

# GCC Economic Review

## Building mortgage markets

Housing has emerged as one of the key policy focus areas in the Gulf region as governments seek to meet the challenges created by their rapidly growing, young populations. Mortgages are seen as critically important for broadening access to housing. Historically, home purchases have depended heavily on personal/family resources as well as subsidized loans from special government funds.

- **A comprehensive institutional infrastructure is needed for efficient mortgage markets.** The international experience suggests that the level of mortgage lending tends to be critically dependent on having adequate facilities for registering properties and mortgages, ensuring cost-effective access to credit information, providing for efficient foreclosure systems, and establishing proper secondary markets. Significant progress has been made in addressing these issues in the Gulf but numerous hurdles remain.
- **The emerging market experience provides examples of rapid mortgage growth.** A number of emerging markets – led by Malaysia, Mexico, and Korea – have successfully used mortgage markets as a way of boosting home ownership. These advances have been underpinned by clear regulation and institutional reform. But improved access to housing has remained critically dependent on government support through subsidies, alternative loans, or secondary markets. Regulatory interventions have been undertaken in some cases to contain market bubbles.
- **Modern mortgage markets are critical for meeting the growing housing needs of the Gulf region.** The dedicated government housing funds have struggled to meet the demand and long queues have become common. Mortgage lending has taken off across the region and is in some cases used to augment government loans. Nonetheless, mortgage penetration remains low by global standards with the value of outstanding mortgages in even the most established markets totaling less than 20% of GDP, as compared to a developed world average of 60%.
- **Mortgages are not enough.** As much as proper mortgage markets can significantly improve access to adequate housing, the goal of very high home ownership is unrealistic. Virtually all established housing markets have grown with a significant element government-sponsored social housing. The current income distribution along with high land and input costs means that government provision of housing will have to play an important role in the GCC as well.

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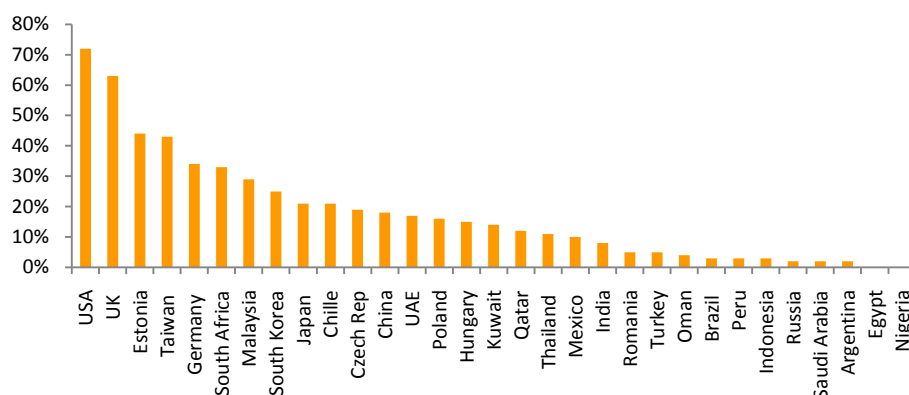
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## Contours of a mortgage market

In essence, a mortgage is a loan securitized by real property. It constitutes an encumbrance limiting the right to the property in question until the loan has been fully amortized. There are analogous Shariah-compliant structures, although for instance the commonly used *ijarah* is strictly speaking a lease agreement offered with the promise to own. The economic appeal of mortgages comes above all from the fact that being able to use real property as collateral typically significantly reduces the cost of borrowing as compared to unsecured personal credit. Paradoxically, this relative pricing has materialized in the Gulf only relatively recently because of earlier concerns about mortgages tenors and security. Hence, mortgages can play an important role in improving access to housing. Such considerations are particularly important in demographically dynamic societies.

But it is important to realize that mortgage industries evolve within a broader institutional and regulatory framework whose nature in turn can have profound implications for the scale of mortgage credit and the stability of the market. Macroeconomic stability is important for successful mortgage lending as are the size and sophistication of the financial sector, as well as policies on land use. But beyond this, the nature of the institutions and regulatory provisions linked to the mortgage market itself can have profound implications for the willingness of lenders to lend. A 2008 review of a sample of 42 mortgage markets around the world by the International Finance Corporation (IFC) found substantial differences in mortgage regulation, which in turn had a major bearing on the size and development of the markets.<sup>1</sup>

### Mortgage penetration globally (mortgage lending as % of GDP)



Source: Central banks, IMF, NCB estimates

Partly as a result of these differences, national mortgage markets differ dramatically in size and sophistication. In some advanced economies, mortgages

<sup>1</sup> *Financing Homes: Comparing regulation in 42 countries*, The International Bank for Reconstruction and Development / The World Bank, Washington, D.C., 2008.

as a share of GDP are close to 100%. In many emerging markets, they are barely 1%, although in for instance Mexico, the proportion is 10%, in South Africa as much as 33%. The average for advanced economies is 60%, that for emerging markets 6%. In the GCC, mortgage lending ranges between 2% and 17%, in most cases remaining below 10%. Paradoxically therefore, countries with the greatest need of housing face the biggest challenges in ensuring access to it.

A great deal of empirical evidence suggests that the development of mortgage markets is significantly linked to factors such as:

- Mortgage registration (time, cost, simplicity)
- Credit information (credit bureaus, ways of collecting payment, insurance, guarantees)
- Mortgage structure (loan size, debt-to-income ratio, tenors, interest rates)
- Foreclosure (time, cost, involvement of the judiciary, enforcement)
- Secondary mortgage markets (size, structure, regulatory underpinnings)

## **Mortgage registration**

Mortgage registration provides the key foundation for mortgage markets by providing clarity on the title to the mortgaged property. It ensures that the borrower has full control of the property and that the lender has priority over other creditors in the event of a default. Delays in registration or the possibility of others claiming the property represent potentially significant risks for the lender.

In many, especially emerging markets, defining the title has been a challenge because of informal or communal ownership and sometimes conflicting interpretations of title. Many countries do not have comprehensive cadastral maps and registers. In some instances competing systems exist. The IFC survey found that registering and mortgage and title transfer can take a year in Rwanda. In the GCC countries, the process of establishing title has in many cases been significantly facilitated by the close link between real estate development and the emergence of mortgage markets. Thanks to the rapid pace of construction, most of the mortgaged properties are new and the mortgagor hence typically unequivocally the first owner of a property.

The cost of mortgage registration is typically made up of transfer taxes, stamp duties, fees, and payments to notaries and lawyers. In some countries, such charges total a fraction of a percent, in Nigeria as much as 19% of the price. In the GCC, such levies are fairly modest. Bahrain charges a fee varying from 1.35% to 3% depending on property value and the timeliness of registration. In Dubai, the Land Department levies a 0.25%, capped at AED1.5mn while Qatar has a similar 0.25% charge. In Kuwait, a nominal fee of KWD1 is assessed, while an updated deed is available from a notary free of charge in Saudi Arabia.

In general, a key element of the costs tends to be linked to requirements to involve notaries. The IFC found that every USD1,000 increase in registration costs reduces outstanding mortgage loans by nearly 5%. In some countries, registration-related challenges have been overcome by mechanisms for establishing the title through an agreement between the buyer, seller, and lender. Sometimes regulatory interventions have been used to streamline the system. Egypt is a salient example of a Middle Eastern economy which has managed to sharply lower the time and costs involved in mortgage registration in recent years. The starting point was a highly bureaucratic system taking close to 200 days, further complicated by the fact that only some 20% of residential properties in the Cairo area were registered in the names of their current owners. The extremely high registration costs were brought down to less than 1% of the value of a property. The result was a threefold increase in the registration of properties.

### **Assessing credit quality**

Mortgages represent a substantial financial commitment to most borrowers. Indeed, the economic development rationale for mortgages comes in important ways from their ability to allow people who otherwise would not be able to buy a home to do so. It is hence important for lenders to have as good an understanding as possible of the ability and willingness of a buyer to honor his financial obligations. Limitations on the availability of this type of information tend to significantly reduce access to credit, either by cutting the size and duration of loans or by curbing the pool of people qualifying for a loan. Lenders can manage informational asymmetries by reducing the loan-to-value ratio, thereby increasing the probability that an eventual foreclosure would enable them to get back most of the loan value. In the GCC, Saudi Arabia and Bahrain have relatively established credit bureaus but the availability of accurate information for the region as a whole is still uneven. The ability to pool accurate data is often further complicated by the presence of a large, transient expatriate population.

In the absence of comprehensive, high-quality credit data, priority tends to be given to customers whose creditworthiness can be assessed through their affiliation, e.g. public sector employees, people working for banks or large corporates. Job security in such positions is usually high and salaries tend to be paid electronically, which makes it easier to deduct loan payments through ongoing standing orders. While such practices can enable significant market growth, they naturally impose significant limitations on overall access to housing. These limitations can be addressed to an extent through guarantees (typically from the government) and the use of insurance products.

### **Structuring mortgages**

In spite of the inherent simplicity of the product, mortgage loans can be structured in a variety of ways. Key parameters include:

- The loan-to-value (LTV) ratio, which sets the value of loans as a percentage of the purchasing price of the property. The higher the LTV, the more debt borrowers can expect to take on.
- The debt-to-income (DTI) ratio calculated the available total amount of the mortgage loan as a percentage of the borrower's income.
- The repayment period, which stipulates over how many years the loan has to be repaid. A longer repayment period will increase affordability by reducing the size of the average monthly installment.
- The ability to make home equity withdrawals. This enables borrowers to realize any increase in their home equity (through repayments or price appreciation) by borrowing more against the value of their property.
- The ability to repay the loan ahead of time. Limitations or penalties on early repayment will reduce the borrower's ability to refinance his mortgage, whether in order to benefit from lower interest rates or to withdraw equity.

Globally the most advanced mortgage markets have tended to have LTVs of 80%, although there have been instances of more than 100%. Loosening the LTV and DTI ratios has often been used as a way of boosting affordability but such steps also tend to sharply increase the probability of defaults. In most established mortgage markets, loan tenors tend to be 25-30 year and the principal is amortized simultaneously with ongoing interest payments. Mortgages can be fixed rate or variable rate. Equity withdrawal is standard practice and fostered by a competitive market place. There are typically no prepayment penalties and capital markets are an integral element of the mortgage sector.

## Foreclosure

Defaults are among the main risks faced by mortgage lenders. Their probability can be reduced by a careful vetting of borrowers and the use of insurance policies. However, the ability of mortgagors to pay is sometimes undermined by unforeseen changes to personal circumstances or broader economic shocks. In many instances, lenders are willing – sometimes with government support – to temporarily or more permanently renegotiate the loan terms so as to enable to mortgagor to retain control of the property. The economic costs of such measures are often less than those of outright foreclosure. By contrast, measures to protect lenders on a non-negotiable, regulatory basis can impose high costs on lenders and result in effective credit rationing. Ultimately, however, foreclosure obviously remains the measure of last resort enabling the lender to realize the value of a property that is in violating of the mortgage agreement.

While balancing the rights of borrowers and lenders is a thorny challenge, credit availability and cost are clearly affected by the ability of lenders to realize their collateral rights in a timely fashion, something that minimizes revenue losses and any deteriorating in the value of the property. The IFC sample study found that foreclosure takes an average of 260 days but as much as 706 days in Ghana. In

Kazakhstan and the US, the duration is below 60 days. The duration tends to depend heavily on the degree to which court rulings are needed. Eliminating the need for judicial procedures has the potential, according to the IFC, to boost the mortgage market by 12%. But such a step must take care to protect the rights of borrowers. Costs are another significant variable. In Zambia, the costs of foreclosure can be up to 48% of the value of the property. This contrasts to less than 2% in Japan and Romania. In terms of costs, public auctions tend to increase the cost by 6%. Allowing private sales tends to increase mortgage penetration by 7.6%. In the GCC, foreclosure for residential real estate remains very rare and tends to be a very lengthy process.

In many countries, foreclosure is complicated by the social sensitivity of evicting people from their homes. In some cases, for instance Russia, such problems have been overcome by ensuring that defaulters can have access to housing. Even if the lender regains the property through foreclosure, the borrower is given a new home whether from a government pool or, in some cases, rental properties belonging to the lender. Even if foreclosure is difficult, timely loan servicing can often be ensured through penalties for non-payment or adverse effects on credit scores in societies that rely increasingly on the use of credit.

## Secondary mortgage markets

A secondary mortgage market is a platform for the sale of mortgage loans or securities collateralized by them. Mortgage-backed securities (MBS) are created by grouping together loans with similar characteristics. MBS are typically tradable instruments. Their existence usually makes for a much more competitive and cost-effective market place by reducing the barriers to entry by potential mortgage lenders. The increased competition in turn encourages specialization and efficiency. The result has tended to be a marked decline in the cost of borrowing.

Secondary mortgage markets can play an important role in improving access to mortgages by enabling lenders to move their mortgage assets off their books. In the absence of secondary markets, portfolio lenders are required to hold their mortgages to maturity. This creates additional problems of maturity mismatches, especially for banks that finance mortgages through deposits that tend to be shorter in duration than the mortgage loans themselves. By contrast, many institutional investors seek long-term, secure investments and properly structured and rated MBS are a very attractive instrument for them. At the same time, they are often liquid instruments which can be disposed of quickly when need be.

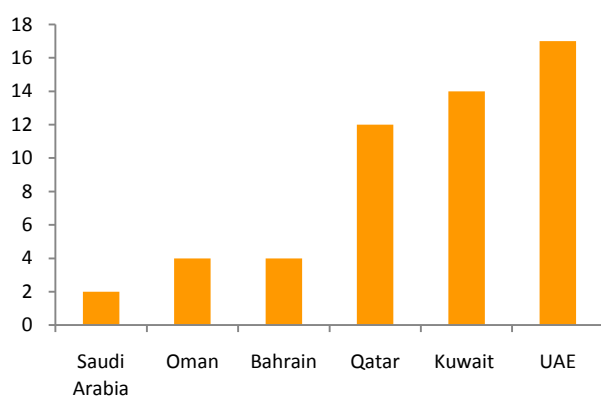
Most emerging market economies with secondary mortgage markets have sought to develop capital market funding through MBS, often with the active involvement of government agencies modeled on the US mortgage giants Fannie Mae and Freddie Mac. Such agencies, much as they were in the US in 1938, are a deliberate response to relieve shortages imposed by the availability of bank credit.

## A GCC mortgage industry is taking shape

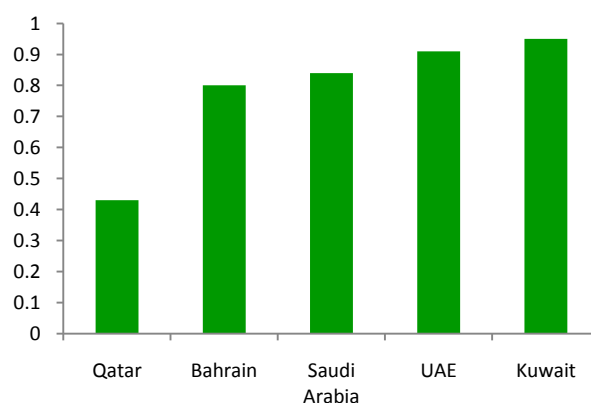
Getting mortgages right is one of the most important challenges facing the GCC region. The Gulf countries have some of the fastest population growth rates globally, unlikely to slow down below 2.0% a year in the foreseeable future. With the average family size furthermore experiencing a secular decline, access to adequate and affordable housing has emerged as an increasingly pressing policy priority. Yet the wealth and income distribution in the region has significantly limited the availability of owner-occupied housing as funding solutions have tended to rely heavily on personal savings and support from family and friends. Bank credit for home purchases has been limited while government funding is significantly rationed. In reflection of these realities, property developers in the region have tended veer towards the high end of the market as well as commercial real estate where the reliance on credit is far less. In some instances, such tendencies have been further amplified by more stringent regulations applied to residential mortgages.

A properly structured mortgage system can help begin to these constraints by boosting the availability of funding to the middle segment of the wealth/income distribution, thereby incentivizing developers to build properties that meet the expectations of this sizeable group of buyers. As borrowers are able to spread their payments over a longer period, the financial burden of a home purchase becomes easier to shoulder. More problematically, the increased availability of credit can push up property prices; the IMF recently estimated that a 10% increase in household credit is on average associated with a 6% increase in house prices. Government involvement tends to involve the effect, especially in advanced economies. While this may necessitate regulatory interventions, it will also further incentivize developers while longer loan tenors ease the burden on borrowers.

Mortgage loans as a percentage of GDP\*



The IMF mortgage index



\*These estimates are not methodologically consistent across the region and often include commercial mortgages as part of the total. They exclude personal loans used for housing.

Source: Central banks, International Monetary Fund, NCB estimates

Source: International Monetary Fund



With for instance the Saudi government targeting 80% home ownership by 2024, private sector funding solutions are likely to be the only economically sustainable way of offering access to buyers who can afford it. At the lower end of income spectrum, public sector provision will inevitably continue to play a key role across the region and should benefit from more targeted initiatives and increased funding as mortgages establish themselves as the default solution for the emerging middle classes.

In spite of the magnitude of the demographic challenges, mortgage lending in the GCC has to date remained very modest by international standards. Even after rapid growth in recent years, the overall industry is still estimated to total significantly less than USD100bn in terms of actual disbursements. The UAE, Kuwait, and Qatar have the most developed regional markets with mortgage penetration (loans as a percentage of GDP) in the double digits at some 17, 14, and 12% of GDP, respectively. However, for instance in Kuwait the majority of this lending has been for commercial projects rather than residential real estate. In some countries, these figures are based on broader categories of real estate lending. By contrast, the region's most populous country, Saudi Arabia, has a modest market estimated at some 2%. Historically also unsecured loans have been used for home purchases, although their weight appears to have declined sharply in response to mortgage products becoming widely available.

Private sector mortgages have to varying degrees eclipsed – and in some cases capitalized on – older government housing banks, which have traditionally served as the primary source of subsidized real estate loans in the region. Notable examples include Real Estate Development Fund in Saudi Arabia, the Kuwaiti Savings and Credit Bank, and the Bahraini Eskin Bank. However, these entities have struggled to keep up with the growing demand and waiting lists in some cases exceed a decade. In response, some GCC governments have recently substantially boosted the resources of these programs.

Even though the past decade effectively marked the inception of modern mortgage markets in the GCC, their development in most regional economies has advanced quite far. In general, unlike some of their emerging market counterparts, the GCC countries have a long history of financial and economic stability. The Dollar pegs entail a fairly modest interest rate risk of the kind that has curbed mortgage lending in high inflation economies. The Mortgage Market Index developed by the International Monetary Fund assigns weighted values between 0 and 1 to key market characteristics such as mortgage equity withdrawal, penalty-free refinancing or tax benefits, the number of mortgage lenders and their products, securitization, and the legal framework. Kuwait at 0.95 ranks highest among the regional economies on these criteria, followed by the

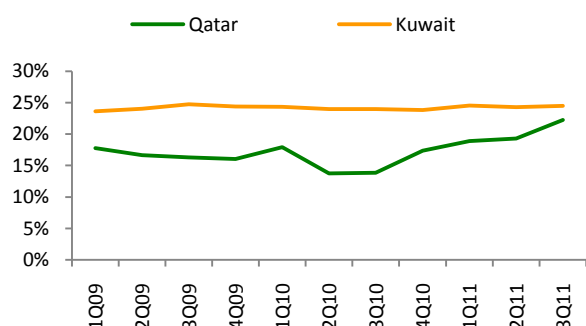


UAE at 0.91. Mortgage markets in Saudi Arabia and Bahrain are somewhat less developed, ranking at 0.84 and 0.80, respectively.<sup>2</sup>

In spite of the impressive progress, the development of the GCC mortgage markets continues to be held back by a number of regulatory and institutional hurdles. For instance, the availability of reliable credit data remains limited, although Saudi Arabia's Simah credit bureau, launched in 2004, is an important step in the right direction. Bahrain has been collecting housing credit data since 2005 and the UAE to an extent since 2006. Property registers and unequivocal title deeds remain generally work in progress but are increasingly recognized as a priority. Kuwait's law on real estate registration dates from 1959. Saudi Arabia first launched a system for the physical identification of properties in 1984 and a Cadastre Law was adopted in 2003. Dubai in 2008 adopted a law on an interim property registry and mortgages can no longer be issued unless a property is duly recorded there.

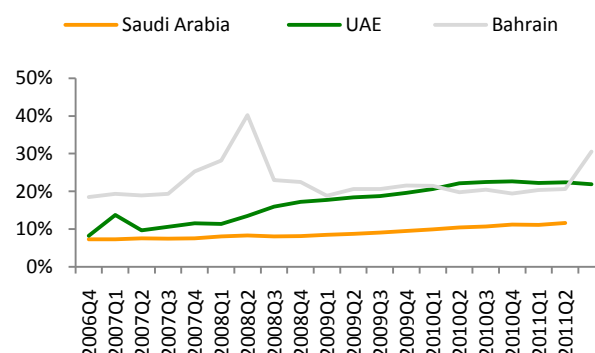
But problems are sometimes still posed by ineffective building codes or inadequate standards or violations of building codes. These regulatory violations can create risks that pre-sale inspections should catch but they are not always available in a standardized way. More generally, the facilities for monitoring the markets and obtaining accurate, timely data are limited. Although price data is increasingly widely available, it is usually obtained by market practitioners, not through a centralized, methodologically consistent system. This makes it difficult to accurately value properties. Also, partly because of the young age and rapid development of many markets, there are usually no clear practices on building maintenance. In many markets, this still creates the somewhat paradoxical prospect of steady erosion in the value of the collateral used for mortgages.

#### Lending to real estate as a proportion of total bank credit



Source: Qatar Central Bank, Central Bank of Kuwait

#### The relative weight of mortgage lending



Bahrain: Contribution of property mortgages to personal credit. Includes Eskan Bank as of July 2011.

Saudi Arabia: Mortgage loans as a percentage of household credit

UAE: All mortgage lending as a percentage of claims on the private sector

Source: Central Bank of Bahrain, SAMA, Central Bank of the UAE

<sup>2</sup> Samya Beidas-Strom, Weicheng Lian, and Ashwaq Maseeh, "The Housing Cycle in Emerging Middle Eastern Economies and its Macroeconomic Policy Implications," *IMF Working Paper*, WP/09/288, International Monetary Fund, Washington, D.C., 2009.

The development of mortgages in the GCC has in part been linked to addressing cultural and religious sensibilities, especially in the area of foreclosure. Foreclosures are a relatively recent phenomenon in the region. Where they have occurred, they have tended to involve expatriate properties. Barclays set an important precedent in January 2010 when it won the right to foreclose under Dubai's 2008 Mortgage Law and courts have allowed other lenders to follow. Repossessions have also taken place in Oman and Bahrain. By contrast, they are considered virtually impossible in Kuwait. In general, the legal basis for foreclosure remains often unclear and the number of universally applicable precedents limited. Even when foreclosure is permitted it tends to be a protracted and potentially uncertain process.

Historically, the lack of effective foreclosure enforcement appears to have been a source of delinquency with for instance some of the government lenders recording relatively high volumes of loans in arrears. On the other hand, the risk of foreclosure in the region's emerging mortgage markets is limited by the relative dominance of borrowers with good credit histories and reasonable assurances to lenders through arrangements such as automatic installment withdrawals from the salary, etc. Some lenders have sought to manage delinquencies through penalty payments and negative reports to credit bureaus, which will obviously adversely affect an individual's ability to obtain credit going forward.

In spite of the small size of the GCC markets, mortgages are often available on terms not dissimilar to those observed in the West or other emerging markets. Their tenors typically run up to 25 years while loan-to-value ratios of up to 85% are common. In practice, however, there is considerable variation in these key parameters and especially in the past many loans have tended to be available only for very specific types of properties. Mortgage-type funding is in some cases provided by property developers, typically in association with financial sector companies. Amlak and Tamweel in Dubai were the most high-profile instances of this approach and eventually come to control 60% of the Dubai mortgage market. Both initially offered mortgages only for properties developed by their mother companies but successfully fostered the expansion of housing credit to a point where one in five property owners had a mortgage.

## **Funding mortgages**

The most basic source of funding for mortgages anywhere is bank deposits. Especially in the wake of the global financial crisis, GCC banks tend to be flush with liquidity and mortgages are typically available at fairly competitive rates, a process further facilitated by the low interest rate stance implied by the US Dollar pegs of five of the regional currencies. Mortgage availability is further boosted by a growing number of non-bank finance companies and specialized mortgage lenders active in the market.

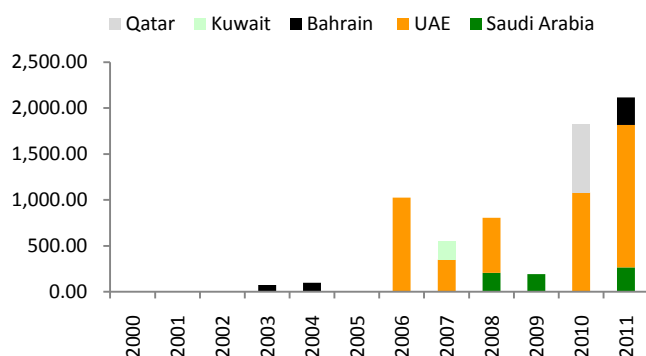
Over time, sustained market growth is likely to necessitate other funding solutions as well. Commercial banks typically struggle to provide long-term mortgages

because of the maturity mismatch created by their predominantly short-term deposits. Partly, as a result, many 'young' mortgage markets have relatively short mortgage tenors, at least on the average. A number of alternative solutions exist for overcoming these limitations:

1. Wholesale financing
2. Mortgage bonds
3. Bonds or sukuk issuance by lenders
4. Securitization
5. Real estate funds

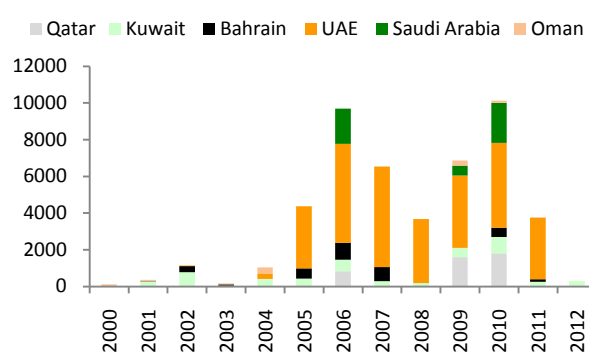
Some regional lenders have used real estate funds as a way of pooling funds for individual real estate projects, albeit on a small scale to date. Bond and sukuk issuance has become increasingly common by regional financial service providers which in recent years have constituted the backbone of the GCC debt capital markets. The two Dubai-based Shariah-compliant mortgage lenders were the pioneers in this regard. Amlak issued its first USD200mn sukuk in 2005 and had ambitious plans for more in the pre-crisis period. Tamweel raised funds through a USD210mn securitization in 2007 and a USD300mn sukuk in 2008. It is returning to the market this year with a USD300mn offering.

Sukuk issuance by GCC banks (USD mn)



Source: Zawya, NCB estimates

Conventional bond issuance by GCC banks (USD mn)



Source: Bloomberg, Zawya, NCB estimates

Securitization remains extremely rare in the GCC with only some experimental MBS issuance taking place in the pre-crisis days. The most significant steps were taken in Dubai, most notably by the Emirates National Securitization Corporation (ENSeC) which was chartered in 2005 by a number of Istithmar-controlled entities. ENSeC effectively strove to replicate the US securitization model in Dubai. It began to issue AAA-rated securities starting in May 2005 with the ENSeC Home Finance Pool I Ltd USD350mn floating rate notes due in 2014. The issuance was underpinned by Tamweel mortgages provided for Palm Jumeirah. The issuance was underpinned by cash collateral, which made it largely symbolic in nature. It was sold exclusively to foreign institutional investors and received orders worth USD4.2bn. Nakheel bought back the issuance in 2007. In December 2007, ENSeC announced the completion of the first Shariah-compliant home finance securitization for Tamweel, based on USD210mn worth *ijarah* contracts.

The four-class issuance had a 2037 maturity. Sorouh Real Estate issued an AED4.0bn securitized sukuk in September 2008. Other securitizations included Thor Asset Finance/Dewa in August 2007 and UAE CMBS/Arabian Real Estate Trust in July 2007. ENSec was eventually shut down in 2009 in the wake of the property crash.

Following the dismantling of ENSec, securitization has been slow to return to the region. However, Emirates NDB in 2010 undertook a USD250mn securitization of auto loans. The Government of Dubai last year undertook a syndicated securitization of its salik road toll receipts. Dubai has recently seen renewed calls for a centralized liquidity facility or a mortgage guarantee corporation that would reduce the down payments by borrowers. Such a measure could potentially significantly reduce the cost of mortgages. Also the pending Saudi mortgage law is similarly expected to be followed by the establishment of a US/Malaysian-style centralized government mortgage institution as a way to boosting the availability of bank funding for mortgages.

## Building the GCC markets

The GCC markets for real estate credit have evolved in two distinct phases. The various special-purpose government funds created typically in the 1970s remained effectively the sole source of mortgage-type housing loans for some three decades. Although some public and private real estate banks emerged and banking liberalization greater new credit opportunities, little changed in the overall market situation. A new chapter began in the history of the GCC real estate markets in 2002 when Dubai became the first regional economy to permit foreign ownership of housing. By broadening the demand for mortgages, especially in the coastal Gulf economies with large expatriate populations, this triggered significant policy and product innovations. The initial solution in many cases was a partnership between property developers and financial institutions offering funding for their projects. Over time, more comprehensive mortgage regulation tended to liberalize such restrictive arrangements.

Powerful real estate booms, first in Dubai, then also elsewhere in the region, eventually prompted regulatory interventions. Initially designed to contain the unsustainable price trends, they eventually sought to restructure the markets after a major correction. In general, regulators and lenders have significantly tightened lending norms and instituted more clearly defined standards. Dubai in 2008 prohibited mortgaged to properties other than the primary residence and imposed limitations of flipping. Risk weights were raised by Kuwait and Bahrain. The UAE banking law restricts mortgages to 20% of commercial bank deposits; Qatar and Oman have a 10% gap. DTI ratios in the region are typically capped at 33%. Kuwait has a 40% ceiling on debt servicing to income ratios.

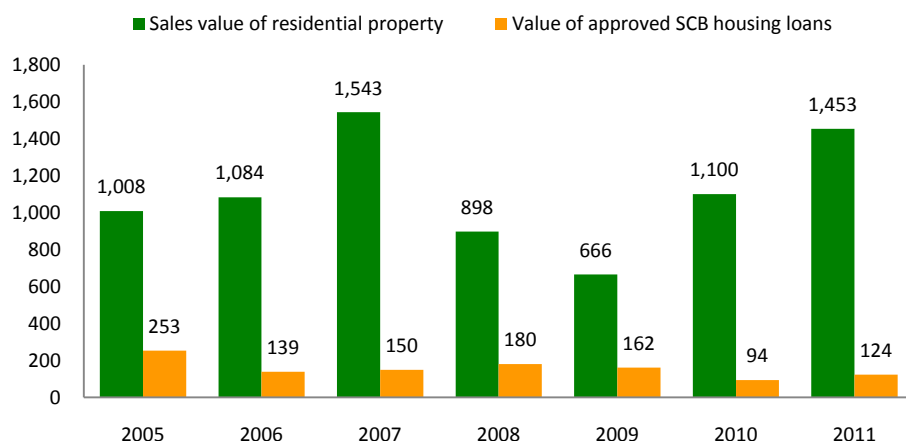
## Bahrain

Home lending in Bahrain was initiated by the Ministry of Housing under a special scheme established in 1979 which in 2005 was restructured as the government-owned Eskin Bank. Overall, Eskin has disbursed some BHD573mn worth of loans to more than 40,000 families since then. The bank has further undertaken commercial property development, partly as a source of additional funds for its lending activities. Eskin has played an active role in developing the infrastructure for Bahraini housing market. It is currently working on establishing a Mortgage Guarantee System and a MBS market. It is further licensed for property development funds. Eskin remains the dominant market lender, although mortgage products are now fairly widely available from the mainstream banks and specialized lenders on terms comparable to most mature markets. The Bahraini market opened up to foreign investment in 2003, something that triggered a major development boom.

## Kuwait: A hybrid model

The Savings and Credit Bank (SCB) remains the backbone of the Kuwaiti housing market. It was established in 1965 for the purpose of channeling funding into key development areas such as housing, as well as industry and agriculture, although its focus narrowed over time. 1973 also saw the creation of the Real Estate Bank which eventually reconstituted itself as Kuwait International Bank. SCB remains the main source of mortgage loans which are capped at KWD70,000 and available typically for a period of up to 15 years. However, borrowers can top up SCB loans through a similar-sized loan from a commercial bank. The loans are available to Kuwaiti nationals only as Kuwait does not permit foreign ownership of real estate. In practice, however, these funds tend to be insufficient for the needs of a representative family. A family villa ordinarily costs around KWD250,000.

### Mortgage lending in Kuwait (KWD mn)



Source: Central Bank of Kuwait, National Bank of Kuwait

Kuwaiti mortgage rates cannot exceed the Central Bank of Kuwait discount rate by three percentage points, they must be fixed for at least five years, and re-setting has to take place within a 5% band. Banks in Kuwait are calling for a reform of mortgage regulations in order to liberalize the market. Among other things, while Islamic banks offer home loans, conventional banks are in many cases unable to do so, although some have analogous products. Foreclosure remains a problem with the laws currently not allowing lenders to evict borrowers. Initiatives are underway to permit restricted ownership of property by expatriates.

## Oman

The traditional government lender for housing in the Sultanate is the Oman Housing Bank (OHB) which was established in 1977 to take over the functions of the Oman National Housing Development Co, operational since 1974. OHB began as a joint initiative between the governments of Oman and Kuwait as well the British Bank for the Middle East. The government currently dedicates some OMR12mn for subsidized loans through the bank. The size of the subsidy depends of the lender's income. At a monthly income of less than OMR200, the borrower pays 3% and the government 6%. The borrower's share gradually rises to 8% for monthly incomes of OMR800 or more. The bank also offers some unsubsidized loans. Subsidized loans are capped at OMR40,000 and unsubsidized loans at OMR100,000. The repayment periods are up to 20 years with monthly installments set at 20-40% of income. The life and property of OHB clients are insured. OHB also buys lands and undertakes project development activities. By the end of November 2007, the bank had made a total of 28,202 loans worth OMR473.3mn.

A new mortgage lender, Alliance Housing Bank, was set up in 1998 simultaneously with a successful IPO. Re-named Ahli bank a decade later, the new institution was initially the first private financial sector institution to dedicate itself to mortgages, although it subsequently diversified its operations. Foreign ownership of land and property in Oman was authorized in 2006. Conventional housing loans have been the norm in Oman since Shariah-compliant banking was only authorized in 2011. Mortgage rates are capped at 8%.

## Qatar

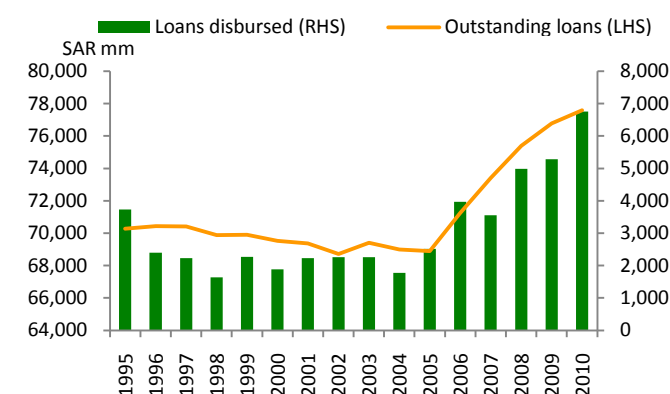
Home ownership in Qatar has been championed by Qatar Development Bank (QDB) which was originally set up as Qatar Industrial Development Bank to support SMEs in 1997. It has since broadened its remit in line with Qatar's National Vision 2030 strategy to foster broader economic diversification with housing loans now prominent among the facilities it offers. The government sharply increased QDB's capital from QAR200mn to QAR10bn in 2008. QDB manages government-funded housing loans mandated as part of social development targets of the 2030 vision. These are available to Qatari nationals only. In 2009, QDB offered more than 5,400 Qatari national a loan of at least QAR600,000. The ceiling of the zero-interest loans was doubled to QAR1.2mn

and the repayment period extended to 37 years in 2011. This will cap the monthly payment for the maximum loan size QAR2,700. This followed a QAR5.2bn allocation to housing loans in the 2011-12 budget. Government employees are charged a 3% service charge while others pay 1%. The Qatari market was opened up to foreign investors in 2004 and mortgage products are widely available.

## Saudi Arabia: Shifting gears

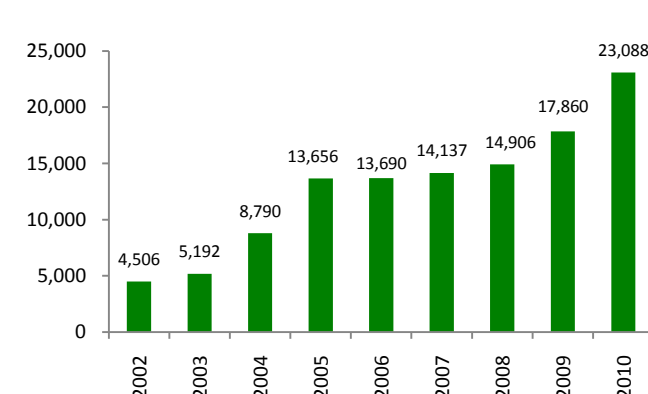
Saudi Arabia, due to its large population base, faces some of the most pressing challenges in terms of upgrading its housing stock. The current shortage is estimated at some 1mn units, while the ninth development plan forecasts an annual need for 250,000 new units. Although official statistics suggest a home ownership rate of some 60%, the actual figure is estimated to be in the neighborhood of 30-40%. Part of the discrepancy may be due to informal ownership, the still widespread reliance in parts of the country on sometimes sub-standard traditional housing, and difficulties of accounting for potential demand. Some aspiring homeowners live in larger multi-generation households not by choice but by necessity. They would live separate if home ownership was accessible but recent estimates suggest that the majority of households would struggle to afford the cheapest villas available. This is partly due to land price inflation running at up to 20% a year while considerable upward pressure persists on input prices.

Real Estate Development Fund loans (SAR mn)



Source: SAMA

Saudi banks' consumer loans to real estate (SAR mn)



Source: SAMA

Home loans in Saudi Arabia were pioneered by the Real Estate Development Fund which was set up as a special-purpose government fund under the auspices of the Ministry of Finance in 1974, initially with a capital SAR250mn. This was boosted to SAR73.8bn in 1992 and, after a number of increments, to SAR115.8bn in 2009. A SAR40bn increment was announced last year. The fund issues 25-year loans for home construction or purchase. It has disbursed a total of some 700,000 loans worth some SAR172bn since its inception until 2010. There has been a marked pick-up in new loan disbursements since the middle of the past decade and the annual total rose to SAR6.8bn in 2010. Nonetheless, the



fund has a large backlog of demand with waiting period before the latest initiatives peaking at 18 years.

The operations of the REDF are currently undergoing a significant change. The fund has increased the maximum loans size to SAR500,000 and the requirement to own land as a precondition for a loan has been removed. In parallel, plans are under consideration to reduce the amount of land available for each family. This year, Saudi banks have begun to conclude agreements with the fund so as to expand home lending through government guarantees. Under the program lenders can receive a fully guaranteed SAR500,000 per property from the REDF. This can be topped up through commercial loans as approved by the Fund. No interest is charged on the guaranteed portion of the loan. There have been recent reports of consideration being given to the potential privatization of REDF in order to further boost its capital resources.

The Saudi home loan market has begun to develop significant traction of late with most banks now viewing mortgages as a priority area. The small size and young age of the market means that many institutions have significant untapped opportunities among the staff of their leading corporate customers along. There is a strong preference for deducting the mortgage payment from electronic payroll, which gives reasonable assurances of timely repayments. Loans are typically capped at SAR3mn and have tenors of up to 30 years. Overall indebtedness levels tend to be capped at 60% of net income with a 50% ceiling at the mortgage product level. By contrast, SAMA's consumer credit regulations cap individual personal finance loans at 33% of income. More problematically, the growing competition in the Saudi market means that the requirements on down-payments have become laxer and in some cases, especially with shorter tenor loans, they can be waived altogether. Under the prevalent *ijarah* mortgages, the lender retains formal title to the property and further protects its rights through life and property insurance.

The landmark event for the Saudi mortgage market will be the eventual implementation of the eagerly awaited mortgage law which is understood to be undergoing some final modifications. All components of the new legislation will be in compliance with Shariah law. Its key provisions will regulate the following five main areas through separate laws:

1. Mortgage registration
2. Execution
3. Financial leasing
4. Real estate finance
5. Finance companies

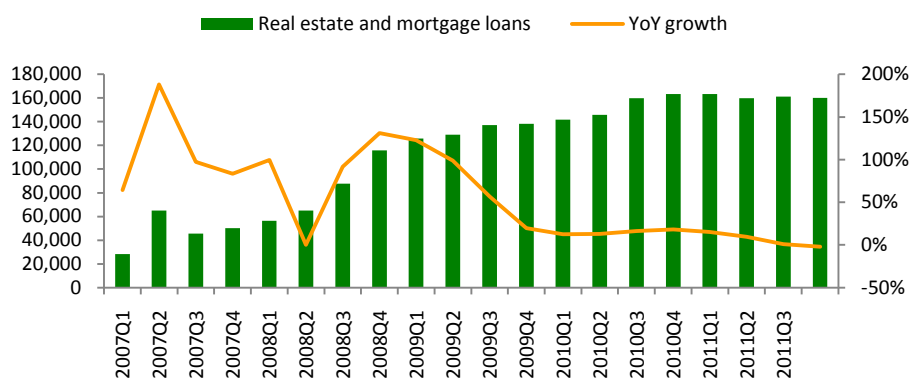
Among its key provisions, the law will limit mortgage lending to entities approved by SAMA. These are expected to include commercial banks, mortgage companies, and lenders owned by real estate developers.

## The UAE: A regional pioneer tested by turbulence

Dubai has been a regional leader in developing modern mortgage markets. However, the initial phase of rapid growth took place in an only partially regulated environment and led to excesses which subsequent regulatory initiatives have sought to contain and prevent from occurring again in the future. At the initial stages, most mortgages were provided by dedicated lenders linked to property developers. The market pioneer, Amlak Finance, was incorporated in 2000, with Emaar Properties as the key instigator and partner. Tamweel came into being in 2004 with support from Dubai Islamic Bank and Istithmar. The two companies at their peak decisively dominated the mortgage markets with a market share of up to three-quarters, equaling some 3% of overall bank credit. Expatriates and foreign investors played a key role among buyers.

With the onset of the global economic crisis, the annual growth rate of mortgage lending in Dubai slowed down from 123% in 2007-2008 to 12.6% in 2009. In spite of growing signs of normalization and the bottoming out of some market segments, the UAE real estate market has struggled to develop traction after the correction. This may be in part due to institutional shortcoming such as the lack of developed credit bureaus. Similarly, the provision of guarantees for borrowers in the event of economic hardship is underdeveloped.

### Mortgage lending in the UAE (AED mn)



Source: Central Bank of the UAE

A major overhaul of Dubai's mortgage regulations was undertaken at the peak of the bubble in 2008, most notably through the Land Department Law 13 and the related Law 14 concerning Mortgages. Law 13 seeks to standardize the market infrastructure by mandating the registration of mortgages with the Dubai Land Department along with information about loan size, the repayment period, and property value. Developers are not allowed to charge transfer fees on off-plan properties. Mortgages for Dubai properties must be issued by registered financial institutions and must be insured. Any sale not registered with the Land Department is considered void. Law 14 sought to overcome market fragmentation by liberalizing bank lending, moving beyond the previous practice of providing funding for selected properties. The Land Department registry obviates the need

for such restrictions. Strict provisions have also been adopted to regulate off-plan sales which in the past have been a key instrument of real estate speculation.

In addition, the Central Bank of the UAE is preparing new rules in an attempt to curb speculation. These are expected to be finalized in Q1 of this year. The regulations will subject borrowers to greater scrutiny so as to better assess their ability to service the loan. Moreover, they will seek to set more explicit and reasonable norms regarding down payments. This is largely a response to the rapid growth of non-performing loans in the UAE. Total provisioning attained a record high of AED67.3bn in October 2011, up 18.5% during the first 10 months of the year.

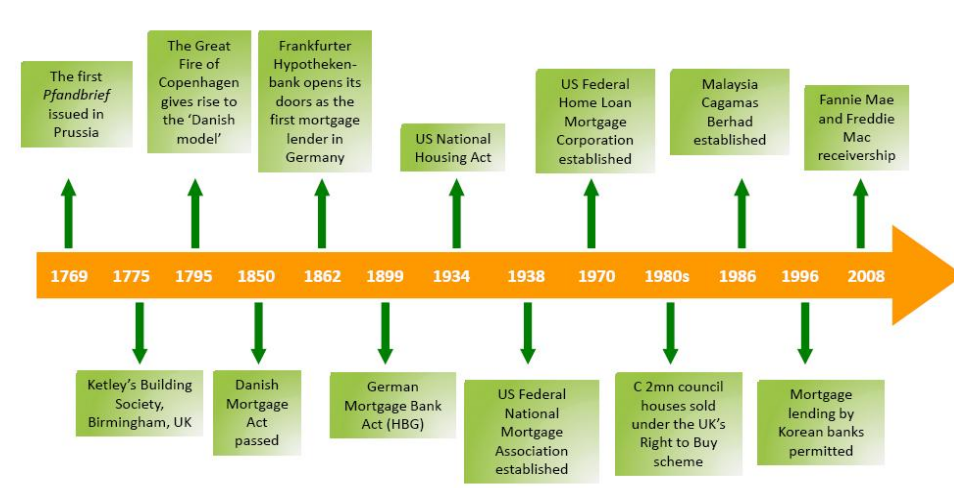
Government-sponsored housing for nationals is available through a number of programs, above all the Sheikh Zayed Housing Program (SZHP) which was established in 1999. The program offers interest-free loans, grants, and access to social housing. The minimum monthly income for loans is AED10,000. In Dubai, the Mohammed bin Rashid Housing Establishment has been active since 2006 and spent a total of AED2.1bn on 2,165 houses in 2007-2009 alone. But waiting times have tended to be long in an environment where for instance the SZHP has in recent year approved only a small proportion of loan applications. This has generated efforts to boost the resources of these programs and to ease the qualifying criteria in some cases.

## The international experience holds important lessons

In spite of the conceptual simplicity of securitized lending, the development of mortgage markets globally has involved the persistence of considerable institutional differences. These have had profound implications for the development stability of mortgage lending in different countries. The oldest model of securitized lending is the Danish-German system of covered bonds (or *Pfandbriefe*). It goes back to the great fire of Copenhagen in 1795 which prompted the Danish government to devise new ways of hastening the city's reconstruction. The system has had an impressive track record of stability with no defaults on record and has attracted global attention as many governments seek to put their crisis-struck mortgage markets back on a sustainable footing.

But also more generally, mortgage markets until the 1980s tended to be subject to stringent regulation. Lending was typically in the hands of specialized intermediaries, interest rates were capped, and there were strict limits of the size and duration of loans. While safe, this system was also relatively unsuccessful in ensuring widespread access to housing. Subsequent developments in the Anglo-Saxon countries such as the US and the UK were characterized by a high degree of liberalization, whereas especially many continental European markets retained a number of restrictive features. The Canadian model offers something of a hybrid where a high degree of stability has been guaranteed by high levels of owner equity, typically at least 20% of value, as well as the absence of tax incentives and the use of insurance. The market is supported by the Canada Mortgage & Housing Corporation.

### Key milestones in the development of global mortgages



The development of mortgage markets in a number of countries has been driven by political considerations such as a desire to foster widespread property ownership. This has often led to direct government intervention in the mortgage

markets, not merely as a regulator but as an integral participant. Some countries offer legal incentives for home ownership such as tax deductions on certain mortgage-related costs, e.g. interest payments. In other cases, governments offer guarantees, subsidies, or institutional support such as the government-related housing market institutions in the US. Nonetheless, many countries in Western Europe, as well as for instance Australia, have attained high levels of home ownership with no government participation in the mortgage market.

## **Established paradigms**

The so-called Danish model has the dual distinction of being the oldest and one of the most stable frameworks for mortgage provision in the world. The market is made up of specialized mortgage lenders who, under the country's 'balance principle,' fully and exclusively fund their mortgage loans by means of covered mortgage bonds. Strict underwriting criteria are used to ensure the stability of the market, a process further bolstered by the fact that the cover assets of the bonds remain on the books of the issuing banks. This keeps credit risk with the mortgage originators even as market risk is transferred from the issuers to bond investors. If the value of the mortgaged properties declines, so does the value of the bonds. However, these assets are not included in the insolvency proceedings of the issuer. No government guarantees underpin the covered bonds. The use of full-recourse mortgages in Europe has limited foreclosures by giving the lender an option to seek loan repayment beyond the value of the delinquent property.

The largest mortgage market globally is the US which has been characterized by a high degree of government involvement since the Great Depression. The National Housing Act of 1934 created the Federal Housing Administration (FHA) with the key objective of increasing the availability of capital for housing. This was done by insuring private lenders against the risk of mortgage default while freeing up bank balance sheets for new lending. FHA in turn chartered the Federal National Mortgage Association (Fannie Mae) in 1938. Fannie Mae bought mainly FHA-insured mortgages until 1970 when it was authorized to buy private mortgages as well. Since 1968, Fannie Mae, joined by a competitor Freddie Mac (Federal Home Loan Mortgage Corporation) in 1970, has operated as a government-sponsored enterprise (GSE). Both became publicly listed companies. The only entity now enjoying explicit government guarantees is the Government National Mortgage Association (Ginnie Mae) which mainly lends through special programs. It has been estimated that the government involvement in the US has helped reduce the cost of mortgages by some 13-28 bps.

The US in recent decades became the global champion of mortgage securitization. The first mortgage pass-through security was created by Ginnie Mae in 1968. In the 2000s, the US model came to rely increasingly on the securitization of the so-called 'conforming loans' sold on by the issuers as mortgage-backed securities (MBS). The GSEs purchase loans from approved mortgage sellers either in cash or in exchange for a MBS composed of the mortgages and backed up guarantees of timely interest and principal payments.

MBSs are usually designed to be 'bankruptcy remote' from issuers. The GSEs charge a fee for the loans they purchase and securitize in return for assuming the credit risk. This is a major departure from the Danish model. The growing use of MBS came to be driven increasingly by unregulated conduits created by investments banks.

Problematically, the GSEs over time came under growing political pressure to increase access to housing. The 1992 Housing and Community Development amended their charters to include "an affirmative obligation to facilitate the financing of affordable housing for low-income and moderate-income families." So-called 'affordable housing goals' were set annually by the Department of Housing and Urban Development and rose from 30% of all mortgage-financed units to 55% by 2007. Market growth was further driven by a desire to perpetuate a mortgage refinancing boom unleashed during a period of low interest rates at the beginning of the century. As of 2008, Fannie and Freddie owned or guaranteed approximately half of the USD12trn mortgage market but the efforts to maximize mortgage volumes increasingly took place at the expense of quality, eventually leading to a government takeover. The federal government in October 2010 estimated that the GSE bailouts would cost some USD154bn. Recent reform proposals of the US system call for a much more targeted government role and the gradual dismantling of the GSEs.

## Emerging market examples

The GCC countries are not alone in facing significant demographic challenges that will both mandate and underpin property developments. For instance the number of households in Mexico is expected to rise from 22.8mn in 2000 to 41.8mn in 2030. Of the estimated 26.7mn families, 17.2mn currently enjoy access to adequate housing. Many emerging economies have in recent years made substantial progress in creating the necessary institutional and regulatory infrastructure for sustainable housing market development.<sup>3</sup> This has led to rapid credit growth and a pronounced increase in home ownership. However, the process tends to – and for the sake of sustainability has to – be gradual. Moreover, it is potentially vulnerable to distortions as the increased availability of credit also feeds into higher prices. This has forced some governments to eventually tighten the lending criteria.

Bank-centric financial systems have often struggled to provide sufficient quantities of long-term mortgage funding on purely market terms. As a result, most emerging economies have seen the government maintain a significant presence in the housing market in the face of a highly skewed income distribution and often substantial housing deficits. A number of countries have emulated the US practice with often a significant reliance on MBSs and more direct interventions to foster home ownership. Mexico, South Korea, and Malaysia are

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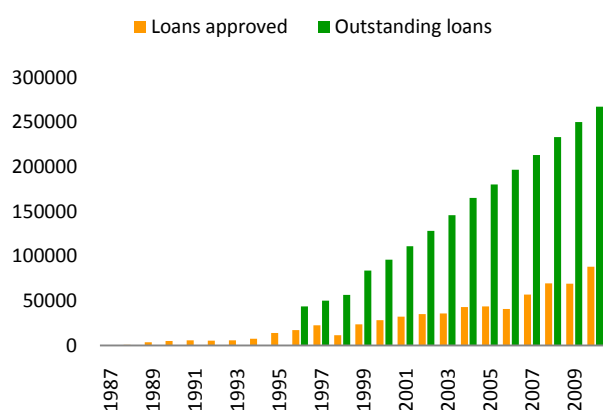
<sup>3</sup> "Durable Financial Stability: Getting There from Here," *Global Financial Stability Report*, International Monetary Fund, Washington, D.C., April 2011

the most prominent emerging market examples of secondary mortgage markets supported by government mortgage institutions.

## Malaysia: Leveraging the capital markets

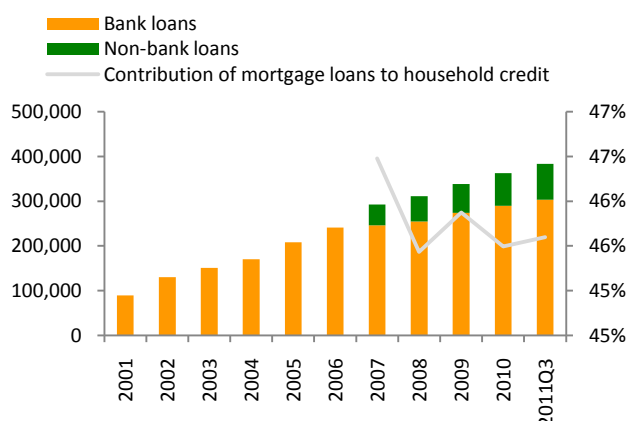
Malaysia has seen dramatic, sustained growth in its mortgage markets since the 1990s. A key institution supporting this process is Cagamas Berhad (National Mortgage Corporation) of Malaysia which was established in 1986. The stated purpose of Cagamas is to mobilize low-cost funds to support home ownership in Malaysia. The authorities have particularly prioritized access to housing by middle and lower income groups. Cagamas is the leading issuer of AAA securities in Malaysia and a major presence in the global sukuk markets. In a further government-sponsored stimulus to the housing markets, the Employees' Provident Fund permits early withdrawal of contribution for home purchases. Similarly, the Treasury Housing Loan Division provides subsidized housing loans for government employees.

Housing loans in Malaysia (MYR mn)



Source: Bank Negara Malaysia

Mortgage lending in Korea (KRW trn)



Source: Bank of Korea

Cagamas purchases housing loans with recourse to the primary lender. The mortgage lender remains responsible for losses arising from the borrower failing to pay, an arrangement inspired in part by a lack of reliable credit information. This remains the dominant model even if loans purchases without recourse were introduced in 1999. Institutions have the option to repurchase the loans later. The Malaysian central bank recognizes Cagamas bonds for liquidity management purposes and funds obtained from Cagamas are free from standard reserve and liquidity requirements. Cagamas has improved liquidity and enabled lenders to hedge their interest rate risks. Housing loans of MYR100,000 or less are subject to an interest rate ceiling of 9.0%.

## Korea: From growth to re-regulation

Following deregulation in the second half of 1996, commercial banks were allowed to enter the mortgage market and the Korean Housing Bank, until then



the sole provider of low-cost long-term loans, was privatized. In the wake of these steps, outstanding mortgage debt more than doubled in relative terms from 12% of GDP in 1996 to over 30%. Nonetheless, loan terms remained relatively restrictive with a basic adjustable rate mortgage having a 56% LTV at origination. Although maturities range up to 20 years, most loans require repayment or refinancing after three years. Banks now control 80% of the market. Following the establishment of the Korean Housing Finance Corporation in 2004, mortgage-backed securities amounted to 5.8% of total mortgage debt in 2010.<sup>4</sup> Apart from the mainstream markets, Korea National Housing Corporation provides low income public rental housing as well as properties for sale.

In response to the 1997-1998 Asian financial crisis and a policy-fueled credit card bubble at the beginning of this century, the Financial Supervisory Service in 2002 began to develop regulatory guidelines for the mortgage market. The regulator first introduced formal LTV limits followed by DTI limits in 2005. Also land use and redevelopment are subject to strict regulation. The FSS further created a Macroprudential Supervision Department for the express purpose of assessing systemic risk factors through early warning systems and stress tests. Policy measures used to control price appreciation have included adjustments in LTV and DTI limits, moral suasion on lenders, subsidies to housing finance, changes in taxation, support for private construction, and government-sponsored development or purchases of housing units.

## Mexico: Post-crisis regrouping

Housing policy in Mexico has for a long time been motivated by a desire to ensure US-style widespread access to home ownership. Starting already in the early 1930s, the main instrument for realizing these aspirations were various governments funds which, however, gained notoriety for their inefficiency and lack of transparency. The situation began to improve in the 1990s thanks to banking sector privatization but subsequent macroeconomic instability undermined much of this progress. In 1994, non-bank intermediaries, Sofoles (Sociedades Financieras de Objeto Limitado), specializing in mortgages were created with a particular focus on low-income households. Through a special program (Apoyo INFONAVIT), potential homebuyers could leverage their INFONAVIT (Instituto de Fondo Nacional de la Vivienda para los Trabajadores)<sup>5</sup> savings to obtain market-based mortgages. Such savings derived from a mandatory 5% contribution from gross wages designed to support low-income housing development. Although bank focused on the middle and upper segments of the market, the success of the Sofoles in their mission also led to some acquisitions by banks.<sup>6</sup>

<sup>4</sup> Deniz Igan and Heedon Kang, "Do Loan-to-Value and Debt-to-Income Limits Work?," *IMF Working Paper*, WP/11/297, International Monetary Fund, Washington, D.C., 2011.

<sup>5</sup> A government institution established in 1972 to sponsor low-income housing development. Still accounts for roughly half the primary mortgage market.

<sup>6</sup> Luisa Zanforlin and Marco Espinosa, "Housing Finance and Mortgage-Backed Securities in Mexico," *IMF Working Paper*, WP/08/105, International Monetary Fund, Washington, D.C., 2008.

The market recovery since 2001 has been underpinned by a clear vision of institutional and regulatory reform. The key focus of reforms has been on fostering market efficiency through private insurance, better foreclosure procedures, and improved property registries. A restructuring of credit bureau market and the emergence of the dominant Buró de Crédito with data on 64mn consumers significantly boosted information efficiency which further benefited from a 2002 banking secrecy reform. A 2003 reform mandated the standardization of mortgage contracts. A new Securities Law in 2000 permitted guarantee trusts (*fideicomisos*) to serve as special purpose vehicles for the purposes of mortgage securitization. Creditors of these trusts received strong rights over loan collateral and could foreclose on delinquent loans using out-of-court procedures. The new instrument of *certificados bursátiles* (ceurs) could be used to create MBSs.

Echoing the US model, Sociedad Hipotecaria Federal (SHF) was established in 2001 with a brief to develop the secondary mortgage market. Initially offering guarantees and insurance as well as serving as a second-tier bank for Sofoles, SHF over time shifted its focus to supporting MBS issuance by banks. SHF also offers swaps to meet the needs of low to medium-income households and is compiling a comprehensive mortgage database. Also private insurance and guarantee providers entered the market after a 2006 reform. A new Hipotecaria Total (HiTo) institution is designed to further facilitate securitization through a centralized, open access technological platform. The Mexican residential mortgage market is projected by SHF to increase from USD80.7bn in 2007 to at least USD338.3bn by 2020, an annual growth rate of 10.1%. Domestic savings are unlikely to suffice to fund these needs, which will boost the importance of securitization. The MBS market rose from USD54mn in 2003 to USD2.4bn in 2007.

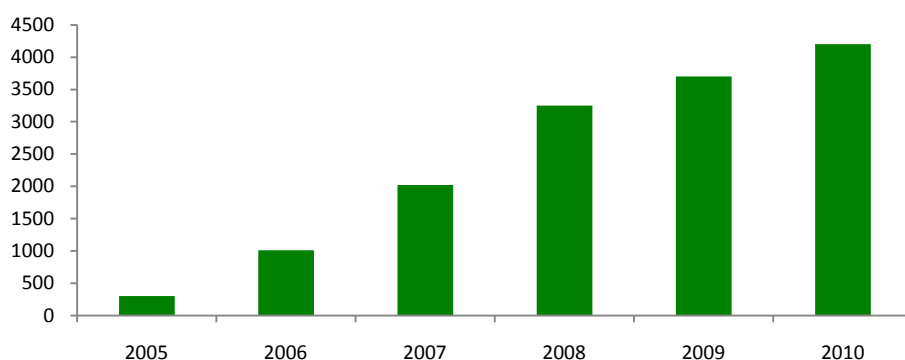
## Regional innovation I: Egypt

Egypt, the most populous Arab economy, faces major challenges in the area of real estate. Although some 45% of the housing stock is owner occupied, about 90% of the supply is built informally and an estimated 11mn people live in slums. Egyptian affordable housing demand alone was estimated by Jones Lang LaSalle at 16.9mn units in 2010. The shortage of such housing was put at 1.5mn units.

Egypt has made significant progress over the past decade in putting in place the infrastructure for a modern mortgage market. The Real Estate Mortgage Law 148 was passed in 2001 and amended in 2004 to provide for securitization. The law allows both banks and non-bank mortgage companies to offer housing loans. It provides for foreclosure for debtors in default. In a bid to foster the development of the market, the authorities have repeatedly lowered registration fees for properties, from an original 12% to a maximum of EGP2,000. Moreover, mortgage contracts are exempt from the proportional stamp duty. The National Urban Observatory was established with Canadian assistance to provide accurate data on the demand and supply of housing in the country. Regulations

have been adopted to enhance the efficiency of collecting and distributing data on creditworthiness. 2009 saw the launch of the i-Score credit bureau. Special provisions have been pioneered for low-income borrowers who are offered subsidized interest rates and longer loan periods of up to 30 years. The Guarantee and Subsidy Fund provides low-income families with up to 15% of the value of a residence.

#### Mortgage lending in Egypt (EGP mn)



Source: Mortgage Finance Authority, Ministry of Investment

The Mortgage Finance Authority (MFA) was created as the mortgage market regulator in 2001. In a key development, it was tasked with actively developing the mortgage market in the country. The new unified regulator, the Egyptian Financial Supervisory Authority took over the functions of the MFA in 2009. A number of mortgage lenders have emerged starting in 2004, led by the First Mortgage Company which was established by the government-owned Housing and Development Bank along with state-owned insurance companies.

The Egyptian Mortgage Refinance Company (EMRC) was established in June 2006 with a capital of EGP212mn and with a mandate to provide long-term finance to mortgage finance companies and banks. Such finance is collateralized by the real estate portfolios of these lenders. EMRC can issue MBS. Egyptian law also now allows for real estate investment trusts (REITs).

Although the Egyptian market remains very small in relative terms at less than 1% of GDP, it has experienced rapid absolute growth with the volume of mortgage lending rising from EGP300mn in 2005 to EGP4.2bn in 2010. The government's medium-term target before the crisis was a EGP10bn market. Prior to the downturn, mortgages typically offered financing up to 90% of a property's value at an annual interest rate of 12-14%. The average maturity of mortgages has more than doubled from seven years in 2005 to 15 in 2010. Mortgage providers target up to 25% of the population.

## Regional innovation II: Turkey

Although Turkey has a high home ownership rate estimated at 70%, the demand remains strong with 70% of the population under 30 and an overall annual population growth rate of some 2%. Annual housing needs have been estimated at 600,000 in 2010 and 800,000 in 2015. Moreover, some 55% of residential real estate was in the informal sector in 2007. As much as 40% of the housing stock requires renewal.

Mortgage loans in Turkey were first introduced in the 1990s and, in spite of rapid growth in recent years, still stand at just under 5% of GDP. Historically, the development of mortgage markets was held back by a lack of economic stability and inflation which made it difficult to commit to long-term contracts or to price them in an uncertain interest rate environment. The slew of economic reforms since 2002 has transformed the situation. By 2006, mortgages of 20-30 years began to be offered by the leading banks, although the rate of interest still deterred most buyers. Turkey adopted a new mortgage law in 2007 for the rapidly growing market.

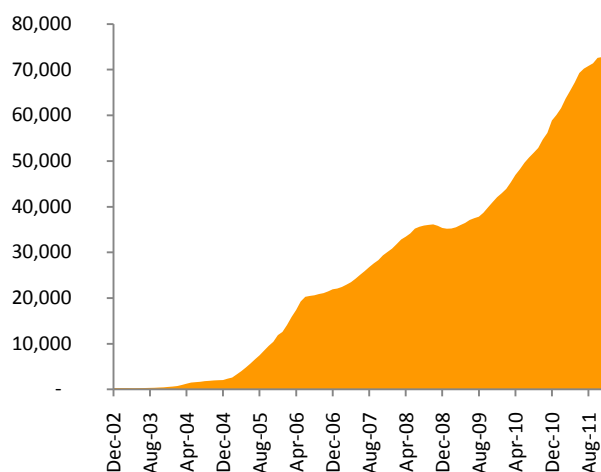
The new law provides a comprehensive regulatory framework for housing finance in all its aspects, as well as providing for foreclosure, the regulation of appraisal services, consumer protection, mortgage-backed capital market instruments, secondary market institutions, and tax incentives linked to the development of primary and secondary mortgage markets. Among other things, the law exempts mortgage loans from the tax on bank transactions (5%) and the savings tax (15%). Mortgages can be provided by banks, leasing companies, and specialized consumer finance companies but all lenders have to be licensed by the Banking Regulation and Supervision Agency (BRSA). Consumer protection is prioritized and lenders are required to inform borrowers about all aspects of the law as well as the risks involved in mortgage loans. Lenders are allowed to charge pre-payment penalties capped at 2% of the outstanding balance. In an important new departure, the law streamlines the foreclosure process which has historically been quite lengthy and tended to penalize lenders, especially at times of high inflation. Higher deposits are now required to suspend foreclosure while penalties in the event of abuse.

The law provides for secondary mortgage markets by introducing two types of products that can be issued by housing finance funds: covered bonds and mortgage-backed securities. The cover pool has to be matched with the bonds issued through clearly defined procedures. In addition, so-called housing finance funds can be established by secondary market institutions along lines of a securitization SPV. The law defines mortgage finance corporations as secondary market institutions. They can either serve as securitization conduits or provide a liquidity facility. Tax incentives are provided in order to cut the operational costs of funding home loans through capital markets. In practice, secondary mortgage markets have failed to develop to date.

Although Turkey has seen rapid growth in mortgage lending in recent years, progress was hit by the global financial crisis. The tenor of mortgage loans is

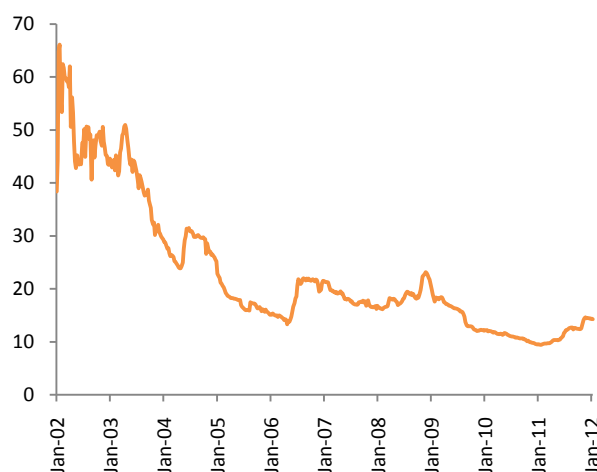
currently typically capped at 10 years and BRSA has capped housing loans at 75% of the value of the property. The limit for commercial properties is 50%. With interest rates still relatively high, typically in the neighborhood of 1% a month, affordability remains an issue. The government reduced the VAT rate of homes of more than 150 sq m from 18% to 8% during a three-month period in 2009. Tax deductions of mortgage payments have also been mooted as a possibility.

Mortgage lending in Turkey (TRY mn)



Source: Banking Regulation and Supervision Agency

Weighted average interest rate for mortgages



Source: Central Bank of the Republic of Turkey

## What does the international experience show?

The increased availability and lower cost of housing finance has almost invariably significantly boosted leverage levels while making mortgages a far more significant part of the economy. Housing has often played the role of a financial accelerator as people have taken loans collateralized against the value of their homes and increased their consumption. In many appreciating housing markets, access to refinancing has enabled consumers to smooth variations in their income, albeit typically with the consequence of even higher leverage. Overall, mortgages remain a significant underexploited opportunity for economic and financial sector development in the GCC.

Even though the Gulf region has not been altogether spared from real estate-related instability, the young age of the regional mortgage markets represents an opportunity to put in place regulations and institutions that will guard against excesses and thereby foster stability. Proper controls are essential for ensuring sustainable real estate development and effective risk management in expanding markets. Global precedents of substantial housing market corrections are numerous and include the Scandinavian countries and the UK in the early 1990s and economies such as the US, the UK, Ireland, and Spain during the current global crisis. By the end of 2010, the US had 11.1mn residential properties – some 23.1% of the total – with negative equity mortgages.

The recent spate of housing market corrections around the world has focused attention on the financial stability implications of housing finance. It is generally agreed that the magnitude and impact of housing corrections is critically linked to the structures used for housing finance. The current global crisis was directly triggered by losses linked to the sub-prime mortgage sector in the US. Problematically, profits in the US market accrued increasingly to the private sector while risks were underwritten by the public. As the MBS model created a separation between mortgage investors and originators, the incentives to issue sound mortgages diminished.

Also monetary policy can create risks as lending tends to accelerate during periods of low interest rates and many borrowers run into difficulties once interest rates start going up again. The experiences of the past few years highlight the importance of preventing pro-cyclical leverage. The US housing boom was in large part connected to looser lending standards. As housing market corrections hit the balance sheets of the financial sector and ordinary homeowners alike, they tend to result in particularly severe economic corrections. The IMF recently suggested that output losses associated with housing market-related downturn are two to three times as severe as they would be without while the duration of such recessions averages 18 quarters as compared to four for 'ordinary' recessions. In order to prevent excesses in such an environment, mortgage lending should be kept in the hands of regulated entities so as to ensure adequate underwriting standards and to maximize the effectiveness of countercyclical regulatory interventions.

Asymmetric regulation constituted an important risk for mortgage credit. As necessary as the robust regulation of residential mortgages is, it may have the unintended consequence of fueling bubbles in commercial mortgages by encouraging financial institutions to operate in a less strictly regulated market segment. This has been seen as a key reason for the uneven development of the Kuwait housing market, for instance. Similarly, regulation needs to address all different types of institutions. In many countries, banks have tended to be subject to closer scrutiny than specialized lenders which has at times resulted in regulatory blind spots, abuse, and a build-up of risks.

There is a need to standardize mortgage structures if a large securitization market is to emerge. In many countries this process has been complicated by different banks using their own distinctive standards. Loans included in a given securitization pool should be uniform in terms of loan terms, documentation, credit quality, and performance history. Moreover, foreclosure procedures need to be well defined.

## Mortgages are not the whole story

As much as widespread home ownership remains a key goal of housing policy in many countries, the US sub-prime crisis serves as a vivid reminder of the folly of pushing home ownership rates to a level where they are no longer economically justifiable. Looser mortgage terms, even if adopted for the sake of increased affordability, risks creating house price bubbles and sharply increase the risk of defaults. As a result, social and affordable housing has been and will likely remain a necessary component of social policy around the world. In many countries, large-scale affordable housing drives have in the past been triggered by developments such as rapid urbanization, wartime destruction, or the need to repatriate war veterans. In especially emerging markets, rapid population growth, and the need to upgrade informal housing are key considerations. Since the 19th century, most advanced economies have established policies for social housing even if their importance has waxed and waned with the overall economic conditions. In some countries, for instance Turkey, but also Saudi Arabia and Bahrain, access to adequate housing is a constitutional or statutory right.

In practice, government-sponsored housing is not a static policy response but dictated by particular circumstances which inevitably evolve over time. As a result, there are many examples of government-sponsored social housing being subsequently privatized. A particularly notable case in point is the UK's Right to Buy scheme which, starting in the 1980s, enabled council house tenants to buy their homes at deeply discounted prices. More than 2mn people took advantage of the policy. But there have been also potential risks with social housing. In some instances, once desirable areas have been allowed to deteriorate and occasionally have decayed to shunned, crime-infested urban slums relegated to last-resort housing. This has led to efforts to better integrate affordable housing in broader communities.

**Housing financing options in Saudi Arabia (examples)**

	Different monthly salaries		
SAR	5,000	5,900	10,000
Maximum financing	250,000	289,100	500,000
Min. down payment	27,778	32,122	55,556
Affordable price	277,778	321,222	555,556
Monthly payment	1,771	2,048	3,542
% of income	35	35	35
Financing cost	7.25	7.25	7.25

Source: NCB Capital estimates

**House prices in Saudi Arabia**

SAR	Riyadh	Jeddah	Dammam
Villa price/sq m	3,200	3,900	2,900
300sq m representative villa	960,000	1,050,000	870,000
Apartment price/sq m	3,800	4,200	3,200
150 sq m apartment	540,000	630,000	480,000
Land price/sq m	1,300	1,500	1,100

Source: Jpnes Lang LaSalle, NCB estimates

Social housing has an important place in the real estate development of the GCC economies. The ability of many aspiring homebuyers to realize their dreams is minimal or even non-existent given the realities of income and wealth distribution as well as the biased pattern of real estate development during much of the past



decade. For instance, the average income for nationals in Saudi Arabia currently stands at some SAR6,000 a month per household, varying from just over SAR3,100 in the private sector (for Saudi nationals) to some SAR8,300 in the public sector. In the current market environment, assuming that a household does not devote more than 35% of its income to housing, this is usually sufficient for a 150 sq m apartment at a price of SAR2,000/sq m, something that falls far short of typical expectations. NCB Capital recently estimated that the shortfall of affordable housing in Saudi Arabia is some 300,000-400,000 units. Looked at from a different angle, it is currently estimated that less than 10% of Saudi households can afford to buy an average home in the market. A major contributing factor is the high cost of land which can account for more than 50% of the cost of a housing unit. Overall, Saudi Arabia is estimated to need more than 200,000 housing units a year over the coming year.

**Low income households (2010)**

Country	Population, mn	Affordability threshold income, USD	% of households below the limit	Number of low income households, mn
Saudi Arabia	27.1	1,333	58	2.7
UAE	6	2,451	43	0.39
Oman	3	1,226	73	0.3
Bahrain	1.2	1,059	86	0.23

Source: Jones Lang LaSalle

**Estimated shortage of affordable housing (2010)**

Country	Total supply	Total demand	Shortage
Saudi Arabia	2,300,000	2,700,000	400,000
UAE	370,000	390,000	20,000
Oman	285,000	300,000	15,000
Bahrain	190,000	230,000	40,000

Source: Jones Lang LaSalle

## Ways of boosting affordability

As much as it is obvious that a free market-led solution cannot efficiently and profitably meet the housing needs of any economy, a number of options exist for alleviating these constraints.

### Special-purpose housing

In much of the world, special-purpose developments have played a key role in ensuring access to adequate housing among the lower-income strata. In many instances, special development agencies are in charge of the driving the process. For instance, the Turkish government in 1981 adopted the Housing Development Administration Fund Law which created TOKİ (Toplu Konut İdaresi Başkanlığı) as the central market institution for housing development. TOKİ operates outside the government budget and has the power to issue its own bonds and stocks. It is responsible for ensuring the banks play a role in housing finance. It can issue individual or mass housing credits. Between 1984 and 2004, TOKİ provided housing loans for some 1.2mn low-income families and, overall, intends to meet some 5-10% of Turkey's housing needs. Costs are managed by using government land.

The Saudi government last year committed to providing 500,000 affordable housing units targeting households with a monthly income of SAR5,000 or less. In a

Country	Institution and programs	Date of establishment	Financial capital	Type and size of loan offered	Additional information
Saudi Arabia	Ministry of Housing	2011		Building and distributing governmental houses to low-middle income households	A 2011 pledge to build new 500,000 housing units worth SAR250bn
	Real Estate Development Fund	1974	SAR159bn	Housing loans SAR500,000	"Dhamen" joint guarantee program with banks
Kuwait	Savings and Credit Bank	1960	KWD3.5bn	Purchases, construction, restoration and expansion KWD70,000	SCB announced the establishment of a new lending company under its supervision
Qatar	Qatar Development Bank	1997	QAR10bn	Purchases, construction, restoration and expansion up to QAR1,200,000	A significant boost to resources in recent years
Oman	Omani Housing Bank	1977	OMR30mn	Purchases, construction, restoration and expansion Loan size depends on salary and income	Interest rate capped at 8%, also unsubsidized loans available
UAE	Sheikh Zayed Housing Program	1999		Purchases, construction, restoration and expansion up to AED500,000	
	Sheikh Mohammed bin Rashid Housing Est	2005	AED12bn	Purchases, construction, restoration and expansion up to AED750,000	
Bahrain	ESKAN Bank	1979/2005	BHD108.3mn	Purchases, construction, restoration and expansion up to BHD40,000	Involved in housing development and market reform

potentially important new departure for the region, the Bahraini authorities have embraced the public-private partnership paradigm in their efforts to boost social and affordable housing. A BHD208mn 4,100 house venture was approved recently. The overall target is 50,000 affordable homes. Similar ventures are observed across the region with for instance some UAE emirates recently unveiling significant new development schemes.

## Subsidies

Providing housing credit at subsidized rates is a long-standing practice in the GCC, as reflected by the original mandates of the special government funds and banks operating in the real estate space. Bahrain's Eskan Bank offers up to 80% of the value of the property to Bahraini nationals with a minimum monthly income of BHD400. The maximum tenor of loans is 25 years. In Saudi Arabia, the Masaken program of the Public Pension Agency matches these criteria with a minimum salary requirement of SAR4,000 and a maximum repayment period of 25 years.

In some cases, subsidies involve downright gifts. In the UAE, the Sheikh Zayed Housing Program offers grants to people below the minimum monthly income of AED10,000. The Omani Housing Assistance Program provides a OMR10,000 gift to families with a monthly income of less than OMR129. Subsidies remain common also elsewhere. In continental Europe, many governments subsidize savings accounts used for housing purposes. The German Kreditanstalt für Wiederaufbau offers special benefits for energy-efficient housing and socially desirable purposes. In some countries, mortgages enjoy tax deductions, although these are typically provided on a blanket basis across the board.

The downside of these programs has been their general inability to keep up with demand and the market dynamics in a way that is economically sustainable. A subsidized price is by definition not a market clearing price. The end result has tended to be de facto rationing with waiting times measured in years, often a decade or more.

## Penalties

In some regional markets, the possibility of penalties as a tool for stimulating real estate development has been or remains under active consideration. This idea is attracting particular attention in Saudi Arabia where substantial housing shortages coexist with the availability of large quantities of undeveloped urban land. As a result, proposals are being considered to reclaim land awarded to citizens by the REDF which has remained unbuilt for an extended period. Similarly, there are plans to fine or tax owners of undeveloped land. For instance, the proportion of undeveloped land in Riyadh was estimated at 77% in 2009. Yet, the situation has persisted as many investors have up to now sought untaxed capital gains in an environment of appreciating land prices.

## Longer repayment periods

In some cases, longer repayment periods are being used to increase affordability with for instance the Qatar Development Fund now offered a 37-year tenor which means that even their largest QAR1.2mn loan will have a monthly repayment of only QAR2,700. Also Egypt offers longer repayment periods for subsidized mortgages while some countries protract the period by capping the monthly

repayments. Japan, as well as some other countries, have introduced multi-generation mortgages in response to poor affordability.

## Managing costs

House prices are inevitably to a large extent determined by the cost of the inputs needed to build a new unit. The key variables in this regard are land and construction costs. Both are to an extent variable and subject to policy choices. Governments in many economies have influenced the availability of land through zoning decisions, purchases through eminent domain, or by developing government land. Often large portfolios of publicly held land can offer opportunities for circumventing the challenge of high land costs. Alternatively, private developers can be supported by reducing the costs and time involved in obtaining the necessary permits and access to utilities. Costs have also been successfully contained by developing new residential areas outside of existing cities, although this necessitates the creation of adequate transportation facilities to service the commuting needs of the population.

Economies can also be achievable through construction costs. In Europe and the US, building types used for social housing have often been highly standardized and relatively basic in their design. Efforts have been made to seek cost-effective construction materials and techniques. The drawback of these efforts has been relatively uniform, 'soulless' districts but ones that nonetheless have ensured access to adequate housing for large numbers of people. In some cases, such developments have been rejuvenated through privatization.

Various options exist in terms of managing the costs of construction materials. These include competitive bidding, special arrangements with suppliers, and government subsidies to developers in select areas. For instance, the UAE government is recently reported to have obtained discounts of up to 45% through partnerships with building material companies. Building more densely or building up remains another possibility, although success in using it remains often conditional on shaping market tastes, with many people having a cultural preference for stand-alone villas for multiple generations.



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