufficient demand below the KES 3.4 million threshold, and to support a blending of the portfolio, up to 20 % of the credit line may be used for refinancing loans above this threshold.

41 Regulation 3(2)(a)

42 The Nairobi Special Housing Fund: Identifying Opportunities, Unlocking Informality and Leveraging Assets to Create Sustainable Housing for Nairobi's Majority Population, Nairobi City County, 2018

43 Section 6(1) of the Housing Act. Under Regulation 3 of the Housing Regulations, 2018, the Housing Fund is declared an affordable housing scheme for purposes of section 30A of the Income Tax Act.

44 While the new Section 31A of the Employment Act, No. 11 of 2007 obliges employers to effect these statutory deductions and ensure payment into the National Housing Development Fund is yet to be implemented. The Ministry of Transport, Infrastructure, Housing, Urban Development and Public Works together with the Kenya Revenue Authority put the country on notice in April 2019 that the provisions of the Finance Act, 2018 relating to the housing fund levy had come into effect. Consequently, employers were required to remit the Levy to the KRA month effective 9th May 2019. This publication of the Notice generated stiff opposition from many quarters, including the powerful Central Organisation of Trade Unions (COTU) especially because the Employment and Labour Relations Court had on 19 December 2018 ordered the suspension of the implementation of the Levy and on 8 April 2019 extended the suspension until 20 May 2019. The ELRC also issued another order suspending the implementation of the Levy until 20 May 2019 and further extensions have since been issued with the implementation of the Levy remaining suspended.

45 Regulation 6 of the Housing Fund Regulations, 2018. Of this amount, Kes 100 shall accrue to the Housing Fund and the balance towards the contributing member's Housing Fund Account.

46 See https://bomayangu.go.ke/downloads/Affordable_Housing_Program_Presentation.pdf

The government has committed to deliver the bulk and link infrastructure to the sites which will be allocated to private developers through a competitive process. Government provision of bulk infrastructure is expected to reduce capital expenditure for developers by a substantial cost margin, thus enhancing project affordability for homeowners as this benefit would be a pass-through cost.

The developers, on their part, will be expected to demonstrate the ability to mobilize construction finance including payment of a deposit which would be allocated towards an early works programme on the allocated sites. The houses are to be delivered to the beneficiaries at pre-set prices to be determined under the AHP and these currently range from KES 600,000 for a single room to KES 3 million for a 3-bedroom unit. Individual members will be allocated houses through a randomized balloting system and a portal for registering members has already been created and is operational.

Under the AHP, the state has committed to guarantee the offtake of the housing units developed by the private sector and plans are underway to finalise the terms and conditions of the proposed offtake agreements. However, a court case challenging the capitalisation of the HF through payroll deductions makes it doubtful that government will be able to sign such agreements in the near term.

The National Housing Corporation (NHC) will play a central role in operationalizing the AHP as the Housing Fund falls under the control of the NHC. Once the AHP is rolled out, the Corporation will be expected to scale up its housing programme in Nairobi and elsewhere in the country. Capacitation of the NHC is planned to enable it to undertake its expanded role.

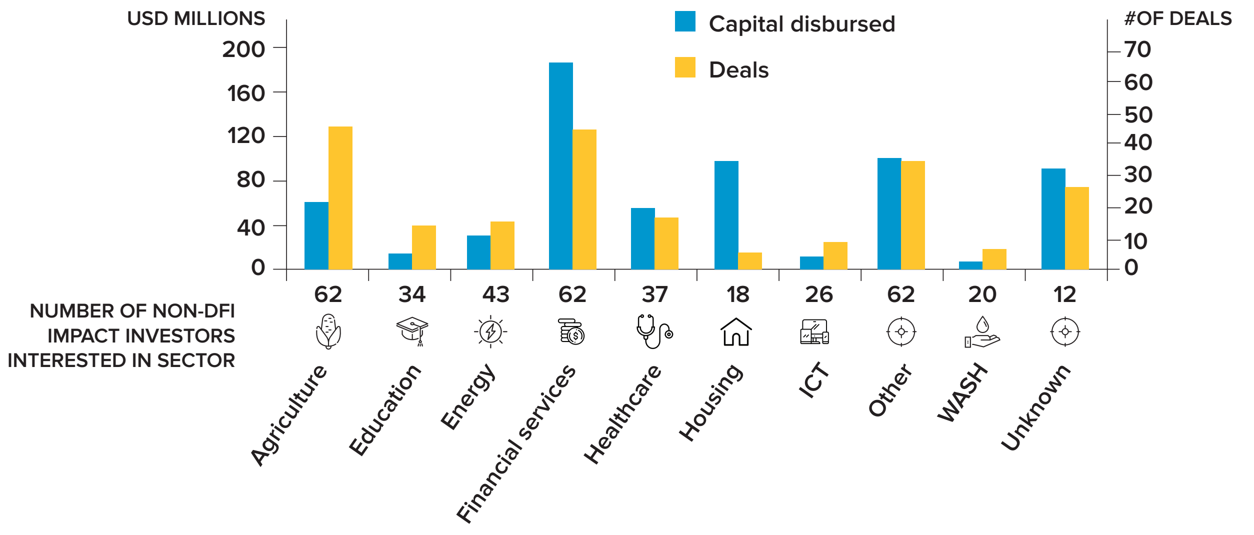
Social Impact Investors

Social Impact Investors aim to achieve social impact alongside a financial return on their capital. This means that such firms are ready and willing to accept a sub-market financial return as long as defined social objectives, such as poverty alleviation, are met.

Nairobi is East Africa's centre of social impact investing.[47] By 2015, USD 240 million had been committed to Kenya by social impact investors (SIIs), excluding investments by development finance institutions (DFIs). Some of this investment was for water, sanitation and health (WASH) and housing (Fig. 1), pointing to the potential interest of SIIs in upgrading slums.

47 GIIN Advisory Team and Open Capital Advisors (2015) "The Landscape for Impact Investing in East Africa". A report supported by The Impact Programme of UK AID.

Figure 1: Non-DFI Impact Investment by Sector



Source: Open Capital Research

In 2018, UNOPS signed a Memorandum of Understanding with SDHUD under which UNOPS committed to provide for 100,000 affordable homes under its Social Impact Investment Initiative.[48] The houses will be built using green technologies and energy efficient solar rooftops, and public facilities, such as children's play grounds, schools and community halls will be provided. UNOPS and its partners will seek to attract USD 647 million for the project from the private sector. There are no details yet on affordability.

3.2 Financing Infrastructure Services in Slums

In recent years, upgrading of on-site infrastructure services in Nairobi's informal settlements has been financed primarily by the public sector through funds procured by the national government from the World Bank under the Kenya Informal Settlements Improvement Project (KISIP) which started in 2011.

Other support to KISIP came from the Swedish International Development Cooperation Agency (SIDA) and the Agence Française de Dévelopement (AFD). Although the project has come to an end, a successor upgrading investment is being prepared.

An important feature of KISIP is that only land in public ownership is eligible for inclusion in the project to avoid the legal hurdles that accompany upgrading of informal settlements on private land. Indeed, the successor project will start by securing titles for residents ahead of investments in infrastructure services. Since a half of the city's informal settlements are located on private parcels of land,[49] the challenge of how to upgrade such settlements will need to be confronted.

Besides KISIP, a forerunner project, the Kenya Slum Upgrading Project (KENSUP), financed the upgrading of a part of Kibera including the construction of housing units to accommodate the residents. These upgrading projects

48 https://www.unops.org/news-and-stories/news/landmark-100-000-green-affordable-homes-initiative-for-kenya-moves-forward

49 AMT et al. (2017) "An Integrated Area Development Plan: Inception Report"

point to the readiness of the national government and the development community to channel funds into improving infrastructure services in informal settlements in Nairobi and other towns.

Off-site infrastructure in the Nairobi Metropolitan area has been financed mainly by the Nairobi Metropolitan Services Improvement Project (NaMSIP), the Kenya Urban Roads Authority (KURA) and the County Government. NaMSIP, which is funded by the World Bank, has in addition financed on-site infrastructure such as security and street lighting and public facilities including markets and fire stations. The project closed in the middle of 2019, but a successor project has been programmed.

In the years ahead, it will be necessary to consider innovative land-based financing methods, such as land value capture (sharing of unearned income), that are effective in raising revenue for financing off-site infrastructure when traditional sources of revenue are inadequate. Increases in private land values occur as a result of public investments, particularly in transport infrastructure, or rezoning of land to higher densities.

If properly designed alongside other instruments, land value capture can be a powerful method of public financing. The increases in private land value (capital gains) as a result of public intervention are unearned profits to the private landowners who do not have to bear any costs. These unearned profits can be captured indirectly by means of real estate taxes, impact fees[50] or other forms of taxes, or directly by converting them to land-related benefits such as on-site improvements and trading of urban development rights.

In Nairobi, as in many other developing cities in Africa, land-based financing has not been adequately exploited in spite of its huge potential to generate the local resources needed to finance urban basic services. The lack of robust land information systems and appropriate legislation are largely to blame. For this reason, it is unlikely that the County Government will be able to tap this source for financing infrastructure in the city.

An alternative, in the interim, would be to require developers to pay an infrastructure levy pegged to the built-up area in any development. India has adopted this approach in its slum upgrading projects (Box 1). An infrastructure levy previously charged by the Nairobi City Council, the county's previous governing body, was poorly ring-fenced and was generally not used to expand infrastructure services.

3.3 Enterprise Microfinance

The microfinance sector, one of the most robust in Sub-Saharan Africa, consists of a wide range of formal and informal bodies. At the one extreme are microfinance banks which are regulated by the Central Bank and are allowed to accept deposits from the public.

At the other extreme are informal merry-go-rounds and investment groups. In between are Savings and Credit Cooperatives, NGOs, and rotating and savings credit associations which offer micro-credit and other services to their members.

Formal microfinance institutions (MFIs) in the country are well-documented. In 2017, their total loan portfolio was nearly KES 88 billion (USD 880 million) with microfinance banks accounting for just over a half of this portfolio while the rest was evenly split between credit only MFIs and SACCOs.[51]

Microfinance has the potential to raise incomes and, in that way, to improve the ability of low-income households to pay for their housing. However, concerns have been raised about the ability of microfinance to address the needs of the lowest-income households.

50 A tax levied by sub-national governments on new residential and commercial developments to defray the cost of providing infrastructure and social facilities.
51 Association of Microfinance Institutions (2018) "Microfinance Sector Report." 4th Edition.

In Mukuru, there is a wide variety of organizations that offer microcredit and related services to the residents (Box 5). The main sources of finance are government, banks, microfinance institutions, and NGOs. Besides these formal organizations, loan sharks also provide loans at the exorbitant interest rates of about 120% per year but it is unlikely that this credit is used for business purposes.

Box 5: Mukuru: Sources of Enterprise Microfinance

A limited-scope rapid survey in Mukuru[52], carried out for this report, revealed a wide range of formal sources of microfinance including: (a) Government: Uwezo Fund, and Women Enterprise Fund; (b) Banks: Equity Bank, Sidian Bank, Faulu Bank; and KWFT (Kenya Women Finance Trust Bank); (c) NGOs: Muungano wa Wanavijiji, and Maxwell; and (d) Microfinance Institutions: Musoni Finance Ltd.

The majority of respondents had been able to access loans and other services from these sources. Loans were made out to either individuals or groups for periods ranging from one week to 48 months. Uwezo Fund charged the lowest interest rate of 5% per year but had the longest waiting period -- 5 months -- before disbursement. Loan sharks, in contrast, disbursed their loan immediately.

The financial providers require security either in the form of guarantors or tangible assets. About a half of the respondents repaid their loans on a weekly basis while others did so monthly. Late payments attracted penalties. Some of the service providers offer financial literacy skills to groups before issuing loans. This capacity building includes savings and lending processes, and record and book keeping. Almost all the microfinance organization offer these training services.

About 60% of those who had borrowed did so to either establish or grow a small business. Such enterprises included tailoring, grocery vending, *bodaboda*[53] , food vending, retail and wholesale general shops and shoe making and repairs. Others were *Mpesa*[54] and bank agency shops. A small proportion of borrowers had used their loans to buy property, such as land, or to meet non-business related costs, including school fees and other personal expenditures.

It was reported that a significant number (about 25%) had defaulted on loan repayments. There were serious consequences for this delinquency, including any one or more of the following: the guarantor was required to repay the loan; assets that had been used as security were confiscated; chiefs were asked by the lender to follow up and demand loan repayment; the outstanding loan amount was set off against the member's deposit. Other constraints that were reported included: (a) collusion by group officials who took out loans without group knowledge; and (b) officials signing up group members as guarantors and hence leaving them with the repayment burden.

Focus groups made a number of recommendations: longer loan repayment periods; lowering of interest rates, especially by the banks and microfinance institutions; reducing the waiting period prior to disbursement of Uwezo loans; and less harsh penalties for defaulting.

52 Priscillah, L. and Otibine, E. (2019) "A Study of Access to Finance by Mukuru Residents"

53 Motor cycle, an increasingly popular means of conveyance in the country.

54 Mobile money transfer/banking service

3.4 Legal and Regulatory Framework for Financing Infrastructure

The formal approach in Kenya to financing infrastructure for housing developments has been for the developer to bear the costs of financing the buildings, the land acquisition and the internal infrastructure which is usually limited to all the infrastructure within the boundary of the area being developed[55]. The public sector then finances the bulk and connecting / link infrastructure as well as the social and community infrastructure. This approach, however, has its limits where the proposed housing development is for the urban poor and population segments living in informal settlements and slums.

Figure 2 describes the different types of infrastructure required to be implemented for any housing development:

Figure 2: Types of Infrastructure Required for Housing Development

INTERNAL	**services within the development site boundary to service that development.**
EXTERNAL BULK	**services external to the development site boundary servicing multiple users at a County-wide scale (new or existing).**
EXTERNAL LINK	**services external to the development site boundary required to connect internal engineering services to existing or proposed bulk engineering services.**

The Physical Planning Act and the Physical Planning (Subdivision) Regulations, 1998[56] issued thereunder, provide the conditions to be complied with on any scheme of subdivision of land within the area of a local authority [county]. These conditions include, amongst others:[57]

(i) where required by the [local authority] and the Director of Physical Planning, land suitable and adequate shall be reserved at no cost to the local authority for open spaces, amenities, recreational facilities, road reserves, public purpose relative to the area to be subdivided and for road widening;

(ii) provision, adequate in the opinion of the Director of Physical Planning, shall be made for the truncation of street corners and the widening of existing streets or lanes;

55 Physical Planning (Subdivision) Regulations, 1998

56 L.N. 140/1998

57 Rule 15 (Requirements when Subdivision Schemes are Submitted)

(iii) plots shall be of appropriate shape and size and shall have proper and sufficient access to a street, such street not being a sanitary lane or passage; and

(iv) where any proposed street or road is included in the scheme of subdivision, the layout and construction of such street or road shall conform to the requirements of the relevant local authority.

The Subdivision Regulations further provide certain Conditions of Approval in the Second Schedule, which are issued pursuant to Rule 5(2) of the Subdivision Regulations.[58] Key conditions include:

(i) the reservation of land for roads and public purpose or for other purposes referred to in the [Physical Planning] Act for which land may be reserved;

(ii) [a description of] the character and type of roads and public utilities or other works, including the standard of construction and/or maintenance of a road, water supply, drainage and sewerage works which are to be undertaken and completed by the applicant for subdivision at the applicant's cost;

(iii) provision as to the forms of security to be given by the applicant of any conditions imposed and provision as to the right of the local authority to carry out any such conditions at the expense of the applicant; and

(iv) the transfer, by the applicant, free of charge to Government or [local authority] of any land reserved [for roads, public purposes or for the purposes referred to in the Act].

Based on the above regulatory provisions, the internal infrastructure would, therefore, at the minimum include internal roads, water supply, drainage and sewerage work whose financing and installation is the sole responsibility of the property developer.

Large property developers have for the last several years also started providing electrical energy within their projects. Recent examples include Garden City, Two Rivers, Tatu City and Tlisi located in Nairobi and Kiambu Counties with the developers serving as both the power generator and distributor within the development. Further, persons who generate electrical energy for their own use that does not exceed 1 MW are also not required to apply for a licence.[59]

The newly promulgated Physical and Land Use Planning Act, 2019, stipulates the key considerations for subdivisions and amalgamations, as well as infrastructure availability and adequacy, and the surrender of land for public utilities.[60] The PLUPA further enumerates the services that require easements and wayleaves including telecommunications, electrical power supply, water and sewerage works, oil pipeline, fibre optic, base transmission stations and any other service as may require an easement and or wayleave.[61]

While the legislation is not clear in respect to link and bulk infrastructure, based on a review of the guidelines issued by the draft South African National Treasury's Policy Framework for Municipal Development Charges[62] these services would include, but not be limited to the infrastructure in Table 2.

58 Rule 5(2) provides that on receipt of an application to subdivide made under the provisions of section 31 of the Act, the local authority may…" approve the applications subject to any of the conditions set out in the Second Schedule".

59 Section 117, Energy Act, No. 1, 2019

60 Section 7 (g) and (h), Third Schedule

61 Section 12, Third Schedule, PLUPA

62 While the draft Policy has yet to be formally adopted by the National Treasury, several cities and municipalities (e.g. Cape Town, Stellenbosch, etc) have already developed their own policy guidelines on the basis of the draft framework proposed by the National Treasury.

Table 2: Description of Infrastructure by Sector

Sector	Description of Infrastructure
Water	Link infrastructure outside the development site required to connect the new development to the existing municipal water network distribution pipelines, reservoirs, water towers, pump stations and control valves required for the new development; New or additional capacity at such a facility.
Sewerage	Link infrastructure outside the development site required to connect the new development to the existing municipal sewer network collector and outfall sewer pipelines, pump stations and diversion structures required for the new development; New or additional capacity at such a facility.
Roads	Link infrastructure to connect the new development to the existing municipal infrastructure; Road structures, minor storm water facilities, sidewalks, traffic controls, street lighting and signage associated with the above roads. Increased road capacity or new junctions and interchanges.
Storm water	Link infrastructure outside the development site required to connect the new development to the existing municipal storm water network; Piped networks (excluding provision for minor drainage system associated with road provision); Culverts, open channels, lined and unlined, detention and retention facilities, energy dissipation structures, water quality management facilities, etc.
Solid Waste Management	Disposal facilities (landfill, transfer stations, alternative treatment technologies); Specialised vehicles used for landfill operations and Specialised collection vehicles; Drop-off facilities and Material recovery facilities.
Electricity[63]	Link infrastructure to connect the new development to the existing County or National network; The additional capacity in the County or National electrical supply network; The proportionate increase in size or capacity of transformer stations and substations; The additional capacity of main transmission lines to transformer stations and substations.
Transport[64]	Public transport interchanges; Non-scheduled service facilities; Street-to-street pedestrian access; NMT including pedestrian and motorcycle / bicycle lanes.

63 Applicable when County Government commences electricity reticulation. Discussions with property developers indicate that they are currently liable for the full cost of the additional transformer, cabling, etc. even in situations where the additional transformer is subsequently utilized by other property developments and there is no formula for pro rating this additional cost amongst various property developers. The Energy Act, 2019 paves way for the de-monopolisation of the power distribution sector, paving the way for County Governments to establish county owned corporations to perform this function.

64 Applicable only when County Government commences service provision of public transport. The planning of public transport within the Nairobi Metropolitan Area covering Nairobi City County, Kiambu County, Kajiado County, Machakos County and Murang'a County is now coordinated through the Nairobi Metropolitan Area Transport Authority.

As indicated elsewhere, the public sector has historically borne the cost of the link and bulk infrastructure. This has been financed through various mechanisms including:

(i) Budgetary allocations by the national government to the state department responsible for housing and urban development;

(ii) National transfers from the National Treasury to former local authorities and now, county governments through the annual Division of Revenue Act as part of the County Equitable Share. Pursuant to Articles 202 and 204 of the Constitution of Kenya, the Division of Revenue Bill, 2019 (Kenya Gazette Supplement No. 18 (National Assembly Bills No. 11) of March 6th, 2019 allocated KES 310 billion to the county governments as their county equitable share for the FY 2019/2020.

This constitutes 30% of the national government's total shareable revenues.[65] This is down from KES 314 Billion in FY 2018/2019 under the Division of Revenue Act, No. 1 of 2018 which represented 33.6% of the total shareable revenues. Marginalised counties are entitled to a further 0.5% of the total shareable revenue under the Equalisation Fund and the FY 2019/2020 sees these counties receiving up to 0.6%.

The County Governments do not, however, have an obligation to spend a specified percentage of their budget on housing, human settlements or infrastructure and this is left to the discretion of the respective county governments to implement in accordance with their county integrated development plans subject to a 30% minimum spend on development projects.[66]

(iii) **Conditional infrastructure grants to county governments such as those allocated under the Road Maintenance Fuel Levy Fund.** The Fund is established under the Road Maintenance Levy Fund Act. No. 9 of 1993. As a conditional grant, the funds are disbursed to the County Governments and are to be utilized for road maintenance purposes only.

The County Executive Committee Member for Finance & Economic Planning is required to submit a work plan to the Kenya Roads Board of the roads to be maintained to ensure that there is no duplication with the roads being maintained by the national government agencies. Allocations under the Road Maintenance Levy Fund for the financial year 2019/2020 are proposed at KES 8.98 billion, an increase from the KES 8.3 billion allocated in the financial year 2018/2019.

(iv) **Conditional grants under various donor funded programmes** such as NaMSIP, the Kenya Urban Support Programme, KISIP, and the Water and Sanitation Development Project, amongst others.

(v) **County own source revenues collected in accordance with the provisions of the Constitution.** These include all money derived by or on behalf of a county government from levies, rates, fees, charges or any other source authorised by the Constitution or an Act of Parliament and have been enumerated under Article 209 of the Constitution as property

65 Under Article 203(2) of the Constitution of Kenya, it is envisaged that a minimum of 15% of the revenue raised nationally should be allocated to county governments.

66 Section 107(2)(b) of the Public Finance Management Act, 2012 requires that over the medium term, a minimum of thirty % of the county government's budget should be allocated to development expenditure. This requirement is further reiterated in the Public Finance Management (County Governments) Regulations, 2015 under Regulation 25(1)(g).

taxes, entertainment taxes, taxes authorized by Parliament and user fees and levies on services rendered by the County Government.[67]

It is important to note that user fees and levies paid by county residents should be for specific services rendered by the County Government such as provision of water, electricity, waste collection or public transport. Well-designed user fees allow residents and businesses to know how much they are paying for the services rendered by the County Government in the performance of its functions under the Fourth Schedule of the Constitution.

(vi) **Infrastructure Development Levies imposed on new developments.** An example of this has been through the Nairobi City County which imposed an infrastructure development levy of 0.05% of the estimated cost of a proposed new building and to be paid prior to obtaining development permission. The last known publication of such a levy by the County was in 2010[68] when the then City Council of Nairobi gazetted its fees and charges for 2010. It was envisaged that the fees collected would be utilized by the City Council towards the implementation of necessary infrastructure associated with the proposed new building.

However, interviews with former city officials indicate that the infrastructure development levy was not ring-fenced from the general funds of the City in a specific infrastructure development fund. For this reason, and the lack of readily available records, the utilisation of the fees collected has been impossible to track.

The imposition of development fees has been formalised under the Physical and Land Use Planning Act, 2019 which empowers county governments to levy a development fee against an applicant for development permission. Such fees are payable prior to obtaining development permission but may be waived upon satisfaction of the criteria published by the County Government. Where a development fee has been waived, the County Government is, however, entitled to require that the applicant develop the infrastructure in relation to the property in question with such infrastructure being available for general use by the residents of the area where the property in question is located.[69]

(vii) **Special Funds established under an Act of Parliament.** These include the Housing Fund under the Housing Act that has now been operationalised through the Housing Fund Regulations, 2018. Other efforts have included the Government Financial Management (Kenya Slum Upgrading, Low Cost Housing and Infrastructure Trust Fund) Regulations 2006[70] whose objective was to provide funds for slum upgrading, low cost housing and infrastructure programmes to support housing development. The initial capitalisation of this fund was KES 400 million (USD4 Million) appropriated by Parliament in the 2006/2007 financial year. However, one report noted that the fund consistently failed in

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67 Act No. 18 of 2012, S. 120 County Governments Act No. 17 of 2012 and the Entertainments Tax, Cap 479.

68 Special Gazette Notice No. 12582 of October 15, 2010 published the Fees and Charges pursuant to the Local Government Act (now repealed), the Valuation for Rating Act, Cap 266 and the Rating Act, Cap 267

69 Section 63, PLUPA

70 The Slum Upgrading, Low Cost Housing and Infrastructure Trust Fund was established in December 2006 under the Government Financial Management Act, No. 5 of 2004 (now repealed).

four consecutive financial years (2008 – 2011), to submit its accounts, keep proper records and supporting financial documents with no accurate details of how and where the funds were to be specifically deployed.[71]

(viii) **Special Rates or Tariffs imposed in designated areas under the Rating Act and the County Governments Act.[72]** The Rating Act requires that rates (i.e. property taxes) shall be levied by the rating authority to meet liabilities of the general rate fund.[73] Further, the local authority was empowered to levy special rates in any part of the municipality, township or county.[74] The County Governments Act further permits the County Government to differentiate between categories of users and geographical areas as long as the differentiation does not amount to unfair discrimination or impose a surcharge in appropriate circumstances on the tariff for a service.[75]

Records of the application of special rates in Kenya can be traced as far back as 1958 when, pursuant to the Local Government (Valuation and Rating) Ordinance, 1956[76] and the Local Government (Valuation and Rating (Amendment) Ordinance, 1957,[77] the Municipal Board of Kisumu published the application of a special rate of 2% for the year 1958 on the unimproved value of lands as appearing in the Valuation Roll of 1957.[78]

(ix) **Borrowings by County Governments through Loans and Capital Markets.** County governments are empowered to borrow provided that all borrowings over the medium term are used only for the purpose of financing development expenditure and not for recurrent expenditure.[79] The authority to borrow is also subject to the Constitution and a guarantee by Parliament,[80] and the debt management strategy of the County Government over the medium term. The authority to borrow money includes borrowing from the capital markets by issuing appropriate securities.[81]

To date, no guidance has been issued by the National Treasury or the Capital Markets Authority on the issuance of county government securities in general and county bonds in particular. Municipal bonds have been widely used in other jurisdictions -- especially North America and Asia -- to finance local government investments. European local governments -- especially in France and Germany -- have however tended to borrow from specialised local government banks. South Africa remains the only African country to have issued municipal bonds with the support of the Development Bank of Southern Africa which issues partial bond guarantees in certain instances..

71 Report on Housing Sector Financing in Kenya, Economic & Social Rights Centre (Hakijamii), 2013 at pp 19 – 20.

72 Act No. 17 of 2012

73 Section 3(1), Rating Act

74 Section 9, Rating Act

75 Section 120(4) and 120(3)(f), County Governments Act

76 No. 7 of 1957

77 No. 7 of 1957

78 Gazette Notice No. 1163 of April 1st, 1958 by J A Berry, Town Clerk, Kisumu.

79 Section 107(2)(d) Public Finance Management Act.

80 Section 58 of the Public Finance Management Act provides that the Cabinet Secretary responsible for Finance may guarantee a loan of a county government and that loan should be approved by Parliament while Article 212 requires a county government's loan to be approved by the County Assembly and guaranteed by the national assembly.

81 Section 144 of the Public Finance Management Act and Regulations 182 and 183 of the Public Finance Management (County Government) Regulations provide the guidelines for issuance of county government securities.

(x) **Mobilising Financing through Public Private Partnerships.** County governments are now empowered to mobilise private sector capital under the Public Private Partnerships Act which envisages that a contracting authority includes a County Government which intends to have one of its functions performed by a private party.[82] County governments may therefore now engage in PPPs with a view to broadening their ability to perform their functions through utilisation of private finance.

The PPP Unit of the National treasury has listed several infrastructure projects to be implemented by county governments which are at various stages of procurement. These include bulk water supply projects in Laikipia County and Murang'a County and solid waste management projects in Nairobi, Mombasa and Nakuru counties. Studies have indicated that there is a good opportunity for the private sector to engage profitably in the city and also benefit low-income households through innovative products that are specifically designed to meet their needs at prices they can afford and delivered in ways that fit their lifestyles.[83] Box 6 gives an example of a PPP for infrastructure delivery in informal settlements in Brazil.

Box 6: PPPs for Infrastructure Delivery in Brazil's Informal Settlements

In Sao Paulo, Brazil, new PPPs – "Urban Concessions" were developed in which impoverished parts of the city were to be converted to private operation in exchange for the execution of an infrastructure plan.

The concessionaires were to recoup their investment and obtain profits from the redevelopment of expropriated properties during the concession period.

It was envisioned that owners of properties would receive compensation according to predefined criteria, while sitting tenants were to either be relocated to low-income housing or obtain rental grants.

Source: Farvacque-Vitkovic, Catherine; Kopanyi, Mihaly (2014)

82 Section 2, Public Private Partnerships Act, 2013

83 Farvacque-Vitkovic, Catherine; Kopanyi, Mihaly (2014). Municipal Finances. A Handbook for Local Governments. Washington, DC: World Bank. P 373. Available at: https://openknowledge.worldbank.org/handle/10986/18725 License: CC BY 3.0 IGO."

3.5 Innovating with Subsidies for Infrastructure

Increasingly, output-based aid (OBA) has been used to structure subsidies to the private sector to ensure that performance targets -- particularly those related to service provision to low-income households -- are adequately met. OBA basically links the payment of subsidies to the demonstration of specific service delivery or outputs: for example, the connection of a specified number of customers to the electrical grid or to the water distribution network.

Private providers must, therefore, carry their own risks of non-performance and provide their own finance up-front (in most cases) to meet the performance targets and obtain the OBA grant. OBA has been found to be especially effective in extending water connections to slum areas through one-time fee subsidies for network extension and connections.

The Nairobi City Water and Sewerage Company (NCWSC) has experience with this type of innovation, enabling it to blend commercial capital with a grant. The Company has leveraged a commercial loan from a Kenyan commercial bank linked to an OBA grant from the World Bank. In this instance, the objective of blended finance was to enable NCWSC to connect 16,000 households to the water and sewerage networks.

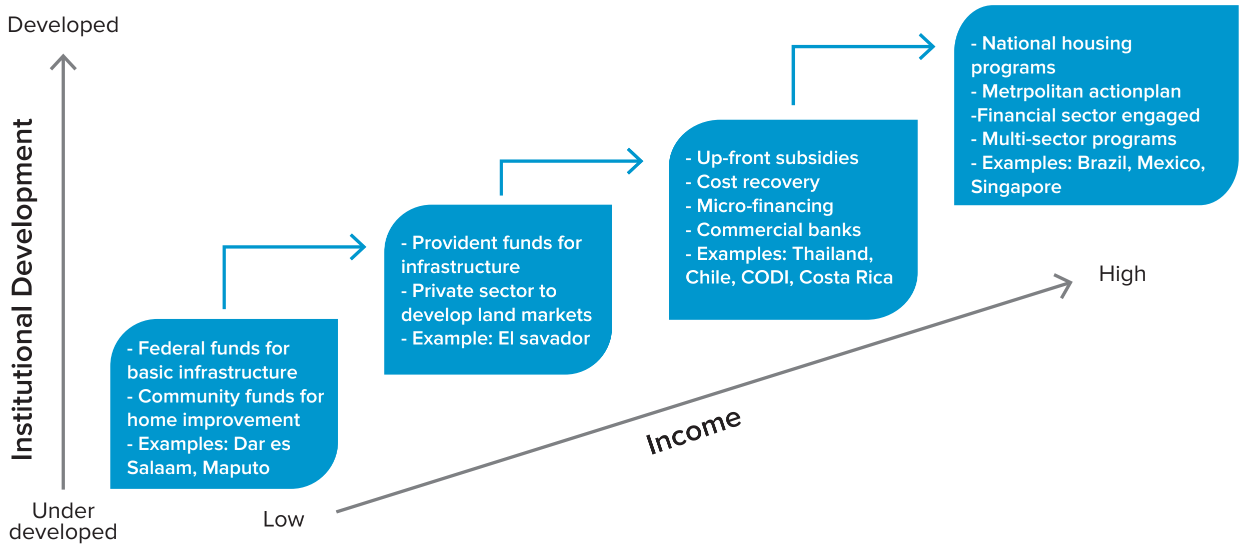
The grant was to “reimburse NCWSC for up to 70% of the costs of the sewerage connections and compound toilets, and up to 40% of water connection costs, upon verification that the agreed outputs had been met. It is expected that the loan will be provided in local currency for a tenor of ten years. The loan will likely not require a guarantee, thanks to the strong balance sheet maintained by NCWSC.”[84] NCIF’s experience will need to be evaluated to determine its implications for financing infrastructure services in Mukuru.

3.6 Outlook

Freire (2013) presents a stylized depiction of the sources of slum upgrading finance as a country’s economy grows and institutional development gathers pace. If Kenya’s AHP and Housing Fund mature quickly by leveraging the national payroll and the capital market, the country could leapfrog some of the intermediate stages postulated by Freire (Figure 3).

84 World Bank (2016) “Case Studies in Blended Finance for Water and Sanitation: Scaling up Blended Financing for Water and Sanitation in Kenya”.

Figure 3: Sources of Slum Upgrading Finance (Source: Freire (2013)



Abbreviation: CODI, Community Organizations Development Institute

Source: Data form World Bank and UN-Habitat (1999)

4. WHAT ARE THE IMMEDIATE FINANCING NEEDS?

In line with international best practice, a financing scheme for upgrading slums in Nairobi should focus on three broad areas: infrastructure, housing, and livelihoods. As already pointed out, infrastructure for slum areas, comprising both on-site and off-site infrastructure, is a public good whose funding is the primary responsibility of the public sector using public funds or a blend of public and private resources. In contrast, housing is a private good.

For this reason, housing is best financed by households supported by capital from the private sector, with public sector subsidies for those at the bottom of the income pyramid. These subsidies support poverty reduction by improving livelihoods, health and well-being. In addition, as explained below, the pattern of spatial development has significant impacts on energy use and hence the potential for low-carbon development. This is a further reason for state intervention. Microfinance for business is best delivered by the private sector although public sector lending is also common in Kenya.

This section provides a qualitative examination of the types of finance that will be required for upgrading infrastructure in Mukuru. A quantitative analysis of the investment needs is premature at this stage and will only be possible when the preparation of the LPDP is at a more advanced stage.

On-site infrastructure services are the most critical area of investment in Mukuru and cost estimates will be available once the consultative planning process is complete. Investigations have clearly revealed that water, sanitation and drainage conditions are dire and public health risks to the residents are very high. The rest of the city and the wider region are also at risk in view of the externalities associated with public health such as the pollution of rivers.

Moreover, there are pressing needs to upgrade roads and, in that way, improve internal circulation and access by fire engines and ambulances. The neighbourhoods that are already well laid out and road reserves are clear and unobstructed, such as in Mukuru Kwa Njenga, road improvements will be easier to accomplish than in the rest of the planning area. For the planning area as a whole, the LPDP will determine the requirements for off-site infrastructure to improve access to the settlement, and the capacity of the main water pipes that serve the SPA and the sewers that traverse it.

The ongoing participatory planning process and the resulting LPDP will dictate the detailed scope and cost of the required investments. It is anticipated that implementation timelines will also be determined, revealing investments that are required immediately and those that are feasible in the short and medium-term as well as in the long term.

Securing low-carbon development

A recent study by IIED and SDI[85] documents the potential implications of climate change for informal settlement upgrading using the example of Mukuru. Planning to date has already begun to prepare for a more positive outlook,

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85 Sverdlik, A., D. Mitlin, and D. Dodman (2019). Realising the Benefits of Climate Resilience and Inclusive Development in Informal Settlements, C40 and Cities Alliance, forthcoming.

potentially supporting both adaptation and a low-carbon development path. Improved waste management will reduce the quantities currently being dumped and reduce flood risks. There are also opportunities to work with local residents, particularly youth groups, to develop opportunities for re-use and recycling.

Housing designs (including both building orientation and construction materials) can help to cool homes and reduce energy use, while the provision of green space can also improve micro-climates. High density neighborhoods will reduce travel times to work, and travel demands more generally, efficiencies that are associated with compact cities.[86]

Mixed use development can help to provide opportunities for local enterprise development and the strengthening of local economies. Pedestrianization and cycling paths will create safe spaces without motorized vehicles and encourage residents to maintain their current low-carbon practices. Solar power for street lighting and the introduction of liquefied petroleum gas stoves for cooking will help to improve safety, encourage evening trading activities, and reduce emissions from paraffin and charcoal.

These approaches will reduce climate risks and potential housing expenditures in the longer term. They also open the possibility of securing climate finance to support the development of Mukuru.

86 See, for instance, Collier, P. and Venables, A. J. (2013). “Housing and Urbanization in Africa: Unleashing a Formal Market Process”.

5. PROPOSED FUNDING MECHANISMS AND THEIR INSTITUTIONAL CHANNELS

5.1 Background

The County Government of Nairobi intends to pass legislation to create a “Nairobi Special Housing fund” which will draw in public and private investments for the redevelopment of informal settlements in the city.[87] While the creation of this fund has been approved by the County Executive Committee, a number of aspects need to be addressed including its design, its relationship with the national housing fund, and its capitalization. This section examines these points and others in order to propose the types of funding mechanisms that would best respond to need.

The Fund Report proposes to mobilise resources from the following key sources: grants or donations, funds appropriated from the County Government, and loans or debt capital. The County is permitted to receive grants or donations from development partners with the approval of the County Executive Member for Finance and such grant or donation should be notified to the Cabinet Secretary of the National Treasury.

Further, the County Assembly will be required, prior to receiving such grants or donations, to promulgate regulations for the administration, control and management of grants. With regards to the annual allocations by the County Government, these would be guided by the County Fiscal Strategy Paper and approved by the County Assembly on an annual basis in accordance with the provisions of the Public Finance Management Act.[88]

As mentioned in Section 3.4 of this Report, any borrowings by the County Government would need approval of the County Assembly as well a guarantee by the National Government.

Financing mechanisms and their institutional channels should be in line with the particular nature of the investments set out in the previous section: upgrading infrastructure services; expanding the supply of social housing affordable by low-income households; and delivering enterprise microfinance. Fund design, therefore, should be tailored to the economic peculiarities of each type of investment besides meeting a number of other important criteria such as sustainability and appropriate corporate governance.

While the proposal for the establishment of the Nairobi Special Housing Fund is a noble idea to address the acute housing shortage within the County, the proposal does not appear to have regard to the ongoing efforts to operationalise the national government’s Housing Fund established under the Housing Act and no detailed investigation appears to have been undertaken to determine whether the Fund can indeed operate as a stand-alone fund alongside the Housing Fund.

The proposal for the Special Housing Fund by the County identifies the target beneficiaries as residents of informal settlements that are in occupation of public land that has been designated for upgrading by the County Government of Nairobi and who:[89]

(i) have been identified as beneficiaries of a County Government upgrading project through an enumeration and GIS mapping process;

87 Report on the Nairobi Special Housing Fund: Identifying Opportunities, Unlocking Informality and Leveraging Assets to Create Sustainable Housing for the Nairobi’s Majority Population, 2018

88 Section 117 of the Public Finance Management Act

89 Nairobi Special Housing Fund Report at pp 30

(ii) are members of a registered co-operative or a corporation under the Community Land Act;[90] and

(iii) are actively saving for their houses.

The County Government also identifies target beneficiaries to include informal settlement dwellers that have jointly purchased land within the county of Nairobi for the development of their own housing and have:

(i) registered as a co-operative or as a corporation under the Community Land Act;

(ii) have a minimum registered membership of 50 members, with a maximum household income; and

(iii) are actively saving for housing.

The SDHUD has identified various parcels of public land within Nairobi County for the development of affordable housing. These include Park Road, Makongeni, Muguga Green, Shauri Moyo, Starehe, and Mavoko. Other sites, yet to be identified, will accommodate an estimated 67,000 housing units and a further 15,000 social housing units all within the first lot of houses to be constructed under the proposed AHP.[91]

The SDHUD has also over the last year, publicly invited private land owners interested in availing their land for development under the AHP to submit details of such land for inclusion into a pool of available land for implementation of the AHP. Finally, the SDHUD is also engaging with county governments to allocate suitable land within their jurisdiction for implementation of projects under the AHP.

While the Report on the Nairobi Special Housing Fund does not identify specific informal settlements within its jurisdiction, it uses the SPA as a reference point for informal settlements. As noted earlier in this Report, the SPA is almost wholly privately owned and would therefore not meet the criteria set by the Fund's Report for purposes of identifying beneficiaries unless the land is appropriated by the government. It is, therefore, likely that the social housing sites in the national government's AHP would be the same areas targeted by, and meeting the eligibility criteria for, the Nairobi Special Housing Fund.

Under the circumstances, the risk of duplicating efforts and incurring wasteful and fruitless expenditure is high when running two parallel efforts i.e. the Housing Fund established as part of the AHP, on the one hand, and the Nairobi Special Housing Fund, on the other. It is therefore recommended that a possible option for consideration by the County Government is the establishment of a Nairobi Community Infrastructure Fund as further discussed below.

5.2 Nairobi Community Infrastructure Fund

It is proposed that the County Government of Nairobi consider restructuring its proposed Special Housing Fund into a Community Infrastructure Fund with the main objective being the financing of off-site and on-site infrastructure serving Nairobi's informal settlements, starting with Mukuru.

The main types of on-site infrastructure would consist of roads and storm water drainage, water and sanitation, street and security lighting, and safe electricity connections but the specific priorities in each locality would be determined through the ongoing planning process. Community facilities, such as markets and schools, would also be financed together with the rest of the infrastructure. While NCIF would not finance housing per se, it would lay the foundation for house building in slum areas.

90 Act No. 27 of 2017

91 Affordable Housing Programme Development Framework, June 2018

NCIF would be the financing focal point for all infrastructure investments in Nairobi's informal settlements, starting with the SPA. Its remit would be restricted to project appraisal and funding with no project implementation role so as to avoid duplicating the functions of executive departments of the County Government and other public-sector utilities.

It would enter into collaborative arrangements with other financiers of infrastructure in slum areas, including NWSC and KURA. It would also collaborate with international financial institutions, such as the World Bank, as well as social impact investors, international and local NGOs, and other organizations that seek to assist the urban poor.

Legal Structure, Governance and Accountability

The establishment of a public fund by a County Government is regulated by the Public Finance Management Act which empowers the County Executive Committee Member for finance (CECM Finance) to establish a county public fund (other than a county revenue fund) with the approval of the County Executive Committee and the County Assembly.[92] The CECM Finance is required to designate a person responsible for the Fund's administration who is obliged to ensure that the earnings of, or accruals to, the fund are retained in the fund unless otherwise directed by the CECM Finance.

A key benefit of establishing the fund would be to ensure that all monies of the fund are utilised only for the purposes for which it is established. This would address the problem encountered by the City in previous efforts to charge an infrastructure development levy whose remittances were not ring-fenced into a specific fund and were therefore utilised for other general purposes. Further, the utilisation of the Fund's money is required to be published and publicised and records maintained in compliance with the standards prescribed by the Accounting Standards board from time to time. All Special County Funds are to be disclosed by the County Government in its annual financial and non-financial reports.[93]

With the enactment of the Public Finance Management Act, the management, administration and utilisation of such funds is now regulated and subject to supervision under the Act and its Regulations.

With regards to the minimum requirements for the establishment of the Fund, the County Government of Nairobi will need to[94]:

(i) clearly set out the justifications for establishment of the Fund and submit it to the CECM Finance;

(ii) certify that the functions and the public services to be delivered through the Fund cannot be delivered through the structure of budget appropriations;

(iii) provide a clear justification as to why the Fund structure is deemed appropriate for improved service delivery in light of the legislative and policy mandate of the County Government under this policy;

(iv) confirm in writing that the establishment of the Fund and its continued existence will not depend on annual financing from the county exchequer and that the Fund will be self-sustaining;

(v) demonstrate how the activities of the Fund will fit in the overall Medium-Term Plan and County Fiscal Strategy Paper;

92 Section 116, Public Finance Management Act, 2012

93 Regulation 131, Public Finance Management (County Governments) Regulations, 2015

94 Regulation 191, Public Finance Management (County Governments) Regulations, 2015

(vi) stipulate the life of the Fund which shall not be less than two years and not more than ten (10) year, provided that where the Fund to be established is for a period beyond the maximum period of ten years, then the approval of the County Executive Committee and County Assembly approvals shall be sought;

(vii) the administration costs of the Fund shall be a maximum of three percent of the approved budgets of the Fund; and

(viii) the County Executive Committee Member Finance shall grant approval in writing before establishment of the Fund.

The roles and responsibilities of the Fund Administrator shall be as designated in the said Act and shall include, but not be limited to:

(i) supervision and control of the administration of the Fund in consultation with any trustees appointed to the Fund;

(ii) preparation of a budget and such plans for better administration of the Fund in consultation with the trustees to be approved by the county executive committee;

(iii) causing proper books of account and other books and records in relation to the Fund to be kept as well as to all the various activities and undertakings of the Fund;

(iv) preparation, signing and transmission to the Auditor-General in respect of each financial year and within three months after the end thereof, a statement of accounts relating to the Fund in accordance with the Public Audit Act,[95] and in such details as the County Treasury may from time to time direct;

(v) furnishing such additional information as may be required for examination and audit by the Auditor-General or under any law; and

(vi) designation of such staff as may be necessary to assist in the management of the Fund.

In order to provide for proper governance of the Fund, it is proposed that the Fund consist of trustees who would include representatives from the County Government as well as representatives from the private sector, property developers, professional associations, civil society organizations such as Muungano wa Wanavijiji, amongst others, who have knowledge and experience in matters relating to housing, urban planning and development, infrastructure finance and mainstreaming of poverty reduction strategies in urban development.

Capitalisation of the Fund

As discussed earlier in this Report, the County Government of Nairobi has in the past imposed an infrastructure development levy of 0.05% of the value of the building or development but the monies collected through this levy were never ring-fenced into a separate account and utilised towards the implementation of the necessary infrastructure.

With the enactment of the Physical and Land Use Planning Act, a legal basis now exists for the imposition of these fees by county governments. It is proposed that the County Government publish its regulations determining the circumstances under which such development fees are to be levied and the applicable rates with a

95 Act No. 34 of 2015

view to providing a framework for the payment of the development fees into the Fund for two purposes:

(i) ensure that the County Government is able to account for the funds specifically collected for infrastructure development in a special fund; and

(ii) allocate a percentage of the infrastructure development levy towards the development of infrastructure in informal settlements.

By scaling back its obligation to provide infrastructure in middle- and high-income neighbourhoods from its general budget, the County Government will now have a dedicated pool of funds for infrastructure development in these areas and in informal settlements. It would also be able to allocate a higher percentage of its own source revenues and the equitable shareable revenue towards the implementation of the much-needed infrastructure in informal settlements.

NCIF would therefore further be capitalised through:

(i) annual appropriations from the County Government;

(ii) conditional grants from the National Government;

(iii) grants, gifts and donations from third parties including international financial institutions, private sector, non-governmental organisations, foundations and similar entities;

(iv) borrowings in the form of loans;

(v) borrowings from the capital market; and

(vi) any earnings from investments made of surplus funds in the Fund.

All receipts, earnings and accruals of the Fund and the balance of the Fund at the close of each financial year would be required to be retained by the Fund for the sole purposes of the Fund and would not be available for payment into the general County Revenue Fund.

6. CROWDING IN PRIVATE CAPITAL

In view of the scale of the upgrading challenge posed by slum areas in Nairobi, it is critical to leverage private capital. Local and international investors as well as financial institutions have limited appetite for investments in social housing which they consider to be a risky asset class. Yet this is the market segment where the greatest demand for housing lies.

The traditional economic argument is that formal institutions are not able to assess the risks associated with lending to the urban poor. This is the classic case of information asymmetry whereby one contracting party, in this case the lender, does not have enough information on the counterparty (the potential borrower) to permit an accurate assessment of the risk of lending.

Attracting commercial finance, therefore, is not a simple task. Lenders generally prefer "low-risk, dependable-return investments" and require that a borrower be "financially healthy and well managed".[96] In particular, they look out for borrowers who meet the following conditions:

- "a clear legal mandate and scope for service provision;
- financial capacity – solid financial track record with a positive net cash flow over several years;
- strong management – including business-minded leadership, operational efficiency and strong performance, financial capacity (i.e. strong revenues to cover costs of operations and debt service), good asset management and business planning;
- track record of borrowing and repaying debts; and
- an asset base against which collateral can be taken."[97]

The commercial banks in Kenya have identified key mortgage risk characteristics that need to be examined before a mortgage is approved, including:[98]

- Ability and willingness to repay - Debt Service Ratio;
- Collateral/security value - Loan to Value and Location of the property;
- Sustainability of the borrower income - terms of employment;
- Industry outlook;
- Legitimacy of the property - it should be free of encumbrances;
- Credit history and Credit Reference Bureau reports;
- Caveats on the property;
- Collateral/security value - Loan to Value and location of the property; and
- Property location and ease of sale in case of default.

96 Pories, L., Fonseca, C and Delmon, V. (2019) "Mobilising Finance for WASH" World Bank Working Paper.
97 Ibid.
98 CBK Bank Supervision Annual Report, 2017 at 19

It is hoped that the project and offtake agreements in the AHP will address many of these concerns by assuring developers that houses that remain unsold for a defined duration will be purchased by the National Housing Corporation which will serve as the off taker of the housing units and purchase these in bulk from the developers subject to the terms and conditions of the project and offtake agreements.

This assurance is expected to provide a substantial incentive to private developers and investors to deliver social housing in approved sites, but a critical success factor would be to ensure that there is demand for the housing developed.

In addition to assurances under the project and offtake agreements, a number of other incentives, if implemented transparently and with efficiency, would give them additional comfort as examined below.

Fiscal Incentives

Corporation tax for private developers of affordable housing has been reduced from 30% to 15% as long as they build 100 low cost houses annually[99]. This requirement was initially set at 1,000 units but was later reduced to 400 units.

However, in both instances, this condition was considered unrealistic as there were hardly any developers with the capacity to meet it. Moreover, the relief has a long approval path which includes the consent of the cabinet secretary responsible for housing[100].

It is not surprising that developers have found the approval process cumbersome and impractical. An additional issue is that the term “low cost housing” was not defined. These issues will need to be addressed through appropriate legislative and administrative reforms for this incentive to be of any practical use.

Stamp duty, at 4% of the price of an urban property, will be waived under the AHP for first time buyers. This tax is paid upon the transfer of real property and acts as a significant financial burden, especially for low-income households because of their limited savings and poor access to loans. Since it will lower entry level costs for lower-income households, and thus raise demand, this upfront demand subsidy might incentivize some developers to take more interest in the AHP.

A fiscal incentive that developers have clamoured for over the years is the waiver of import duty (25%)[101] and Value Added Tax (16% on the after-import-duty amount) on building materials imported for use in building affordable housing. Such tax waivers could significantly reduce the overall construction costs, probably by as much as 30%, but they are not supported by the National Treasury because of their potential for abuse.

Approval Fees

The County Government has already announced the waiver of approval fees for affordable housing. Similarly, the National Management Environment Authority (NEMA) and the National Construction Authority (NCA) have waived fees for the approvals that are required before construction can start. These are yet other incentives for private developers.

Non-fiscal Incentives

There are non-fiscal barriers that impede the mobilization of private capital for housing development. These impediments consist of lengthy processes for approvals of land subdivisions, change of user, and transfer and registration of title deeds. They also include delays in approvals by the National Environmental Management Agency (NEMA) and the National Construction Authority (NCA).

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99 Cytonn Real Estate (2017) “Nairobi Metropolitan Residential Report 2017”. See https://www.cytonn.com/uploads/downloads/residential-research-report-vf.pdf.

100 Deloitte (2017) “International Tax: Kenya Highlights 2017”. See: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-kenyahighlights-2017.pdf?nc=1

101 There is in addition an import declaration fee of 2.25% and a railway development levy of 1.5%.

The approval process takes too long from application to obtaining a building permit.[102] The AHP intends to address these approval bottlenecks as a way of attracting private capital for housing development.

Even in the absence of the AHP, Social Impact Investors (SIIs) provide another means of attracting private capital for slum upgrading. The high poverty penalty currently paid by slum dwellers provides a compelling case for attracting resources from such investors. This penalty arises from the disproportionate prices for housing, water, and electricity in conventional residential areas.

Potential impact investors include those working with UNOPS in the 100,000 houses programme for which a memorandum of understanding was signed with government. Besides housing, SIIs take an interest in improving infrastructure services. Novastar, for instance, has invested in Sanergy, a company that franchises small-scale hygiene centres in Kenya's urban slums, providing a cheap and efficient way to reduce the prevalence of disease.[103]

To encourage SIIs to come forward, it would be useful to have in place a suitable risk sharing arrangement. Institutions that help de-risk investments include the African Guarantee Fund (Box 7) or the United States International Development Finance Corporation.

A risk sharing facility could also be included in the Affordable Housing Finance Project supported by the World Bank, along the lines of a similar project in Pakistan.[104] It would not be necessary to establish a new guarantee facility. Another important constraint these bodies could be asked to address is the general lack of cost-effective ways of hedging against foreign exchange risk for SIIs whose investments generate returns in local currency.[105] Social housing falls squarely in this category.

Box 7: The African Guarantee Fund

The African Guarantee Fund (AGF), with its main office in Nairobi, started operations in 2012. It was established by the African Development Bank (ADB) in collaboration with the Danish Ministry of Foreign Affairs and the Spanish Agency for International Development Cooperation.

The French Development Agency and the Nordic Development Fund subsequently joined the Fund. Its mandate is to bridge the financing gap for local SMEs in high-impact sectors and to promote job creation by providing financial guarantees to financial institutions, covering their lending to SMEs, and thus catalyzing private sector resources for financing SMEs.

AGF has so far implemented its business activities in 38 countries including in 12 transition states across Africa. It has collaborated with 84 financial intermediaries, enabling banks to increase available financing for lending to SMEs by about US $1.2 billion. Over 8,600 SMEs have benefitted from AGF guaranteed loans, creating about 86,510 jobs. Approximately 60% of these jobs have been for the youth and 30% for women.

AGF continues to broaden and deepen Africa's local financial systems. With the support of the ADB, AGF will continue to catalyze lending to critical sectors such as manufacturing and trade, renewable energy, housing, health, education, the financial sector and agriculture, in line with the ADB's priorities.

Adapted from: https://www.afdb.org/en/news-and-events/deepening-africas-financial-systems-african-development-bank-promotes-smes-access-to-funds-18315/

102 Saad Yahya and Associates (2018) "Situation Analysis Report". A report prepared in support of the formulation of a housing policy for the Nairobi City County.

103 Bell, A. (2015) "The Case for Impact Investment in Africa in 2015". Article published on 12th February 2015 by Executive Director of Social Finance at JPMorgan Chase & Co.

104 World Bank (2018) "Project Appraisal Document – Pakistan Housing Finance Project". http://documents.worldbank.org/curated/en/176481522548036067/pdf/Pakistan-Housing-PAD2385-vF-03122018.pdf

105 GIIN Advisory Team and Open Capital Advisors (2015) op. cit.

7. ROLLING OUT THE FINANCING MECHANISMS

The integrated LPDP will likely set out implementation timelines for the respective investments in Mukuru including the upgrading needs that deserve an immediate response. Other investments will require financing in the short-term, and yet others in the medium- to long-term.

As soon as the financing mechanisms proposed in this report have been approved, with the necessary modifications, the County Government and its partners should take the following steps:

County Government:

- Pass a resolution to establish the NCIF as a public corporation under the Public Finance Management Act;
- Prepare a draft bill setting out details on: (a) the objects of the NCIF; (b) the Fund's governance structure as well as representation of slum residents organizations on the board; (c) appointment of senior staff; (d) utilization of the resources of the Fund; and (e) financial reporting and auditing;
- Ensure the draft bill is prepared having due regard to the mandate of the national Housing Fund with a view to avoiding duplication of efforts by both funds;
- Ensure that the bill is subjected to public participation ahead of its enactment in compliance with the County Governments Act;
- Agree with the National Government on how NCIF will play its rightful role in prioritizing slum infrastructure projects financed by international financial institutions since such projects fall within the devolved functions in the Constitution;
- Negotiate with SDHUD to ensure that Mukuru upgrading is listed as a priority project, commencing with the sites within the SPA that are publicly owned;
- Negotiate with SDHUD so that both bulk and on-site infrastructure in Mukuru are prioritized for World Bank funding during the next round of projects under preparation;
- Negotiate with the SDHUD so that for slum areas, loans from the national Housing Fund will be available at a concessionary rate substantially below the 7% annual interest recommended in the Housing Regulations;
- Jointly with SDHUD, engage with the National Treasury to negotiate with the World Bank for the inclusion in the KAHFP of a risk sharing facility for social housing designed to enable small property developers to secure bridging finance for their social housing projects from commercial banks;

Partners

- Work with residents in informal settlements, commencing with the residents within the SPA, to agree on the sequencing of upgrading investments;
- With the assistance of other organizations, such as SDI, UN-Habitat and SIDA, negotiate funding agreements with financial institutions interested in financing on-site infrastructure services and on-plot connections;
- Sensitize residents in informal settlements about the AHP and encourage them to register as members; and
- Organize the residents into cooperatives or other appropriate collectives so that they can start saving for infrastructure connections and other neighbourhood improvements.

8. SEVEN KEY MESSAGES

To conclude this report, seven takeaway messages are set out which summarise the main arguments in the report, and the recommended financing mechanisms that they give rise to:

Financing mechanisms for slum upgrading are heavily influenced by a country's political context, and its financial and legal infrastructure

The prominence given to affordable urban housing in Kenya's development agenda is both recent and unprecedented in the country's history. The establishment of the AHP and development of the KAHFP are a reflection of the political will to introduce institutional reforms in the housing sector and to mobilize the resources needed for programme implementation.

In parallel with these changes, devolution has given County Governments the power to legislate, providing them with legal tools to create new institutional funding channels where these are merited. The financing terms for social housing embedded in the AHP, including subsidized interest rates and supply side subsidies, would not have been possible only a few years ago.

Moreover, Kenya has over previous decades created a well-functioning financial system and deepened its capital market. This financial infrastructure has in turn raised the prospects of mobilizing private capital to support slum upgrading. This is the broad context that has influenced the financing mechanisms proposed in this report.

Funding of infrastructure services should be led by the public sector but mechanisms are needed to mobilize complementary resources from the private sector

Infrastructure in Nairobi's informal settlements, and bulk infrastructure in particular, is a public good whose funding responsibility rests primarily on the public sector. Many sources of capital exist to meet this mandate, including budgetary sources, loans and grants from multilateral and bilateral organizations, social impact investors, and NGOs. In the near-term, the County Government will likely not have the policy levers to unlock private funding on a scale commensurate with demand. Although land value capture is potentially an important means of raising capital for infrastructure, alongside other land-based financing, it will take time for this source to become feasible. In the interim, imposing a levy on developers who benefit from publicly funded infrastructure would be a more practical alternative.

A dedicated institutional channel is needed for financing infrastructure in Nairobi's Informal Settlements

A Nairobi Community Infrastructure Fund should be created to act as the financing focal point for all infrastructure investments in Nairobi's informal settlements, starting with the SPA. It would be established as a public corporation under the Public Finance Management Act. As already pointed out, its mandate would be restricted to project appraisal and funding, with no project implementation role, so as to avoid duplicating the functions of executive departments of the County Government and other public-sector utilities.

Capital funds for house construction should be the responsibility of the private sector - financial institutions, SACCOs, developers and households – a role that should be fostered by means of appropriate risk sharing facilities as well as fiscal and non-fiscal incentives. However, low-income households need additional support from state subsidies for housing to be affordable. Incremental development approaches improve affordability and scale.

The AHP has established a framework for attracting private capital for house construction and a city-specific housing fund is, therefore, not a priority. At any rate, financing house building should be the responsibility of the private sector. However, commercial finance for house ownership is not affordable unless it is blended with concessionary funds and other subsidies from the public sector. The main incentive in the AHP is the offtake agreement which assures developers that the affordable houses they build, including in slum areas, will be bought by the HF if they do not sell quickly. Other incentives include the financing of off-site infrastructure by the public sector as well as a range of fiscal and non-fiscal incentives.

There is a need for financial support to be available for low-income housing – and particularly to community-led housing initiatives - as well as support for higher-income private housing developments. Support for housing is an important component of poverty reduction, while support for compact cities (higher-density housing) helps to secure a low-carbon development trajectory. Support for community-led housing developments helps to reduce vulnerabilities through strengthening social capital. This is particularly valuable if housing-related debt increases household vulnerability.

Sequencing of investments matters, with infrastructure taking precedence over other improvements in slum areas in line with the priorities of the residents

The preference of slum residents, in general, is to have infrastructure investments precede other improvements. In Mukuru, for instance, investments in on-site infrastructure are immediately feasible in neighborhoods with clear and unobstructed wayleaves. The LPDP will reveal which infrastructure investments can proceed immediately as well as those that will require funding in the medium-term and beyond in step with the resolution of issues surrounding wayleaves and road reserves. The sequencing of investments needs to take into account the need for new innovations to assist in the development of models to secure inclusive upgrading at scale.

Optimizing land use in strategically located slum settlements, to ensure high social and economic returns, is a critical element in determining the appropriate upgrading strategy

In the future, land values in slums in strategic location will likely be very high relative to house building costs. This fact, and the imperative to promote a compact city, provides a compelling case for building apartments to high densities based on cultural preferences and appropriate building regulations. Only in this way can social and economic returns be maximized. When determining appropriate regulations it is important that thought be given to the ability of low income households to maintain project facilities, such as lifts in high rise buildings. Cost savings stemming from economies of scale and the subsidies available under the AHP, especially low-interest rates, would substantially enhance affordability.

Support to micro-enterprises should be an integral part of slum upgrading

There is an active community of micro-enterprises in Kenya's informal settlements, receiving financial and capacity building support from a wide range of organizations: government, commercial banks, microfinance institutions and NGOs. There is a strong case for believing that microenterprises help low-income people (but not the lowest income) increase their incomes and thus their ability to pay for better infrastructure services and housing. Support should be offered through the capitalization of micro-finance agencies able to offer affordable loans, and through the development of mixed-use neighbourhoods with workshops and units for retail trade and local services.

Annex 1: List of Contacts

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