FINANCIAL FLAGSHIP

HOUSING AND REAL ESTATE FINANCE IN MIDDLE EAST AND NORTH AFRICA COUNTRIES

OLIVIER HASSLER*

JUNE 2011

The World Bank

*

1. INTRODUCTION **3**

2. MENA MARKETS OVERVIEW **3**
2.1 Residential real estate finance 3
2.2 Demographics and socio-economic factors 6
2.3 Housing market and credit interactions 6
2.4 Non residential real estate 8

3. MARKET BUILDING BLOCKS **10**
3.1 Property and security rights registration 10
3.2 Mortgage laws 11
3.3 Credit reporting systems 12
3.4 Financing current construction projects. 12

4. THE STRUCTURE OF MENA'S HOUSING FINANCE MARKET **13**
4.1 Private vs. public institutions. 13
4.2 Specialized vs. diversified institutions 15
4.3 Microcredit 15
4.4 Shariah compliant lending 16

5. REAL ESTATE RISK ASSESSMENT AND MITIGATION **16**
5.1 The Dubai real estate market crisis 16
5.2 Micro-level risk factors 17
5.3 Real estate market opacity 18
5.4 Islamic Finance 18
5.5 Systemic consequences of the Dubai Real Estate Collapse 19
5.6 Sector specific prudential measures and practices 20
5.7 Real estate lending supervisory structures 21

6. FUNDING CONSTRAINTS AND ASSET LIABILITY ISSUES IN HOUSING FINANCE **22**
6.1 Liquidity strains 22
6.2 Fixed rate lending 22
6.3 Capital markets 24

7. DEEPENING THE HOUSING FINANCE MARKET **26**
7.1 Deepening the housing finance market from the supply side 26
7.2 Deepening the housing finance market from the demand side 27
7.3 Housing finance subsidy challenges 28

8. MAIN FINDINGS AND POLICY IMPLICATIONS **31**
8.1 Improve the transparency of real estate markets 31
8.2 Create mortgage lending data bases for the housing sector 32
8.3 Strengthen mortgage market infrastructure. 32
8.4 Strengthen prudential frameworks 32
8.5 Develop and modernize the framework for mortgage related securities 33
8.6 Develop prudential norms for the management and mitigation of liquidity and market risks. 34
8.7 Promote leveraging public support schemes by market resources. 35

ANNEX **36**

1. Introduction

Real estate investment is a key contribution to economic growth, household welfare and urban development. Construction is one of the sectors with the most impact on the economy. It deepens and makes the financial system more efficient by helping to mobilize savings, expand access and reduce informal sources of finance.

Financing real estate investments, however, is challenging. Housing is made affordable by a robust lending system that can facilitate long-term transactions, spread large investment costs, and use fixed interest rates for stability purposes. These features are not present in most emerging economies and are difficult to build. Without such a system, however, lending remains short term and restricted. Real estate lending, including commercial and development investments, can destabilize the financial system, particularly if linked to cyclical and sometimes speculative market risks, as demonstrated by the recent global financial crisis.

MENA lags behind other regions in making market resources available for real estate investment. A tradition of heavy state intervention, a dependence on oil wealth, macro economic instability, and weak financial infrastructure has hindered financial system development in the region. However, growing housing needs, economic liberalization and sounder economic contexts have converged to spark new developments in markets resources in the past decade.

In spite of the small size of the housing and real estate finance sector in MENA, real estate bubbles risk parts of the banking system. These risks must be addressed when promoting real estate finance mechanisms to ensure that their development is sound and sustainable.

This paper is organized as follows. The second section will provide an overview of real estate finance markets, benchmark their development against international references and briefly analyze their dynamics with other markets, particularly the real estate market. Section 3 assesses the main components of the mortgage market’s infrastructure in the region. Section 4 overviews lending market structure, and examines the evolving role of governments. The report analyzes real estate risk through the experience of the Dubai “bubble” and the robustness of prudential frameworks in section 5. Section 6 considers funding constraints and asset liability management issues, and section 7 gives a succinct overview of policies designed to expand the access of lower income groups to housing finance. The paper concludes with the policy implications of these various analyses presented in section 8.

2. MENA Markets Overview

2.1 Residential real estate finance

Residential real estate finance is still underdeveloped in the region, despite strong existing and future need. Housing finance as a market-based activity is relatively new in MENA. Except for housing loans directly extended by government agencies, most countries are still in a nascent phase of housing finance development. Globally, the region lags behind other markets of comparable or lower income levels. Regional averages for housing finance/ GDP and to overall credit ratios are lower than in ECA and LAC, and only higher than in Africa and South Asia (Figure 1 and Figure 2)[1].

---

[1] Countries with none or hardly any housing finance (Iraq, Yemen) are excluded

Figure 1: Housing Loans/GDP - Regional (simple averages)

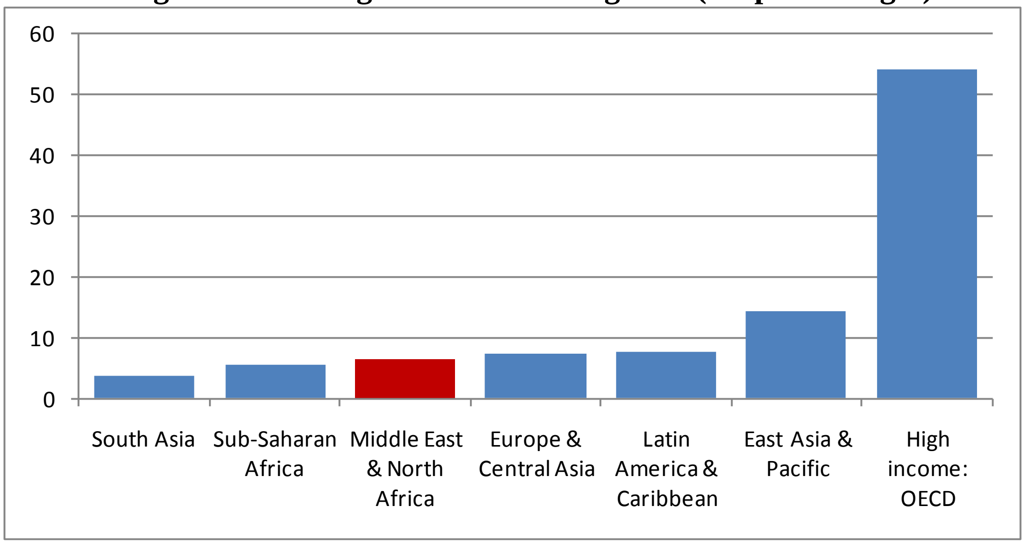
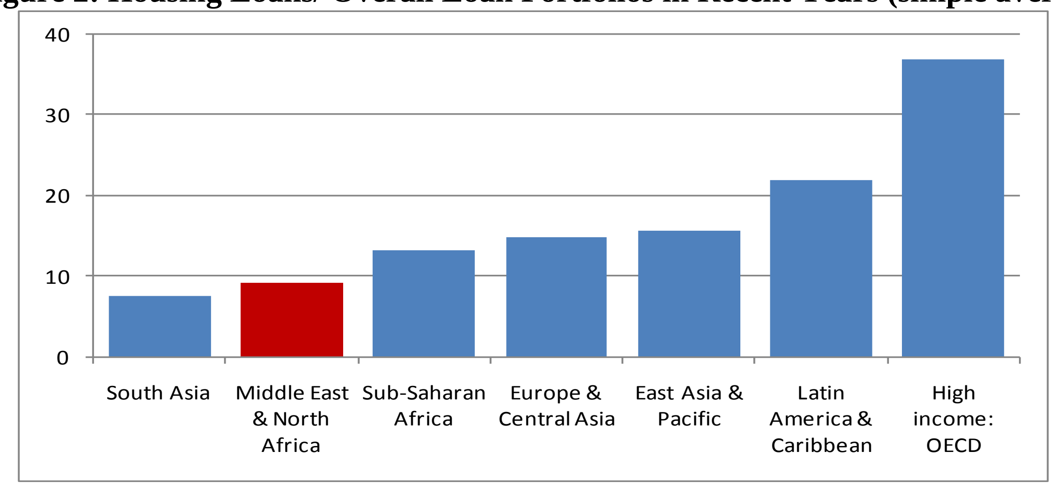


Figure 2: Housing Loans/ Overall Loan Portfolios in Recent Years (simple averages)



*Sub-Saharan Africa: the average would be less than 7% without South Africa

The region, however, is far from being homogenous. A few markets have been growing very rapidly-- above 20% p.a in Morocco, Tunis and UAE (until the 2008 Dubai real estate crisis)-- and 4 markets have reached a noticeable higher degree of maturity than other markets in the region--Kuwait, Morocco, Tunisia, and UAE (see Annex Figures 3 and 4).

Countries in MENA have shallower housing finance markets than predicted by their income levels. Figure 5 and Figure 6 illustrate the depth of housing finance markets as compared to income for a significant sampling of countries. Besides Morocco and Tunisia, MENA countries have lower housing loans/actual GDP levels than predicted by GDP per capita. The trend is consistent for the share of housing loans in credit portfolios:

Figure 5

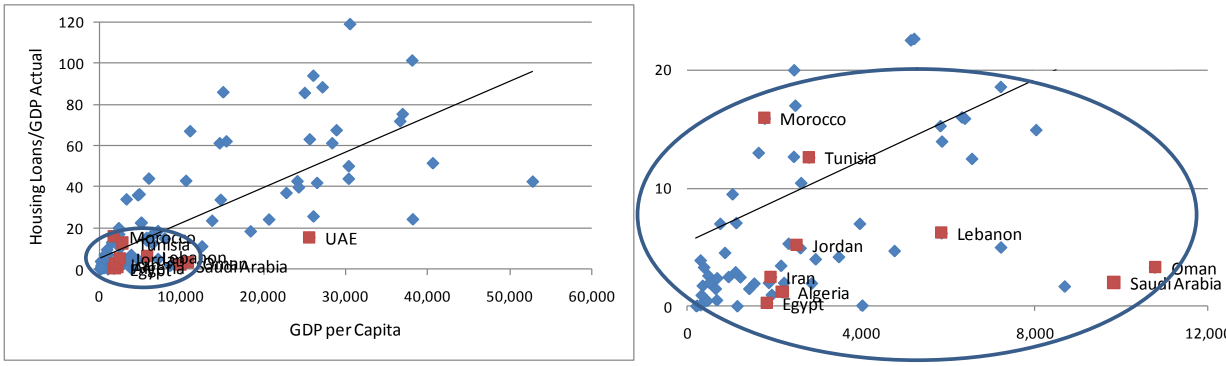
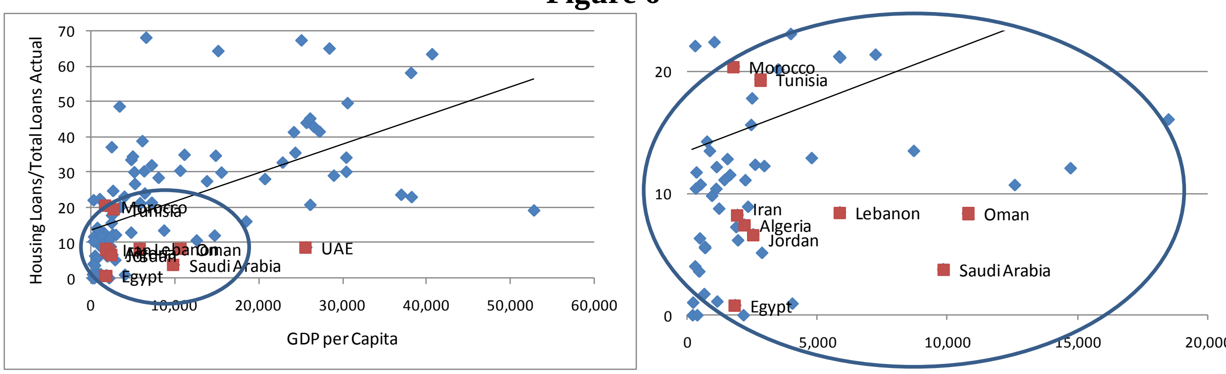


Figure 6



To measure the gap between the current and potential depth of housing finance markets, housing loans/GDP and housing loans/total loans were regressed against several variables, including income per capita, population size and density, and inflation. For both regressions**,** the model shows that for most MENA countries, housing finance is below expected levels. This discrepancy indicates the potential growth in housing finance that exists in these countries, and the potential to catch up with international references, without new significant demographic or economic developments (Figures 7 and 8).

Figure 7

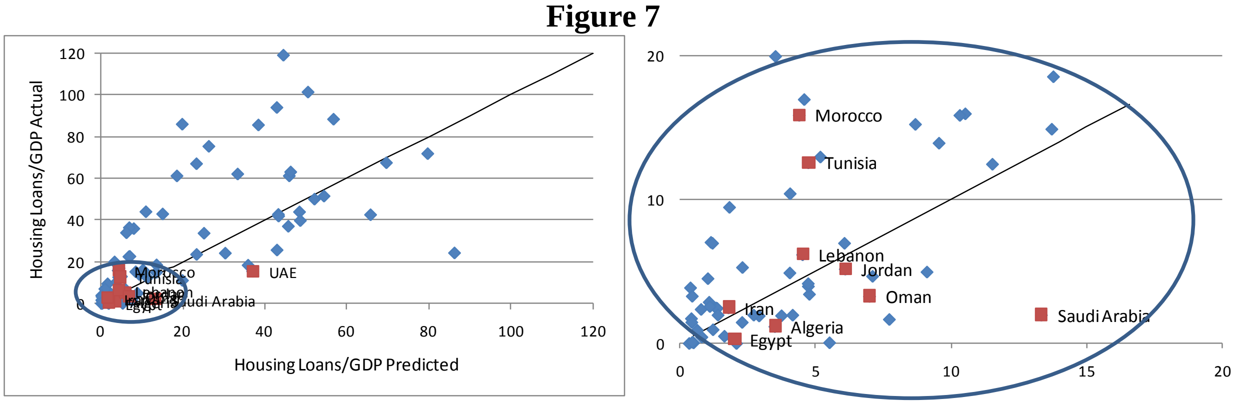
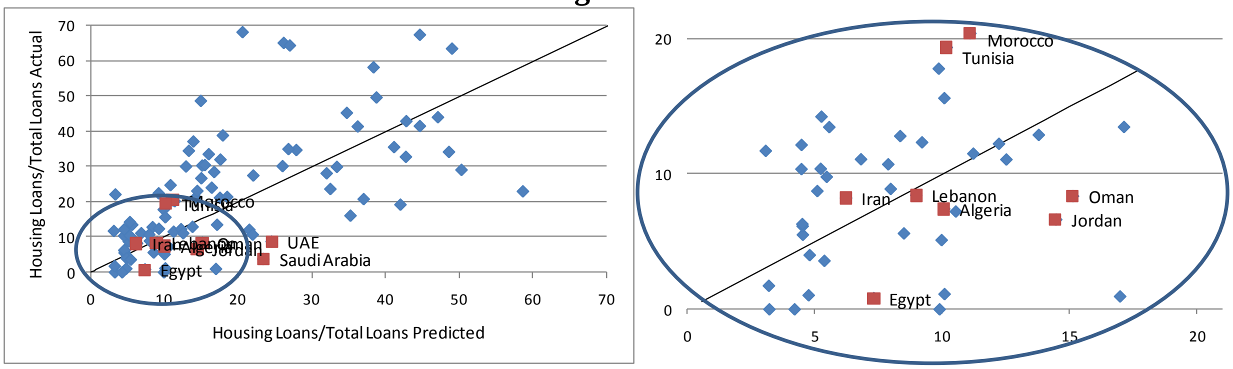


Figure 8



2.2 Demographics and socio-economic factors

As in other regions, most MENA countries face large housing shortage due to dynamic demographics. The region's population is generally very young and growth rates are high both in GCC and non-GCC countries. In addition, household size is declining in several countries, adding new demand for natural demographic growth. These factors cause more substantial housing shortages than does urbanization. The region is on average highly urbanized, at 63%--urbanization in the Maghreb and Iran is similar to the regional average, whereas in most other countries, the urbanization rate is 80% or higher.[2] Egypt and Yemen are outliers, with 50% and 30% urbanization rates, respectively[3].

Homeownership is important culturally, and this aspiration should continue to drive growth both in countries where homeownership is low (e.g. Egypt, 38%) and even where it is higher (e.g. Tunisia, 78%, one of the highest rates in the world, which, however, largely reflects traditional and customary ownership**).** GCC countries are a special case, where low ownership rates--45% in KSA and in the UAE-- are largely due to restrictions limiting housing ownership by non-citizens and the dominance of expatriates as residents--2/3 of the population in Kuwait, 80% of the workforce in KSA. [4]This creates a compartmented market, with an owner-occupied sector for nationals and a rental sector for non-national residents. Some relaxation measures taken or considered in the last few years (e.g. Kuwait) indicate there is a significant market segment that could eventually be opened to housing finance.

2.3 Housing market and credit interactions

Housing market and credit interactions can create a paradoxical situation with low penetration and high exposure to risks. The role of finance behind the overheating of real estate markets has been under scrutiny following the collapse of several housing markets in developed economies and the price bubble burst in Dubai. Since credit growth and price increase developed in parallel in MENA since the 2000s, and at times very quickly, a perfunctory conclusion is that the former is responsible for the latter. The relationship is in fact complex and cannot be apprehended in a uniform analysis. Following are some important considerations:

---

[2] A characteristics especially observable in countries with large desert areas

[3] Sources: World Bank World Development Report 2009, UN Urban Division

[4] With the exception of Dubai, whose policy of serving as a regional hub implied attracting foreign investors

- Abundant credit, and more importantly, low interest rates, are linked to asset price inflation. The relationship, however, works both ways-- loan amounts are tied to the value of transactions. In the GCC, most markets experienced price increases that paralleled strong lending growth. [5] In the UAE for instance, real estate mortgage loans extended by commercial banks increased by factor of 4.5, from AED 31 billion at the end of 2006 to 141.7 billion at the end of 2009. Domestic bank credit "only" doubled in the same period. In other GCC countries, with the exception of Oman and Saudi Arabia, mortgage lending increased between 30% and 100% faster than overall credit from 2005 to 2007[6];
- Price appreciation, however, often takes place in countries where the mortgage system is still under-developed (e.g. Algeria and Egypt). Factors that drive up prices independently of credit can include: (i) land or housing supply shortages, sometimes accentuated by land use rules or government owned land allocation policies; (ii) foreign direct investments[7];(iii) remittances by non-resident nationals, such as in Jordan and in Lebanon[8], where prices have rapidly increased since 2003, despite the limitation of foreign investments and a lax land policy; and (iv) lack of investment opportunities due to the size of the economy and/or the volume of oil wealth (e.g. Algeria and most the GCC). The disconnect between price cycles and mortgage lending can also be seen in downturn phases as demonstrated by the decline of prices in KSA in 2009, independent of the activity of a still infant mortgage market.
- Price increases can be a source of growth and of improved security for lending activities thanks to higher collateral values. But they become a source of systemic vulnerabilities for financial systems when they reflect speculative behaviors and are driven by expectations of an appreciation trend which can suddenly reverse, or are too closely related to the level of oil prices (e.g. Kuwait in 2008). [9]
- High price levels restrict credit development when housing becomes unaffordable.

Many MENA countries exemplify a combination of these interactions. What commonly happens are price movements will spread from one segment to the next, as a spillover effect from the higher part of the market. Strong price appreciation will occur in the upper end of the market, leading to oversupply as a result of increased developer and lender interest. Affordability issues in the middle and lower segments emerge as a result of supply shortages and price spillover effects.[10] The transmission channels are land prices and the shift of demand from segments that became unaffordable towards less pricy ones.

[5] Although measuring the exact importance of such trends is difficult (see below the opacity of real estate markets)
[6] Markaz Real Estate Research February 2009 :http://www.markaz.com/DesktopDefault.aspx?tabindex=0&tab_ikey=223
[7] In Jordan, they nearly doubled every year between 2003 and 2006 in connection with the Iraq war. . Prices increased in Dubai largely as a result of its active policy of attracting foreign investors since 2002 (see below).
[8] Remittances amount to about 10% GDP in Lebanon
[9] An abundant literature has been written since the global financial crisis on characteristics and warning signs of bubble situations. An important characteristic is provided when price increases are paralleled by an increase of the supply longer and stronger than the normal leads-and lags adjustments.
[10] Contrarily to consumption goods markets, such as cars or clothing, where a strong demand in a luxury compartment has little effect on cheaper ones.

Land is a bottleneck in the supply chain, and a factor of high prices, in many countries. Constraints on land availability can be physical (importance of desert areas, trade off with agricultural usage), but are man-made more often than not. Where the state is a major owner of land, as is the case in Algeria, the narrowness of privately held land relatively to a sustained demand tends to magnify the pressure on prices, The allocation of state owned land by priority to government sponsored programs may have this unintended consequence, which not only affects the affordability of private sector housing, but also increases opportunity costs for the government. Another phenomenon that can be seen in the region is the the speculative retention of land by private owners. This is notably the case in KSA, where large developers build up land banks with the view of eventually reselling land with capital gains. Their profits derive sometimes more from this trading activity than from the development of new housing projects. A third and relatively frequent factor resides in sub-optimal land use rules that lead to urban sprawl and excessive consumption of land and infrastructure. Low density zoning policies reflect a cultural preference that is fairly widespread in the region, from Egypt to Lebanon, Jordan and the GCC countries.[11]

The dynamics of price formation overall result in a dual market structure. This happens frequently in MENA. Except for a thin, higher-end section of the market, the bulk of the demand remains unmet due to high prices as compared to income-levels. In most countries (Egypt and Tunisia are noteworthy exceptions), the typical (market) price-to-income ratio is above 5, which is considered the affordability threshold.[12] Where this dual structure exists, housing finance systems lack depth but may still be exposed to significant market risk in property segments that are both narrow and subject to speculative investments, resulting in ample price cycles and volatility.

2.4 Non residential real estate

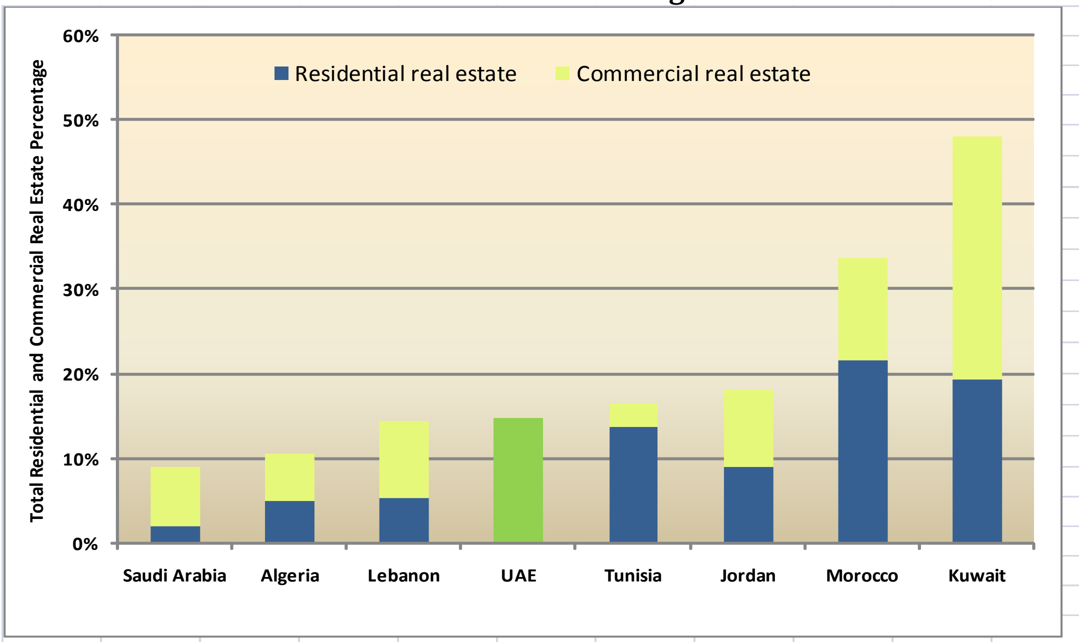
Non-residential real estate is often more substantial than housing real estate. Development and Commercial real estate financing is a significant banking sector activity in MENA (Figure 7). In Algeria, Lebanon and Kuwait, commercial real estate finance represents a larger share of total bank lending than retail housing finance[13].

[11] In KSA low density urban expansion has been in addition promoted by the policy of the government of the Real Estate Development Fund, which until 2011 only provided (interest free) loans to households already owning an individual plot

[12] Or a level that implies a large amount of resources beside borrowings

[13] In Morocco, developer finance represents nearly a third of real estate loans, but mostly for residential porjects

Figure 7: Relative Size of Residential and Commercial Real Estate Finance in Total Bank Lending



The data for UAE (2009) could not be broken down between residential and commercial real estate

Commercial real estate differs from residential real estate finance, due to the high unitary volumes involved and the factors shaping its market. It can still link the credit industry to real estate markets, particularly through the collateralization of financed properties and hence, price movements. In fact, commercial real estate links **the credit industry and real estate markets more strongly than residential real estate finance.** The degree of market risk is therefore aggravated, due to factors specific to the sector:

- Firstly, the sizes of individual loans are much bigger, implying a higher concentration risk even when taking into account the correlations that make the dispersion of retail loans less important than a loan by loan analysis can imply;
- Secondly, the size and duration of investments result in longer production cycles, which increase the probability of mismatches between demand and supply and can lead to much deeper price cycles than in the residential sector. Since 2008, oversupply significantly affected office markets in Tunisia, Kuwait and Dubai, resulting in the decline of rents;
- Thirdly, in the case of companies, economic health and collateral values are much more connected than in the residential sector. This linkage lowers the degree of protection that collateralizing properties is supposed to provide lenders. It exists in all types of secured lending, but is strongest for commercial real estate. Economic health and collateral values are very connected in the case of developer loans as well. If a new development comes onto the market at an inopportune moment or is based on flawed demand assessments; this will jeopardize the capacity of its promoter to repay its banker. It will also affect the value of the pledged properties by creating an excess of supply and accessorily implying a destruction cost for already completed construction simultaneously increasing the probability of default and the severity of losses.

These market dynamics and their potential effect on the banking system are particularly relevant to the MENA region because of the scarcity of non-real estate investment opportunities and the relative narrowness of most markets.

3. Market Building Blocks

Mortgage finance is based on the principle that the long term immobilization of resources requires special security for lenders and investors. This security is provided by the collateralization of properties, which must be clearly identified; properly registered ownership and security rights; and creditor-right enforcement that ensures credit discipline.

Weaknesses in the legal and institutional foundation of the mortgage system have hindered housing finance growth in the region. Numerous governments have begun to overhaul the foundation of their respective mortgage systems, underscoring a general desire in the region to foster market-based housing finance. However, such an undertaking will require time and significant resources before improvements in finance-provision materialize. Some countries have chosen a piecemeal approach, while others (e.g. Algeria, Egypt, currently Saudi Arabia), have designed comprehensive strategies that aim not only to establish secure mortgage systems, but to improve access to bond markets and promote market deepening towards lower income groups.

3.1 Property and security rights registration

Property and security rights registration is generally strong in the GCC and improving in other countries. The physical identification of properties--cadastres-- and the clear definition and registration of rightful owners--titling-- are key infrastructure components of a mortgage market. In Kuwait, registration is compulsory, normally takes place within a few days, and only involves .5% charges. Saudi Arabia passed a Cadastre law in 2003 with the goal of improving and completing the physical identification of properties system first initiated in 1984. Saudi Arabia and the UAE are ranked ahead of countries worldwide for ease of registration systems according to “Doing Business 2011”.[14]

With exceptions such as Lebanon and Jordan, titling needs significant improvement in MENA for mortgage finance to develop. There has been some progress, however, in several countries. With World Bank support, Algeria has undertaken a nation-wide systematic physical and legal properties registration system, while designing a special ad-hoc procedure to expedite the process in urban areas. In Egypt, a comprehensive program has been launched to include the extension and modernization of the titling system and streamlining the registration process[15]. Results for the time being have been mixed. In Tunisia, a strengthening of its property registration system is being prepared. Multiple property rights regimes can coexist, an obstacle to a global land management and large scale developments. For instance, Morocco has a three-pronged system: customary (collective) ownership governed by village councils, Islamic based Habou land and statutory land. Only the latter can be recorded in a formal land registration system – which in itself is efficient and reliable[16]. The latter segment includes the existing urban

---

[14] The World Bank Group, November 2010
[15] WB and USAID
[16] The organization of the cadastre - physical description and identification of properties- is a specificity of the Moroccan system: it has a legal value and is integrated with the properties registries- is a specificity of the Moroccan system

areas, but titling problems arise where urban or industrial land expands. To stimulate formalization, initial registration has been made free of cost, and a revision of the land law is being prepared.

Ensuring appropriate transactions costs for titling is essential. Excessive levels generally lead to highly negative consequences by: encouraging informal ownership, which not only limits access to finance, but perpetuates legal uncertainties, litigation, and irregular settlements; and inducing the development of a "dual price system," where true prices are dissimulated, which affects the transparency of the real estate market and reduces the collection of property taxes generally used for urban infrastructure. **MENA is fairly well positioned with regard to transaction costs**. After the reduction of registration charges in several countries, the average registration cost in the region is reported to be 5.7%. Notably, Egypt switched to a fixed registration fee system for property values above a low threshold.[17] The average for the region is below South Asia, Latin America and Sub Saharan Africa[18]. This cost is less than 1% in Egypt, Kuwait, and Qatar; and Syria is the only country to impose dissuasive charges of 28%. Still, price dissimulation remains a practice difficult to overcome like in other regions. It affects the transparency of real estate markets and the monitoring of asset values.

3.2 Mortgage laws

Mortgage laws are being reviewed in the region, but enforceability remains an issue. Security rights and their enforcement are at the core of a mortgage system. Although the actual execution of mortgages generally remains as a last resort, especially when the second hand market for properties is underdeveloped (as it is in MENA), the credibility of the instrument is essential to guaranteeing credit discipline.

The value of mortgage rights has historically been underestimated in the MENA region overall. In GCC countries, the reluctance to use this security instrument is seen through the absence of legal provisions (e.g. KSA) and the prohibition of mortgage on residential properties. In Kuwait, the Civil and Commercial Procedure Code forbids mortgaging and foreclosing on primary residences[19].

There has been some progress in reforming the legal framework for housing finance in MENA. Egypt was one of the first countries to reform its mortgage framework in 2001, although the law had remained little tested until 2008, and it still requires some adjustments. More recently, Algeria modernized its mortgage laws, removing legal uncertainties and offering lenders a cheaper and faster option for a foreclosure procedure that had been, until 2006, restricted to the government[20]. Dubai issued a comprehensive mortgage law in 2008, while in KSA a draft reform of the mortgage finance system includes the introduction of clear mortgage rights and a foreclosure law. In Syria, a Mortgage Finance Authority was established in December 2009. As the industry's regulator, its first responsibility will be to design a mortgage law. In West Bank & Gaza, the rationalization of mortgage provisions stemming from heterogeneous legal regimes is under way.

---

[17] Typical costs are now a still high 7.5% in Jordan but less than 1% in Egypt
[18] Source: Doing Business 2011
[19] Housing loans de facto equate with "installment loans", which are what are considered in Figure 1
[20] The creditor still needs to ask a judge to recognize the validity of its claim

Enforcement of mortgage laws is generally cumbersome in MENA. Out-of-court procedures aren't used[21] and eviction from residential properties is difficult. Morocco has one of the more efficient systems, where foreclosure proceedings take less than a year, except when there are multiple contestations. Lebanon is a rare case where there are specialized courts dedicated to property litigation and foreclosures, which strengthens enforcement procedures. Dubai very recently established such specialized courts. The upcoming Saudi framework will allow the creation of special enforcement courts in all the major cities and will introduce time bound procedures for the foreclosure of collateral. The disposition of seized collateral will become more efficient due to the possibility of outsourcing sales to the private sector.

The difficulty in reselling repossessed properties is the most significant obstacle to efficiently exercising mortgage rights. This problem stems from the narrowness of second hand real estate markets, and in some cases, a cultural reluctance to buy the foreclosed house of another family.

3.3 Credit reporting systems

Credit reporting platforms often limit their scope to loans exceeding a certain threshold because of operational reasons and the perception of risk. This leads to excluding retail mortgage lending from mechanisms that provide information on borrower creditworthiness, and institutions become reluctant to provide housing loans except to their wealthiest and best-known customers. Centralized credit information is essential for lenders to build scoring systems and develop risk evaluation models. But it is also critical for market segments, such as informal sector borrowers, for which risk assessment should not be automated but based on expert judgment and a careful assessment of a number of factors.

The chapter on Credit Reporting gives an overview of the creation or upgrading of Public Credit Registries and Private Credit Bureaus in the regions. It is of course of utmost importance for housing finance that retail lending be included in such systems, which is becoming more and more the case, e.g. in Bahrain (2005), Egypt (2006), UAE (2006), Morocco (2008), West Bank & Gaza and Algeria (under way). Four systems go as far as covering micro-credits, sometimes on a voluntary basis.

3.4 Financing current construction projects.

A component of a sound housing finance system that is too often overlooked is the security of financial means invested in real estate developments before their completion (off plan sales). This area is, however, important on several accounts: by facilitating the housing supply , requiring consumer protection, and by being a possible speculation vehicle. It is also a source of working capital that is cheaper than developer credits. In advanced legal systems, mortgage liens can be created on well identified and registered properties, enabling banks to finance buyers at this early stage in order to include buyers who cannot pay cash. However, advance payments should not take place without warranties protecting buyers and banks against developers' insolvency. Although the situation varies from one country to another, this objective

---

[21] An exception is West Bank Gaza where the option of a partially out-of-court procedure through the land administration is available. It does not, however, protect lenders from frivolous contestations being brought to courts

is globally better taken into account in MENA than in many other regions. Algeria in particular developed an interesting guarantee mechanism as early as 1997 (Box 1)[22].

Box 1: The Real Estate Development Guarantee Fund in Algeria (FGCMPI)

Algerian law makes insuring advance payments made during the construction phase compulsory. This applies to residential as well as commercial real estate. FGCMPI was established in November 1997 to fulfill this function. Its purpose is to reimburse payments made by purchasers in case the developer dies (natural person), becomes bankrupt, is liquidated, or has committed fraud. It became operational in 2000.

The fund is controlled by the Housing Ministry and is a not-for-profit mutual entity, meaning that losses are shared between its members. The contributions paid by developers include a nominal membership fee, an annual fee that varies according to the size and record of the developer, and a risk-based premium for each insured program - typically, 1% in the subsidized sector, and 2% for purely market based programs.

In addition to its role as a guarantor, FGCMPI adds value by screening developers (although it does not provide any certification) and building a ratings system. It is also a market monitoring entity that has a unique capacity to gather information about real estate prices, transaction volumes and sale rhythms.

The compulsory purchase of guarantees has not always been enforced, especially in the system's early years. Its major shortcoming is arguably the state's close involvement, which could implicitly transfer risks of a highly cyclical market to the government.

Off-plan sales can also be a powerful speculation vehicle if contracts are traded while construction is on-going. With small down payments, investors can cash in full capital gains and achieve huge returns. Dampening such use is another objective that can be seen in new frameworks introduced in Dubai and KSA in 2008 and 2009, respectively, with the aim of securing transactions but also limiting the "flipping" of purchased properties[23].

4. The Structure of MENA's Housing Finance Market

This section overviews of the shape of MENA's housing finance market and analyzes a set of alternative configurations: (i) private vs. public institutions; (ii) specialized vs. diversified lenders; (iii) Islamic vs. conventional approaches; and (iv) mortgage vs. unsecured lending.

4.1 Private vs. public institutions.

Governments are still major players in the housing finance system, and their interventions must be distinguished in two ways:

- *Direct lending by governments outside market mechanisms*, using budgetary resources to fund housing loans. This is mostly the case in GCC countries, where such systems are used to redistribute part of the oil wealth. They typically only benefit nationals and are as much subsidy as lending schemes. Archetypical examples are the Real Estate Housing Fund in KSA--which extends about 80% of the housing loans originating in the country of home

[22] Morocco also developed a mechanism meant to secure advanced payments on future sales, but the law is in practice largely ignored

[23] Dubai introduced in 2008 the possibility of mortgaging off-plan properties as well as an innovative mechanism for the compulsory, temporary registration of such transactions. In KSA, the new rules require the administrative approval of off plan sales and the use of escrow accounts for advance payments. A more comprehensive Real Estate Development Guarantee Law has been drafted

purchases in Riyadh-- and the Public Authority for Housing Welfare in Kuwait[24]. Both provide interest free loans, and in Kuwait's case, there is a KD 70,000 maximum and a capped monthly installment, which implies a potential near- infinite maturity. From a technical point of view, these systems-- which are not included in the loan data used in this paper-- are not optimal. They generally fail to match the artificially generated demand, resulting in long waiting lists, lack of precise social targeting, and tend to apply lax servicing standards, increasing the actual financial burden for national budgets. Moreover, they hamper the development of market-based housing finance systems and risk affecting the culture of household credit.

- *Participation of governments through state controlled specialized banks***.** This is particularly wide spread in MENA (Algeria, Egypt, Iran, Lebanon, Morocco, Syria, Tunisia, etc). A tradition of heavy state involvement in the economy has resulted in the creating of a financial tool to implement public policies for each sector, including housing (Algeria, Syria). Current government involvement in housing finance systems is largely to remedy market failures, which can exist: (i) in the infancy of housing finance systems, when a state housing bank is meant to provide an otherwise unavailable service and pioneer its development; and (ii) at a more mature stage, where the focus is on underserved populations by mainstream lenders.

Two types of problems often arise with government housing lenders. First, a quasi monopoly, political interferences and/or the implicit transfer of risks to the state induce lax management practices, leading to frequent public bail-outs (e.g. Algeria and Tunisia). Second, these banks enjoy specific regulatory advantages and subsidies (sometimes implicit) linked to their special mandates. For instance, the Tunisia Housing Bank benefits from privileges on its savings on housing schemes, e.g. tax exemptions and state liquidity back-up, which enable it to offer conditions significantly better than the market. It is also the exclusive manager of a Social Housing Fund (FOPROLOS) as well as more minor government funds, giving it access to important market segments.

Ensuring the fulfillment of development goals while maintaining a level playing field and developing private lending is challenging. Once commercially based housing finance had developed, MENA governments took various steps to try and reconcile both priorities:

- *Ensuring state lenders adhere to strict commercial principles; achieve stand alone profitability; and enjoy a privileged position on certain market segments, owing to their business franchise and not to quasi entry barriers*. This was seen in the restructuring of the Algerian CNEP (La Caisse Nationale d'Epargne et de Prévoyance) in 2000-2001, based on the overhauling the organization in exchange for compensating past loan losses
- *Opening housing banks' capital to private shareholders while the government retains a significant stake (Lebanon, Morocco, Tunisia)*[25]. This reform is encouraging, provided that private partners bring expertise, especially in risk management and corporate culture, and are not merely seeking easy rents from the government's backing.
- *Opening the distribution of state assistance to any interested lender*, as is the case in Algeria, Lebanon, Morocco and Egypt.

[24] Through the Credit and Savings Bank, a government agency.
[25] The private sector share in the Banque de l'Habitat de Tunisie (42%) will change with the planned merger with the Sate owned Société Tunisienne de Banque

When implemented effectively, these measures help strike a balance between government social policy and the mobilization of market resources. Diversified sets of private finance suppliers have already begun to emerge in Lebanon and Morocco. At a later development stage when markets reach full maturity, maintaining specific government instruments should become less relevant.

4.2 Specialized vs. diversified institutions

The advantages of specialized versus diversified institutions depends on a country's level of development and the importance of capital markets in its financial sector. In many cases, specialized institutions appear to have been the preferred driver for developing housing finance at an early stage. As mentioned before, governments have established housing banks to provide this specific financial service. Private sector specialized entities have been promoted as well, with the rationale that dedicated entities are more motivated and more efficient than commercial banks. This has been the case in Egypt, where legal reforms to the housing financial market created a framework for such institutions, as well as in KSA and in Bahrain.

However, the access to long term funding is critical to the viability of specialized lenders. When lenders are also savings institutions, as is the case with the Maghreb state housing banks, their activities are mainly financed by internal resources. But non-deposit taking entities can only succeed if they raise enough resources from the capital market. In Egypt, a specialized mortgage company model is being developed in conjunction with a central liquidity facility, the Egypt Mortgage Refinance Company (EMRC). However, the reliance on bond markets is a handicap when these markets are very small, like those in GCC countries. Vulnerability is also a concern, since lenders are exposed to capital market disruptions, especially if they issue short term funding instruments. In addition, when non-deposit taking lenders are lightly regulated, they do not have access to collective risk management tools, such as credit registries or central bank liquidity support, as is the case in KSA.

The constraints to specialized lending are a major reason why banks[26] have become the largest category of lender in nearly every country. In addition, having a deposit network gives access to a customer base that is not only captive, facilitating the cross selling of other financial products, but whose creditworthiness is known to lenders through its bank accounts.

4.3 Microcredit

Microcredit for housing is very limited in MENA. Microfinance is limited in general--Morocco and Egypt are the only countries with a mature microfinance market. Recent developments have included the creation of a microfinance entity in Jordan and one in Bahrain in 2009 (the first in the GCC). Specific products for housing only seem to exist in Tunisia (in one institution) and Syria, where the first microfinance institution, established in 2003, has been focusing on housing improvement loans. There have been pilot projects in Egypt that have yet to take-off.

---

[26] Sometimes resulting from the conversion of a specialized institutions – e.g. CNEP in Algeria

4.4 Shariah compliant lending

Shariah compliant lending for housing has strict specifications but does not significantly modify the overall market landscape. Faith based housing finance is used to a different extent throughout the region. The banking law in Iran (the law for Usury Free Banking of March 1987) stipulates this approach, and faith based housing finance is wide-spread in most GCC countries, notably in Bahrain, UAE and Kuwait. Saudi banks that extend housing loans mostly do it through Islamic products, but also offer conventional ones. By contrast, Shariah compliant housing loans are rare in the Maghreb.

Islamic housing finance does not target lower income categories more than conventional finance in MENA. In some countries – for instance Pakistan, Bangladesh or Indonesia-- Islamic institutions tend to be active in segments underserved by conventional banks, and contribute to expanding access to housing finance. This specific positioning is not pronounced in MENA and cannot be considered a characteristic of the Islamic sector.

Overall, no significant differentiation in financial conditions between Islamic and conventional institutions emerges. Where mortgage markets are competitive, or where traditional lenders remain price leaders, Shariah compliant lending and traditional housing loan conditions tend to be aligned.

5. Real Estate Risk Assessment and Mitigation

5.1 The Dubai real estate market crisis

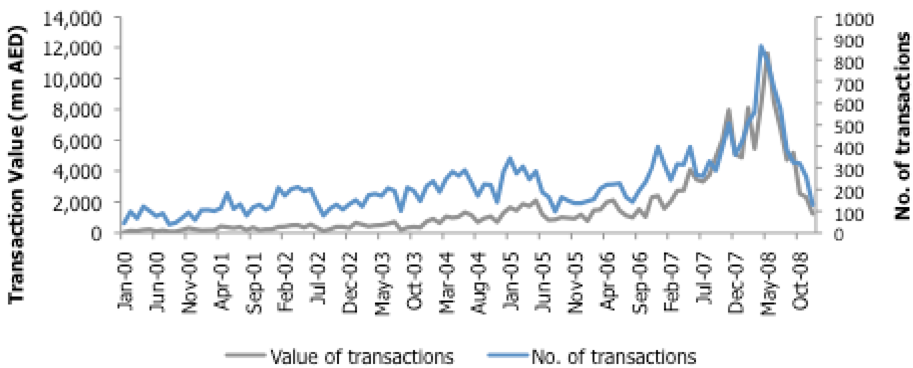
The recent global financial crisis demonstrated the extent to which real estate risk can affect financial sector stability. This section underscores the extraordinary overheating of the Dubai real estate market and the dramatic trend reversal. Despite ultimately having a limited impact on the financial sector, the crisis provides valuable lessons on risks factors and on ways to mitigate them.

Box 2: The Dubai Real Estate Bubble- a Succinct Description[27]

The Dubai real estate market witnessed a boom during 2002-2008 in all segments, resulting in very rapid price increases. Towards the end of the boom, these price increases accelerated, following a surge of financial inflows that were motivated by the expectation of a currency reevaluation. For instance, according to some estimates, office rentals increased by 55% and 86% in 2006 and 2007 and housing prices jumped by 65% in the first half of 2008[28].

Such price moves were clearly unsustainable. Starting in the third trimester of 2008, the real estate market sharply declined. The trigger events were the end of the 2003-2008 increase in oil prices and the global financial crisis, where investors lost confidence in real estate investments and real estate-backed financial transactions. Dubai was particularly vulnerable since the real estate boom had largely involved foreign capital inflows (foreign investors became entitled to freehold ownership in May 2002). Expectations of future price appreciation that had initially driven demand disappeared. Numerous development projects, especially in the commercial sector, came to market after the downturn occurred, exacerbating the decline in prices.

The figure below gives a view of the sharp decline in transactions.[29]



In the 12 months following the peak of the market, prices were said to drop by 43% and 58% in the residential and commercial sectors respectively.

5.2 Micro-level risk factors

Two micro-level factors aggravated the impact of real estate risk on financial institutions: excessive concentration and direct involvement in property development. The demise of the two main housing finance providers in the UAE, Amlak and Tamweel, illustrate the layering of risks that can occur as part of the specialist lender business model:

- *The concentration of activity in one economic sector, which can be magnified by a geographic concentration.* The lack of diversification is particularly obvious in GCC countries, given their small size, except for KSA. The restriction of property ownership by non-nationals, sometimes a majority of the population, increases the concentration on one segment of the population.

---

27 For an incisive and comprehensive analysis, see Bertrand Renaud : Dubai's Real Estate Boom and Bust of 2002-2008 – Dynamics and Policy Responses, in Housing Finance International Summer 2010

28 Source on prices: Colliers International

29 Source: Markaz Real Estate Research, February 2009, based on Dubai Land Department data

- *The close ties between financiers and developers, either capitalistic or commercial*. Both Amlak and Tamweel were created by major Dubai developers. These fairly common ties can work in two ways: lenders can seek an external distribution channel, especially when they do not have a deposit network, through partnerships or subsidiaries– the CNEP in Algeria owns the largest developer in the country, and several Tunisian banks have development subsidiaries. Developers can aim to facilitate the sale of new developments by integrating the provision of finance into their value chain. Close business ties may lead to a more lax screening of borrowers' creditworthiness and looser assessments of the viability of new housing projects, than would be the case with an arms-length approach. For instance, CNEP experienced heavy losses on developments by its affiliate CNEP-Immo because projects decisions were motivated primarily by administrative decisions, rather than demand.

5.3 Real estate market opacity

Real estate market opacity is a macro-level factor that exacerbates risk. Very few official price indices exist in the MENA region. Morocco offers one of these rare exceptions: a residential properties price index was developed, following an overheating in the upper end segment of the market, an initiative of the financial Authorities in cooperation with the National Property Registry and Cadastre Agency. The index has been operational since 2009 and is in the process of being expanded to commercial properties. Lebanon has also developed a housing price index. In some countries (Bahrain, Jordan, Kuwait and the UAE) land registries deliver information, but only on the number and value of transactions, a statistic that does not necessarily reflect individual price trends. Information on supply and demand conditions is usually limited.

Limited information prevents accurate real estate market assessments. Market studies prior to property development are not systematic. Information on new construction in different segments, pending sale stocks, turnover velocity, etc., is generally scarce. Informal, non-registered, transactions, price dissimulations and the weaknesses of market infrastructure, particularly the lack of regulated brokers, also prevent thorough assessments.

5.4 Islamic Finance

The impact of Islamic finance in managing real estate risk is ambiguous. Firstly, Islamic products seem to protect creditor's rights better than conventional mortgage finance since lenders retain property ownership (Ijara and Murabaha loans), or release it only progressively (Musharakha templates), and therefore depend less than conventional mortgage finance on the (often low) efficiency of the collateralization system. But on the other hand, this very feature may result in a propensity to engage in asset based, instead of income-based, lending, a policy that was at the root of the subprime crisis.

Secondly, on the one hand, Islamic banking excludes purely speculative investment– finance must support the economic use of tangible assets, and funding pure financial transactions, considered as a form of gambling is prohibited. It is therefore less subject to the temptation of "irrationally exuberant" lending than traditional finance. But on the other hand, Islamic lenders tend to focus more than average on real estate transactions, which are not only based on tangible assets, but also facilitate risk and profit sharing arrangements[30]. This relative specialization, including developer finance, results in a sometimes high sectoral concentration.

Islamic Finance's dual function can be seen in the recent financial crisis. Islamic finance as a whole was more resilient than conventional financial sectors to the global financial crisis, having avoided investment instruments that were the transmission channels of the subprime market debacle. If one considers the direct exposure of individual institutions, however, the Shariah compliant approach does not seem to have shielded lenders from the Dubai real estate meltdown more than traditional finance. Amlak and Tamweel are Islamic finance companies. NPL ratios have been often higher than average in the Islamic sector-- Dubai Islamic Bank, the UAE's largest institution, faced a NPL rate of 6.2% in 2009, compared to a UAE average of 4.3%[31]. In Bahrain, NPL ratios in the real estate and construction sector in March 2010 stood at 2.3% and 7.7% for conventional retail and wholesale banks respectively; and for Islamic banks, the same performance indicators were 12.1% and 12.9%[32]. On the bond market, there were at least 2 cases of default on Sukuks issued by GCC institutions to fund real estate investments[33] and at least one near default by a major Dubai developer[34].

5.5 Systemic consequences of the Dubai Real Estate Collapse

The overall impact of the real estate turmoil remained sporadic and was not systemic beyond the financial companies in Dubai and Kuwait that fell victim to the crisis. It is worth stressing that the crisis developed against the background of a robust banking sector, and was part of a wider economic and financial crisis, to which forceful global policy responses were developed. Liquidity facilities were offered by the Central Bank, and a restructuring vehicle was created (Dubai Financial Support Fund), which, together with a loan by the Abu Dhabi government, helped the main Dubai developer avoid defaulting on its bonds. Additional measures were taken by GCC countries in general to stabilize the financial system[35].

At the regional level, the contagion was limited. Most other GCC countries, including KSA, where mortgage lending is very underdeveloped, Egypt and Jordan experienced a mild downturn in their real estate sectors in 2008-2009. It was more of a consequence of the global financial crisis than cross-border linkages with the Dubai market.

Foreign investments in Dubai did not result in spillover effects. Although they were a major driver of the market boom, and more than 60% of investments in terms of transaction value came from other MENA countries, [36]the dispersion of investments[37] seems to have been large enough to limit the impact of the crisis to individual cases in the respective countries. Moreover, foreign participation in the Dubai banking sector is limited by law, like in most other

[30] See IMF Working Paper Jan 2008 Islamic Banks and Financial Stability: An Empirical Analysis
[31] Source: Fitch Ratings. It must be stressed that real estate was only one source of impairment, in addition to credit cards, corporate loans and exposure on two ailing Saudi groups
[32] Source: Central Bank of Bahrain Financial Stability Report June 2010
[33] KSA Golden Bely and Kuwait Investment Dar in 2009
[34] Nakheel, part of the Dubai World group, November 2009.
[35] For a comprehensive assessment, see "Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries" May Khamis, Abedelhak Senhadji and al. IMF, 2010
[36] From Bertrand Renaud
[37] 17% from KSA, 14% from India, 12% from Iran

GCC countries; and although foreign presence is at 21% and one the highest in the region[38], it was likely too low and fragmented to ignite a wide reaching external spillover.

Similarly, the withdrawal of Dubai investments from other MENA countries did not affect local markets. UAE real estate companies have been active in a number of MENA countries (Jordan, Lebanon, Morocco, Tunisia), and largely in commercial real estate. Withdrawals did take place, leaving an overhang of uncompleted projects, but the relative size of involved investments was probably too small to generate significant shocks in the host markets.

5.6 Sector specific prudential measures and practices

Sector specific prudential measures and practices mitigated the impact of property market downturns in the region. Steps taken by banking regulators at the onset of the real estate crisis likely played a significant role in safeguarding banks' stability. The Kuwaiti government passed two legislative measures in 2008 to dampen speculative transactions: the prohibition of mortgaging was extended to housing other than primary residences, and the "flipping" (quick turn-over) of properties was restricted[39]. Risk weights for capital adequacy calculation were notably raised in 2008 in Kuwait[40], and are up to 200% for any kind of real estate loan in Bahrain.

Prudential frameworks and practices beyond crisis management measures are in place in the region to protect financial systems against real estate risks. Approaches are used utilizing different degrees of sophistication, quantitative restrictions and lending standards.

Quantitative Limits

Some countries set quantitative limits to the share of housing or other real estate loans within lending portfolios. This is the case in a number of countries: UAE-- the banking law restricts real estate loans extended by commercial banks to 20% of deposits[41]; Qatar; Oman-- residential mortgages may not exceed 10% of the banking book; Jordan-- 20% limit on real estate loans; and Egypt--5% of commercial bank loans. This approach is rudimentary and does not address risky lending practices. It is helpful to limit the concentration risks of an individual bank, but because caps do not generally apply to specialized non-deposit taking entities, they miss the main area of concentration risk. An indirect lending restriction may come from prohibiting (conventional) financial institutions from directly holding properties, except for their own use. This is the case in Lebanon, where reposed collaterals must theoretically be resold within 2 years or be subject to heavy provisioning charges.

Lending standards

A more efficient alternative to setting quantitative limits on housing loans is lenders adhering to sound underwriting norms. This approach can combine development with stability objectives. This has been the trend internationally in the aftermath of the subprime crisis, and the MENA region is fairly advanced on this path, with specific prudential rules for mortgage lending in several countries. The main lending criteria of such a framework should be

---

[38] A. Al-Hassam, M.Khamis, N. Oulid: "The GCC Banking Sector: Topography and Analysis," IMF Working Paper April 2010

[39] August 2008 law promoted by the Dubai Real Estate Authority

[40] 150% for commercial real estate, 100% for retail loans (including housing loans)

[41] But by definition, no restriction exists on specialized, non deposit taking institutions

to ensure the capacity to repay and avoid over indebtedness. Several regulatory regimes have been imposing affordability checks, either as a principle (Lebanon), or through hard limits to debt service-to-income ratios, generally at 25% or 33% (KSA, Egypt, and Kuwait). Kuwait is probably the most drastic example with respect to debt service-to-income ratios. Strict provisions exist with the dual purpose of protecting consumers and limiting credit risks incurred by lenders. Loan amounts are now limited to a low level[42] and a 40% ceiling is imposed on debt repayment-to-income ratios[43]. In Egypt, the Mortgage Finance Authority (MFA)[44] has been promoting sound lending standards, which include a down payment requirement (10% minimum), Payment to Income ratio limits (40% in general, 25% for lower income borrowers)[45] and the obligation to verify incomes. Lenders have been encouraged by the Central Bank to access borrower credit history through the newly established credit information platform.

Other norms or guidelines include Loan-to-Value limits, which should be assessed on an on-going basis, as they are in Lebanon[46]**.** This parameter is a component of the Basel II framework through its impact on asset risk weightings. In a few cases, regulation prohibits lending to speculative investment (Kuwait, Lebanon).

There have been recently further developments in enhancing lending regulation, including consumer protection requirements. In the UAE, the Central Bank began drafting new mortgage lending regulation and consumer protection rules with respect to financial services at the end of 2009. The upcoming mortgage law in KSA should include provisions preventing lending beyond borrowers' repayment capacity.

Lenders tend to follow conservative lending policies in many MENA countries anyways, regardless of prudential regimes. In particular, salary assignment is a widespread practice that enhances the security of lending, although it excludes large segments of the population from housing finance.

Commercial real estate loan regulation contrasts with retail lending regulation. Commercial real estate loans are a riskier type of lending and oftentimes a more substantial part of banks' portfolios, but they are in general lightly regulated. Egypt has designed a specific framework for developer finance with components that could be replicated elsewhere in the region. It includes a requirement for a title check and an assessment of a developer's standing by lenders. Ancillary service providers, such as appraisers and brokers (a category that played a significant role in the sub-prime debacle in the USA), are also regulated and supervised by MFA. Lebanon also imposes lending standards for developer finance.

5.7 Real estate lending supervisory structures

Real estate lending supervisory structures are essential to making prudential frameworks effective. As seen in the USA's subprime mortgage crisis, the division of the supervisory functions between banks and non-banks can hinder an efficient prudential framework, all the more so when specialized institutions (e.g. Saudi Arabia, Egypt initially, UAE, West Bank & Gaza) are either lightly regulated, or overseen by non-financial Authorities

---

[42] KD 70,000 or USD 250,000.
[43] Housing and consumers loans are consolidated for the application of these limits
[44] now part of the Egypt Financial System Authority
[45] However, these limits have been set by law, which is a potential source of rigidity
[46] In Lebanon, since most types of residential loans are excluded, the limits de facto apply mainly to developer loans

(e.g. Ministry of Commerce in Saudi Arabia currently). This division induces regulatory arbitrage, may split the market between different degrees of discipline and prices, and often affects the information needed to adequately monitor market developments. In the UAE, Amlak and Tamweel were lightly regulated despite their systemic importance – they held the majority of the mortgage portfolios in the Union.

Improving the oversight structure is an objective throughout the region, although countries have approached reform in a variety of ways: (i) the integration of supervisors, such as in Egypt, although the separation from the banking Authority has raised some issues; (ii) coordination between supervisors, such as in Palestine, where an MoU between the Capital Market Authority and the Monetary Authority will harmonize the regulatory environment of the two kinds of lenders[47]; and (iii) repatriation under the umbrella of the bank regulator, as included in Saudi Arabia's draft real estate finance law.

6. Funding Constraints and Asset Liability Issues in Housing Finance

Funding is a major constraint to residential mortgage lending. Long term maturities enable households to afford a large investment by spreading its cost over many years. But long maturities are generally difficult to match on the liabilities side, which exposes lenders to liquidity risks as well as interest risks when loans are offered with fixed interest rates.

6.1 Liquidity strains

Liquidity strains are high in the GCC and low in most other MENA countries. A clear division exists in the region regarding the liquidity of banking sectors. Liquidity easiness prevails in countries such as Algeria, Jordan and Egypt. This first group has low loan to deposit ratios – typically around 50%. Financial institutions that control a large excess of savings through their deposit bases have little incentive to raise more costly resources from the capital market, even in the long term. In a second group, loans to deposits ratios are close to, or exceed 100%. With the exception of Morocco (92% at the end of 2009), these countries belong to the GCC[48], the highest ratio being in the UAE--136% at the end of 2009[49]. Because bond markets are so little developed in the GCC, liquidity shortages are traditionally covered by foreign borrowing.

6.2 Fixed rate lending

Fixed interest rates generally prevail and match demand in MENA. This reflects a sort of "benign neglect" in the least developed markets, where the size of open interest rate positions is too small to become a concern. Furthermore, fixed rate lending is often imposed by regulation, or quasi regulation, aimed at consumer protection, particularly regarding lower income borrowers. In Kuwait, stringent restrictions are set by regulating interest rates[50]: their level cannot exceed the Central Bank's discount rate by 3%, they must be fixed for at least 5 years, and their re-setting is limited to a 2% variation band. In Oman, interest rates on mortgages are variable and a cap of 8% applies. In Tunisia, a 2007 Central bank regulation requires that housing loans of more than 15 years maturity be extended at a fixed rate (Box 3). In Morocco, fixed rates are eligibility criteria for the credit default guarantee of FOGARIM, while in Egypt

[47] Which will allow in particular specialized lenders to access the credit bureau maintained by the bank regulator, PMA
[48] Despite regulatory limits for loan-to-deposit ratios in several GCC countries
[49] Calculations exclude deposits by government and foreign banks
[50] The maturity of housing loans is moreover limited to 15 years

loans extended as part of the National Housing Plan carry fixed rates. These typical mortgage asset profiles cannot in most cases be mirrored by the resources that support them. When mortgage lending represents a significant portion of banks' portfolios, this mismatch ends up affecting the stability of banking systems, as illustrated by Morocco, where 70% of residential mortgages carry fixed rates.

In the absence of hedging instruments, such as interest rate swaps or options[51], various techniques are used to mitigate interest rate risks when lending regulation permits. Some of the techniques include:

- *Adjusting the otherwise fixed rates of mortgage loans to reflect significant movements of internal sources of funds*. A common practice in the region – e.g. in Algeria, Jordan, and recently in the UAE -- is to include in loan agreements the right of lenders to adjust the conditions of on-going loans to this Cost of Funds Index (COFI) at their discretion. This allows them to optimize the trade-off between interest rate and indirect credit risk that too steep interest increases would generate. This is achieved at the expense, however, of the transparency of the index and the control of the validity of the changes;
- *Offering benchmark-based variable rate loans*. This method ensures transparency to customers, but restricts the maneuvering capacity of lenders. For this reason, virtually all UAE mortgage lenders switched out of EIBOR based mortgage loans in 2009-2010 to return to the COFI approach. The choice of the benchmark is critical to avoiding undesirable consequences[52]. Short term references tend to be volatile, and significant swings can affect the ability to pay of numerous borrowers. In Morocco, the more stable Treasury bond index was used, but the government reduced the issues of long term debt (however needed for bond market development) to avoid making housing loans more expensive. The reference was changed to the average daily money market rate on a 12 month period, which is a good way to smooth unwanted volatility. This solution was already used in Tunisia[53];
- *Attracting more stable savings at pre-determined conditions by linking them to housing loans*. This is an option for lenders that are also savings banks (Algeria, Tunisia and Iran). This solution can, however, create new liquidity and interest rate risks if the conditions for future lending are pre-set. The Iranian housing bank, Bank Maskan, offers this scheme, which allows a multiplier of up to 7 between accumulated savings and the resulting loans. Maghreb housing banks avoid these risks by simply offering savers conditions based on the general ones at the time of borrowing, with a discount. The future mechanism in Morocco should set this principle in the regulation, by requiring lenders to price housing loans following a savings phase at least 50 bps under the prevailing conditions at the time of borrowing. ;
- *Raising funds from the capital market where institutional investors normally have symmetrical needs of fixed income investment opportunities*. When the capital market only offers medium term maturities, rates can be periodically adjusted – typically every 3

[51] Morocco is the first country to take a step in this direction by preparing the creation of a interest rate future market

[52] The hypothesis of caps is not considered here since building such protection requires the availability of derivatives

[53] In Tunisia the adjustments of variable rates are subject to usury law type of limitations – an increase may not exceed by more than 30 % the rate applicable during the previous period

to 5 years- according to the refinancing conditions of lenders. This is the strategy employed in Algeria and Jordan for loans funded by the respective liquidity facilities.

Foreign exchange risk in mortgage lending, as the other form of possible market risk, is limited to a few countries. Mortgages denominated in hard currencies--in practice US dollars--are mostly used in Lebanon for non-subsidized loans and West Bank and Gaza. This practice reflects the nature of lenders' funding. The exchange risk is, however, transferred to customers, who are generally paid in local currency.

6.3 Capital markets

Capital markets still only provide a marginal contribution to the extension of housing finance in the region. The limited size of institutional investors' bases and the lack of market infrastructure prevent bond markets from providing adequate funding solutions for long-term lending. Morocco has the most promise in this respect, both on the demand side-- loans-to-deposits ratios are high, and the fixed rate is quite widespread-- and the supply side -- Morocco has the most developed NBFI system in the region[54]. The volume of assets managed by insurance companies alone was MD 131 billion in 2009, and is equivalent to the housing finance market. Investments are now up and strongly biased towards stocks, partly as a result of a lack of appropriate fixed income investment opportunities. Moroccan pension funds amass a large amount of savings (20% GDP), despite using a pay-as-you go mechanism, thanks to their policy of pre-funding liabilities.

Funding instruments which link lenders and bond investors exist in most countries but are still under-developed. The most significant are explored further.

Securitization:

Securitization is in its nascent stage in the MENA region as a result of a number of structural issues. Morocco and Tunisia were the first countries to develop a securitization legal framework (1999 and 2001 respectively) [55], but the actual usage of the instrument has been limited: 3 transactions occurred in Morocco (US$150 million total), 2 in Tunisia (US$80 million), and by a single institution in both cases. The subprime crisis unfolded shortly after the first deals surfaced in both countries and contributed towards stalling the market, but its interruption also reflects more structural weaknesses. The following weaknesses have contributed towards a global confidence crisis towards securitization: (i) insufficient transparency, including the lack of historical data series on housing prices and other indicators; (ii) risk valuation difficulties, aggravated by the absence of rating agencies (Morocco) and hence pricing inconsistencies; and (iii) flaws in transaction structures - e.g. concentration of roles by the originator with possible conflict of interest (Tunisia).

Sometimes, demand for securitization may exist, but the legal framework is not in place (e.g. Jordan and Oman). In general, the complexities and the cost of the instrument make it seem premature in many markets. Algeria chose an intermediary path: it facilitated the sale of portfolios to the mortgage refinance facility SRH (see Box 5).

[54] Their assets are equivalent to GDP, a very high ratio relative to the country's income level

[55] In Morocco, the framework was revised in December 2008 to better adjust to markets needs, and include new options such as multi-seller or rechargeable structures and more flexibility.

Securitization grew, however, in the Islamic sector, and Sukuk issuances in USD from GCC institutions on the international (largely regional) capital market[56] increased substantially in 2001-2008. Sukuks are in fact intermediate instruments between secured bonds and securitization: their holders have a beneficial interest in the underlying assets ("asset based"[57]), with recourse against the issuer in case of defaults. True sale structures with transfer of ownership ("asset backed"), are however, possible. They have been done for mortgages in KSA. In the UAE, a securitization conduit, Emirates National Securitization Corporation, was established in 2005 and arranged a few properties-based Shariah compliant securitization deals. This impetus came to a halt in the middle of 2008, as a consequence of the global confidence crisis towards asset based instruments, the defaults on two Gulf Sukuks, and contestations about the real adherence of some aspects of securitization to Islamic principles.

Centralized mortgage refinance facilities

Centralized mortgage refinance facilities have been developed with relative success in the region. These facilities pool mortgage-lender funding needs, refinance portfolios that are usually pledged with significant overcollateralization, and issue matching bonds in the market. The advantages of the model are its simplicity, the scale effect it generates, and the credit enhancement its intermediation represents vis-à-vis individual issues, since these entities are essentially a joint undertaking of primary lenders with some form of state-support. Centralized mortgage refinance facilities therefore raise capital on behalf of lenders, especially small ones, which would otherwise either have not had access to the capital market, or had access at much more expensive conditions. Such institutions were established as early as 1995 in Jordan, 1997 in Algeria, and more recently in West Bank Gaza and Egypt (EMRC has been operational since 2008). Their experience demonstrates their potential catalytic impact on market development quantitatively – in Jordan the number of active lenders went from 1 to 8 thanks to JMRC-- and qualitatively – liquidity facilities set quality standards for the loans they refinance. For this reason, they receive government backing through equity participation, the favorable prudential status of the loans they refinance (Jordan) and of their bonds, as well as tax exemptions for their bondholders (Jordan, Egypt).

Covered bonds

Covered bonds have yet to be considered in the region, although they are decentralized and simpler than securitization. They require a strong legal framework that waives some bankruptcy law provisions, a relatively high level of activity by individual originators, and mortgage lenders of high standing. [58] Morocco is preparing a framework for covered bonds with the World Bank's support and is the first MENA country to develop this instrument.

Asset-liability mismatches

The risks generated by asset-liability mismatches (ALM) are not systematically taken into account by prudential frameworks. Prudential regulation should theoretically limit ALM, but rarely does so in the region. Some countries that have attempted to limit ALM include

[56] Sukuks do not have necessarily a strict securitization profile. The first true sale sukuk was issued in 2007 by Tamweel

[57] See Sukuk and Islamic Capital Markets: a Practical Guide C.Boyle, J. Moore editors Globe Business Publishing Ltd 2011

[58] Contrarily to securitization, holders of covered bonds are primarily exposed to the issuer's credit risk

Algeria, Jordan and Tunisia. Algeria's Central Bank requires at least 60% of long term loans be funded by stable resources. In Jordan, regulatory incentives are given when lenders refinance their activity with JMRC.[59] Tunisia passed very precise rules in November 2007, which include not only maturities matching requirements, but also require a fixed interest rate for the longest housing loans (Box 3). The latter stipulation illustrates the trade-off faced by lenders and regulators between consumer protection and financial stability objectives. But in fact, fixed rate requirements create financial risks without instruments managing financial risks, and can be counterproductive. This may be the case in Tunisia. Despite the increase in bond issues by banks as a result of the new regulations, some lenders have considered shortening housing loan maturities in order to comply with the new stipulations.

Bank regulators can adopt a more pragmatic approach than setting regulations that are hard to meet. For instance, the Bank of Algeria considers on a case-by-case basis whether to classify deposit bases as a stable and long-term source of funds, when it is implementing the aforementioned long-term loan transformation limit[60]. Regulation could also be principle rather than rule-based ("Pillar II" in the Basel II framework), and incorporate internal control and reporting to supervisors when dealing with financial risks. This is the approach chosen by the Moroccan Central Bank, which issued in April 2007 detailed instruction on interest rate risk management letting lenders, without defining mismatch limits or specific capital charges. Bank Al-Maghrib oversees financial risks case by case, also evaluating the run-off rate of deposits to assessing liquidity risks.

Box 3: Regulation of Housing Loans in Tunisia

(Central Bank Instruction 87-47 as modified in November 2007)

-Loan To Value Ratios limited to 80%
-Loans maturities limited to 25 years
-Long term liquidity matching requirement: housing loans longer than 10, 15 or 20 years must be funded by resources with maturities of at least 10, 15 and 20 years respectively
-Interest rate of housing loans longer than 15 years must be fixed
-Conditions of loans based on contractual savings for housing schemes are free

7. Deepening the Housing Finance Market

Affordable housing shortages in MENA affect the living conditions of a large portion of the lower and middle income population. For instance, it is estimated that yearly shortages amount to 150,000 units in KSA and 280,000 in Egypt[61].

7.1 Deepening the housing finance market from the supply side

Addressing housing shortages first depends on the supply side. Strong obstacles often prevent the development of affordable housing, including certain land policies, markets, construction costs and developer strategies. Public finance is often used to offset high price-levels, which is unsustainable if price increase is driven by demand-supply gaps. Not only does

[59] Loans refinanced by JMRC benefit from a low risk weight (20% as against the general rule of 75%), they are excluded from the 20% lending ceiling, and lighter provisioning rules apply
[60] 20% in the case of one of the major deposit taking institutions
[61] The shortage in Egypt, like in other countries, does not exclude a large number of vacant units. This is due in particular to mismatches between supply and demand, and by the impact of restrictive landlords/tenants regulations

such a policy result in inefficient fiscal expenditures, but it can perpetuate imbalances if the factors causing high prices remain unremedied because of the purchasing power injected by governments.

The first remedy to housing shortages should stem from government policies, particularly in the area of urban planning and land management, which should aim for inclusive urban development. In the UAE, for instance, developers and urban policy makers have become acutely aware of concentration risk and the need for commercial diversification in light of the recent real estate crisis. In Abu Dhabi, the Urban Planning Council decided in 2010 that all developments above a certain size must include rental options for middle-income population sector. Some large developers, who had been focusing on the top end of the market, initiated beginning in 2008 a re-orientation towards less risky moderate income segments.

7.2 Deepening the housing finance market from the demand side

Housing supply cannot increase if adequate financial resources are not available to making potential demand effective. Financial systems often fail to provide such resources to lower income categories, or to households active in the informal sector. Many lenders, especially foreign controlled institutions, mainly serve the top of the income pyramid. Products are not always suited to the needs of lower middle income groups (e.g. short amortization periods) and there is a general lack of loans for self-construction projects.

Governments must first provide the enabling environment for financial institutions to extend affordable and well secured loans –i.e., facilitate long maturities and efficient collateralization. But a more pro-active role is needed to bring the financial system down market. Insurance schemes and guarantees are policy instruments that can help mobilize market resources for lower income groups and are analyzed below:

Insurance schemes

Mortgage default insurance has had mixed success in MENA. It has been developed in several countries (Jordan, Algeria, West Bank & Gaza, Egypt) and aims to help households with small down payments access housing finance. One challenge in developing effect mortgage default insurance has been the focus on high Loan-To-Value ratios as the main risk factor. However, LTVs are often low in MENA—they are not much more than 50% in Algeria or Jordan, for instance. Algeria overhauled its state-owned mortgage insurance by making loan refinancing with the SRH compulsory for loans with a LTV above 60%, and by establishing risk based premiums.

Guarantees

Income based guarantee mechanisms are more appropriate to inducing lending to lower income categories and informal sector households. Opposite to mortgage default insurance, such schemes take income as the main eligibility criteria, and normally define a “corridor” with 2 thresholds: an upper limit reflecting a policy decision and implying some government support to alleviate the risk assumed by financial institutions; and a lower limit ensuring the borrowers’ capacity to repay, which is the responsibility of the lender, but sometimes with government-set norms. The Moroccan FOGARIM illustrates this approach and provides a very interesting example of a credit support scheme to informal sector borrowers (see Box 4). FOGARIM insures over MAD 9 billion[62] mortgage loans to low-income and mostly irregular income borrowers. This is about 7.5% of the overall market for a segment that had been ignored by the banking system until 2005. 4 banks actively participate in the program. The delinquency rate among guaranteed loans is, as expected, higher than the market average -slightly over 7% compared to 4.9%, although by the time the guarantee can be enforced, the rate falls to 3 to 4%. Arrears are especially high in the first months of loans granted to relocated slum dwellers (program "Villes Sans Bidonvilles"), evidencing the inadequacy of inflexible installments for independent, low income workers, as well as moral hazard in some relocation developments.

Box 4: The Moroccan FOGARIM Guarantee Scheme for Low Income Housing Finance

Created in 2004, FOGARIM primarily targets low-income households with irregular earnings. It provides guarantees covering 70 percent of mortgage loans. Given the type of income, the main selection criteria are prices (limited to USD 25,000), and the level of monthly installments, capped at about the equivalent to USD 200 (upper income threshold) and 40% of the households' income (lower threshold). Guarantee can be enforced after 9 month arrears, and once the foreclosure process has been initiated. After an initial phase where guarantees were granted for free, FOGARIM switched to a risk-linked premium system, where the amount of premiums is inversely linked to the size of the down payment.

In 2009, FOGARIM was merged with another guarantee fund that targets moderate income civil servants, middle class independent workers and non-resident Moroccans buying or building houses up to USD 100,000 in value.

The consolidated fund, Damane Assakane, was guaranteeing MAD 9.3 billion at the end of 2010 (USD 1.2 billion), while its own funds amounted to MAD 0.95 billion.

A reform of the guarantees has been underway in 2011. In the "social housing" compartment, the ceiling of prices has been lifted to USD 31,000, and the maximum monthly installment to USD 300. For other categories, the price ceiling should be removed but the guaranteed amount capped at USD 50,000. Claim processing will be overhauled, with payment first and validity checks afterwards.

However, if not carefully designed, guarantee schemes may increase risks by inducing moral hazard and creating the false impression that the risk is reduced by being transferred to governments, while the exact opposite can happen. The prospective risk burden must be regularly evaluated, to make the conditions of actuarial soundness clear and to charge risk-based premiums – even if governments can assume part of them. Originators and servicers should retain a significant share of the risk.

7.3 Housing finance subsidy challenges

Housing finance subsidies face two main challenges: accurately targeting beneficiaries and leveraging financial resources. Housing finance subsidies also have a dual function: they assist households who are creditworthy but need support to invest; and subsidies also, as stressed by Marja Hoek –Smit[63], provide behavior changing incentives to consumers and lenders in order to achieve specific goals. Experience shows that subsidies programs can distort the market and reduce the overall supply of finance, instead of stimulating it and efficiently helping the groups they were meant to serve. This is often the case when subsidies are distributed exclusively through closed channels; are attached to lending conditions –the more a household can borrow,

---

62 End 2009

63 In "Housing Finance Policy in Emerging Markets," L. Chiquier and M. Lea editors, The World Bank 2009

the more subsidies it receives-; or are located too far upstream in the value chain, allowing them to be captured by intermediary players.

Most countries have or have had inefficient subsidy programs, but governments have progressively developed direct demand subsidies, which can better target and remain neutral in the lending market structure. The following countries have made some progress:

- *Jordan* was a path breaker in this area in 1998-2000. Institutional subsidies to the housing bank were removed and replaced by demand side subsidies associated to loans from any bank, and are linked to criterion including social conditions and a requirement of prior savings.

-*Algeria* comprehensively overhauled its subsidy policy along similar lines as Jordan during a major liberalization of its financial system (Box 5).

-*Egyp*t is in the process of instituting direct demand subsidies to replace an inefficient housing supply subsidization system (Box 6).

-*Lebanon* offers a good model for leveraging bank lending, thanks to an open subsidy mechanism. A government owned Public Fund for Housing established partnerships with banks, through which it advances the payment of interest due by borrowers to lenders over a 15 year period, and then recovers this advance from borrowers from year 16 onwards. 28 banks have agreed to participate in the scheme.

Box 5: Algeria Main Housing and Mortgage Subsidy Schemes

There are 4 main housing assistance programs in Algeria :

- *Social rental housing* targets the lowest income groups (income below 1.5 times the minimum wage). Most of the stock belongs to the government, which has outsourced its management to specialized agencies. Land is provided for free and construction is financed by budgetary resources. Rents are well-below market level, and tenants have the right to stay at the end of a lease, and can even transfer this right to their heirs. As a consequence, turnover is very low – even when tenants' incomes have increased-- and incentives to develop an intermediate market segment of affordable housing are stunted. Also, rent levels often do not allow adequate maintenance, and delinquency rates are high. A lease-to-own option is in place, with moderate success.
- *Social Participative Housing Program* aims at ownership housing for households earning up to 5 times the minimum wage. An upfront subsidy is allocated subject to price limits, and land is provided by the government at deeply discounted conditions.
- *Lease-to-Own Program* is for households with little down payment. Serviced land is provided for free, and finance (distributed only by the government owned CNEP) is subsidized.
- *Rural Housing Program* is for rural areas and upfront subsidies are available for renovation or housing. No borrowing from banks is required and there are no income conditions.

There is in additional program to assist slum re-development.

As part of the 2005-2010 economic plan, the government initiated a one million unit construction program, including 120,000 rental accommodations, 315,000 intermediary owner occupied dwellings, 275,000 rural houses and 310,000 'free market condition' units –a goal that faced difficulties because of the rapid price increase in the small free land market.

Box 6: Developments in the Egyptian Mortgage Subsidies System

The Government of Egypt has in the past provided a range of subsidies through numerous programs. Housing subsidies, from both national and local government, have traditionally targeted the supply-side and benefitted developers – most recently in connection with the 2005-2011 National Housing Plan. In addition, implicit housing finance subsidies have been extended through below market interest rates on mortgage loans issued by government banks and on construction loans. Because the financial system does not serve moderate or low income households, this system resulted in a high level of ill-targeted subsidies.

In 2006, a new small scale experimental mortgage-linked subsidy scheme was launched by the Guarantee and Subsidy Fund under the Ministry of Investment. This is a demand side, upfront subsidy of LE 15,000 to low and middle income households who take out a mortgage loan for a new or existing house, priced below LE 95,000. The subsidy is meant to reduce the down-payment requirement or, in case the household can contribute more than the required down-payment, the subsidy can be applied to the loan amount.

A new program was then designed, building on lessons from the NHP and the experimental GSF program. It intends to gradually replace the supply-side subsidy approaches to housing delivery for low and middle income groups by improving and expanding GSF's mortgage-linked demand-side subsidy program.

A system of direct subsidies to households meeting transparent criteria will progressively replace subsidies to developers and distortive subsidized lending by government banks. GSF will stop acting as a developer of low/middle income housing, but rather focus on the implementation of the new subsidy program. This new program is currently still in its development phase.

Source: World Bank, Project Appraisal Document 2009

8. Main Findings and Policy Implications

For the past decade there has been an effort to develop market-based financial mechanisms to address substantial housing needs in MENA. The need to foster lending led to the progressive strengthening of legal and institutional infrastructure, and the awareness of credit risks encouraged countries to adopt valuable prudential measures, which played a role in limiting the impact of the 2008-2009 global crisis, particularly the Dubai real estate bubble burst. There have also been improvements in funding mechanisms, developed generally with government support, to help lenders raise long-term resources. In addition, new public policies without state controlled mechanisms have been designed and implemented to help lower-income groups access housing finance.

Progress in developing these market-based mechanisms, however, is still ongoing. Public intervention has traditionally been high in MENA compared to other regions, as a result of a number of factors, including large public land holdings, oil wealth, distorted housing prices, and a weak developer industry. State intervention can be more efficient and better targeted. Market deepening is in an initial phase in many countries and coverage gaps are still very large. The understanding of real estate risks and of the interaction between exogenous investment and the global market equilibrium is limited, partly due to the lack of appropriate monitoring systems limiting the capacity of governments to counterbalance price distortions that result in social exclusion and pose a recurrent threat to financial stability. The trade-offs between policy goals for lending security, improving access, reducing funding constraints, and consumer protection remain to be comprehensively assessed and addressed. What follows is a series of recommendations to help foster the sustainable development of the housing finance market. Needless to say, deepening this market also implies developing upstream policies to promote the availability of affordable housing. Particularly crucial in this respect is the availability and the price of urban land, a stringent constraint. in many countries, both GCC and non-GCC. .It is important that governments : allocate more efficiently the large tracks of land they own themselves; promote orderly and efficient urban expansion through adequate planning - possible references being given by the new towns or new districts projects developed in Egypt, KSA or Tunisia; and curb speculative pressures through adequate regulatory or tax measures aimed at limiting the retention of idle land or sharing the wealth creation induced by urban expansion.

In this respect, the objective of larger access meets the prudential concern of preventing or mitigating price bubbles that can have devastating effects on the stability of banking systems. "

8.1 Improve the transparency of real estate markets

To improve the quality of real estate market information and reduce uncertainty, governments should consider:

- *Developing price indices*, using information from land registries in particular, including prices by unitary units (square meter/foot, room) and controlling for quality and location factors;
- *Strengthening housing demand analyses* by building income distributions data bases and disaggregating demand by resident/non-resident status, price segments, geographical areas, etc.;
- *Creating real market observatories* to monitor market equilibrium indicators, such as the on-going and future delivery of new units, vacancy rates, sale speed of new developments, etc.;

- *Strengthening the capacity and independence of the appraisal industry*. While it is difficult to perceive turning points in market value trends, norms should be set to avoid the extrapolation of price increases for lending purposes, and to ensure the independence of valuers vis-à-vis both lenders and borrowers

These reforms are particularly important for commercial real estate and developer finance, given the significant impact leads and lags between demand and supply can have on market equilibrium.

8.2 Create mortgage lending data bases for the housing sector

A comprehensive knowledge of mortgage lending is critical for policy makers, lenders, guarantors and investors to price risk accurately. Financial Authorities should consider:

- *Improving statistical information* available to supervisors by distinguishing mortgage loans between real estate and other (SME finance) purposes, and classifying mortgages as residential, developer, or commercial.
- *Tracking new lending by vintages*
- *Monitoring, by annual cohorts, LTVs, Debt Repayment-to-Income Ratios and NPLs.*

8.3 Strengthen mortgage market infrastructure.

While registration systems have often been made efficient and reliable in many MENA countries, their scope often remains limited. Important investments need to speed-up their geographic coverage. Transaction cost can be excessively high and encourage dissimulation and informalities, fueling the difficulties in assessing real estate market risks and affecting the ability to fund infrastructure.

Enhancing the credibility of property collateralization, including for residential real estate, is a general requirement in the MENA region. Cultural behaviors make foreclosures and evictions difficult in most countries. But it is of utmost importance for developing the supply of finance that this last resort instrument have an actual impact on credit discipline. The efficiency of mortgage rights is not only a matter of expedient processes and operational capacities of judges and enforcers of judicial decisions; it also implies the ability of lenders to distinguish between good faith and willful defaulters and to develop loss mitigation policies, as well as a consumer protection framework aiming at borrower awareness and including safeguards against abusive claims.

8.4 Strengthen prudential frameworks

Global and regional crises have demonstrated both the value of prudential frameworks and the deficiencies that remain specific to housing finance. Such tools can be targeted sectoral alternatives to interest rate adjustments, particularly in countries where the flexibility of interest rate policy is limited by the foreign exchange regime. Rules or principles at micro (lending guidelines) and macro levels can be developed along the following lines:

- *Emphasizing affordability assessments*, especially for low income groups, by including budget/net surplus analyses, instead of simple debt-to-income ratios;

- *Developing lending standards for informal sector households*, including prior savings requirement income evaluation by lenders using savings habits, economic surveys, profitability analyses, etc., and the centralization of information by credit registries;
- *Designing a prudential framework for commercial real estate and developer finance*
- *Systematically preparing a counter-cyclical use of prudential measures* by adjusting parameters including LTV limits; the risk weight of differentiated types of loans; and provisioning requirements, particularly through the admissible valuation of collateral, to the context prevailing in real estate markets. These parameters should be disaggregated by type of underlying asset and geographic area. The relatively limited impact of recent real estate crashes in GCC countries, Jordan, and Egypt has demonstrated the effectiveness of prudential tools. Such adjustments are essential to fighting price bubbles and their effectiveness requires a reliable real estate information system;
- *Introducing portfolio level prudential norms* incorporating diversification standards that are more relevant and precise than a simple cap on real estate finance globally. This should apply in particular to Shariah compliant lending.
- *Mandating stress tests at origination for certain types of loans, such as floating rate and foreign currency denominated mortgages*. Stress tests should be ongoing and conducted periodically to assess the impact of financial and real estate market shocks on mortgage portfolios.

8.5 Develop and modernize the framework for mortgage related securities

Bond markets are underdeveloped in the MENA region and are not expected to significantly contribute to housing finance in the short term. However, it is still important to develop them as a funding instrument. For investors, the diversification of investment vehicles and the availability of well-secured, long term instruments can attract resources and contribute to market deepening. While the growth of finance for housing requires long term maturities and as much fixed interest rates as possible on the demand side, such loan features create an unsustainable risk on the supply side if offered in absence of tools to match assets and liabilities .

Issuing mortgage related securities is a good way of limiting interest rate mismatches if hedging derivatives are not available. The type of security depends on market capacity and acceptance. Central mortgage refinance companies are particularly well suited to markets in an early stage of development-- with limited origination, small lenders, investor demand restricted to simple bonds-- because they can play a catalytic role. Mortgage covered bonds are decentralized instruments that are a little more difficult to value and require a more developed environment and an excellent standing of individual issuers. MBS are a more complex instrument which, in the aftermath of the global financial crisis, must demonstrate a high degree of transparency and security to be acceptable to investors.

A regional mechanism channeling long term resources towards housing investment is an option for GCC countries that have pegged their currencies to the US dollar. Such a mechanism would allow countries to shape their own housing policies, but would set loan and lender eligibility standards. The best structure is likely a liquidity facility that would issue high standing bonds and insulate investors from the risk of remote portfolios. This facility could focus on Shariah compliant securities, helping to standardize and buttress investor confidence in this component of the financial sector. The benefits of a regional facility for the stability of financial systems that currently rely on foreign capital inflows to fill loans/deposits gaps could be significant. However, sensitive issues, such as the implications of a mutual mechanism between different levels of oil wealth and the continuity of the foreign exchange regime, would have to be addressed. The Arab Monetary Fund could be a natural champion of such a mechanism.

Support from governments and Financial Authorities is essential for establishing a solid mortgage related securities market, in any context. This implies appropriate legal, tax and accounting frameworks, as well as prudential rules for investors. Another condition for success is ensuring a minimum degree of liquidity to the market for mortgage securities – this is key to the funding and liquidity management of mortgage lenders, and will become even more important in the new Basel III environment. To this end, the standardization of securities is a primary requirement. The lack of standardization is a significant impediment to the development of the Sukuk market, and conversely, the reason for the success of some refinance facilities. Valuation methodology, secondary market organization and the repo-ability of securities meeting clear quality standards are equally important and should be part of a development strategy for a mortgage related securities market.

8.6 Develop prudential norms for the management and mitigation of liquidity and market risks.

Asset liability mismatches must be contained for stability reasons, but regulators cannot ignore real financing constraints or other objectives. Developing the provision of finance and avoiding "time bombs" by passing on interest rate or currency risk to borrowers, are among several important considerations. If the absence of funding or hedging instruments and the size of mortgage markets make fixed interest rates too risky for lenders, the use of variable rates (or in some cases, foreign currency denomination) maybe the only realistic answer. It is the role of prudential regulators, however, to strike a balance between the various considerations.

The development of long term liquidity[64] and fixed-rate funding sources should be encouraged by regulatory incentives, in synchronization with the development of capital market solutions. This often implies a practice of fixed-- but adjustable, every 3 to 5 years for instance-- rates in the initial phase of development. Depending on the national circumstances, incentives could be merely principle-based, with the requirement that lenders be able to: measure and monitor their exposure and test stressed scenarios; be linked to additional capital adequacy requirements; or be enshrined in compulsory rules general or individual. In the latter case, an important factor would be if and to what extent deposit bases can be considered stable and fixed rate resources.

If only variable rates (or foreign currency denomination) are possible in the absence of funding or hedging instruments, borrower interest must guide a set of balanced prudential norms. For instance, testing customers' ability to repay in distressed circumstances, both at origination and on an on-going basis, should be a standard. Debt servicing ratios, and Loan to Value ratios should be limited to a lower level than allowed in the absence of such risk factors to avoid dangerous risk layering.

When using internal cost of funds references, regulators should stipulate they be transparently established and publicized. For instance, concepts such as "prime rates" for

[64] The new "Basel III" framework provides a model for realistically managing liquidity.

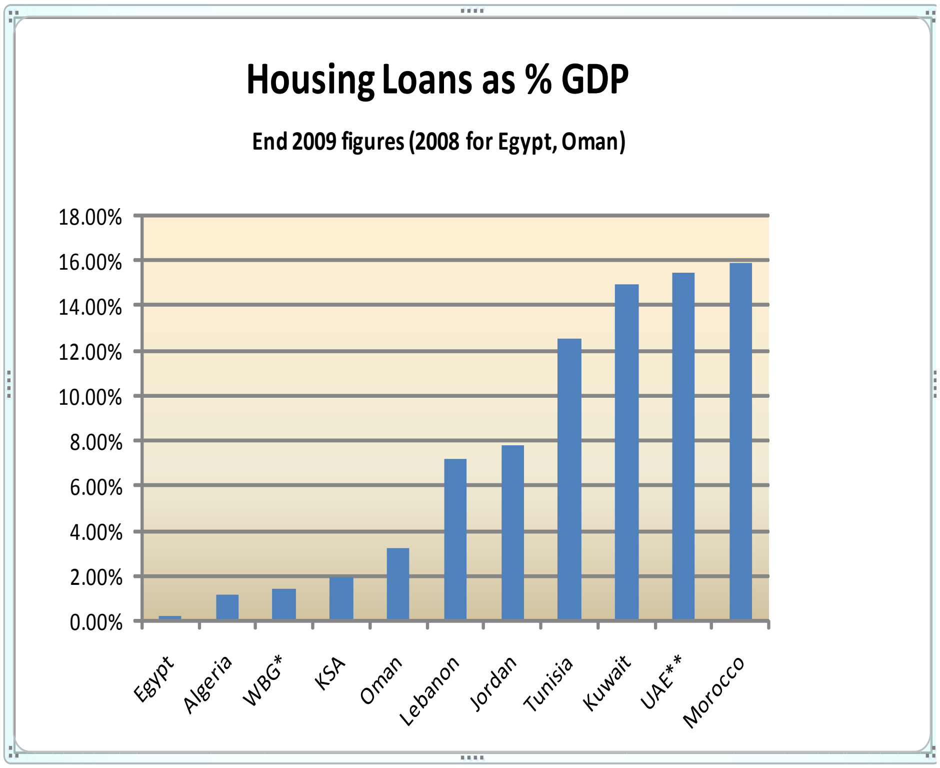
housing loans could be regularly published by each lender. If external benchmarks from interbank markets or central banks are used, lenders should be induced to smooth out the volatility that generally characterizes short-term interest rates.

8.7 Promote leveraging public support schemes by market resources.

Subsidy and guarantee schemes should mobilize market finance designed to limit the credit risk of lower income groups and make housing finance more affordable. They would multiply their impact and act as levers for channeling more resources towards the housing needs of lower income groups

Annex

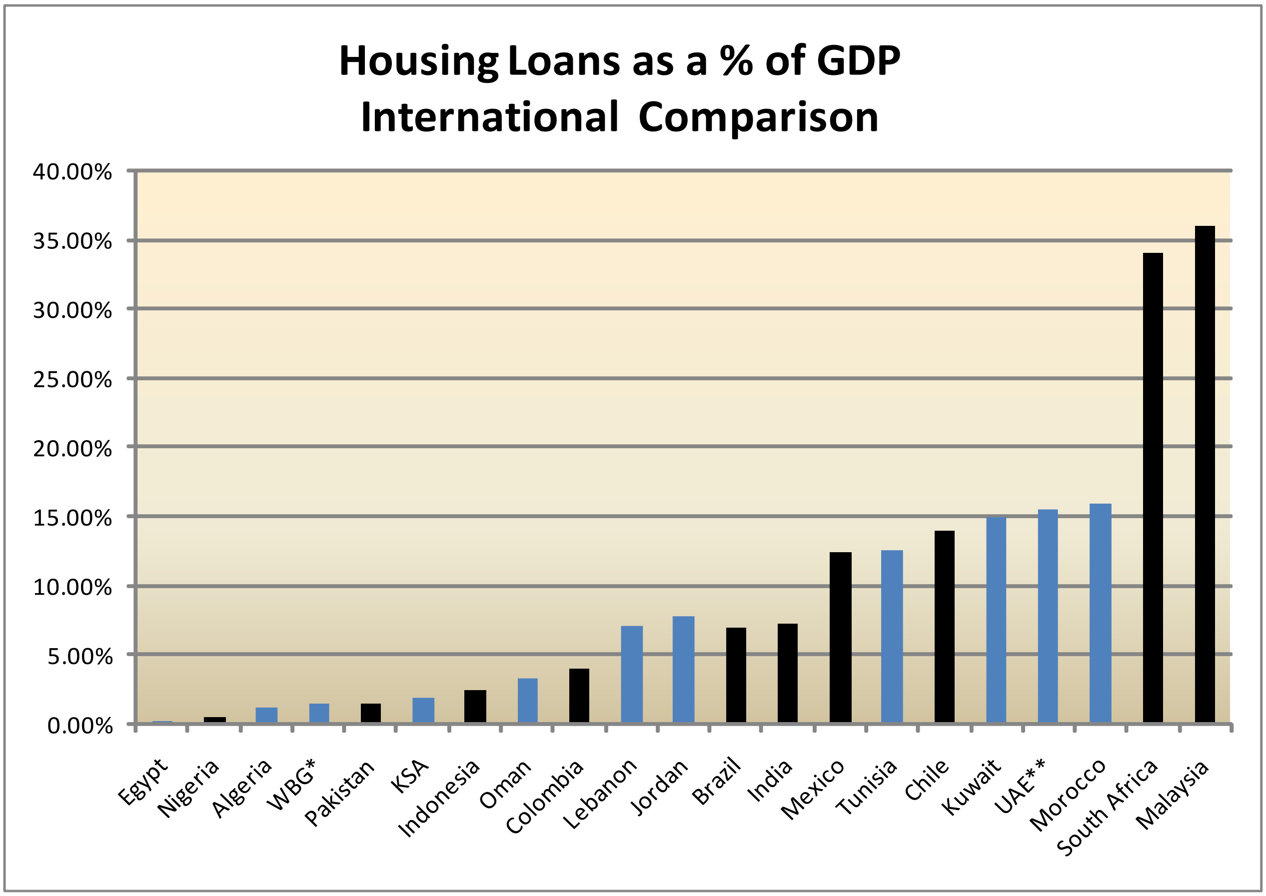
Figure 3: Housing loans as a % of GDP by Countries[65]



* World Bank estimation for West Bank & Gaza ** All mortgage lending

Figure 4: Housing Loans / GDP International comparison

[65] Sources: Central Banks, Fitch, World Bank


Housing Loans as a % of GDP
International Comparison
40.00%
35.00%
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
Egypt
Nigeria
Algeria
WBG*
Pakistan
KSA
Indonesia
Oman
Colombia
Lebanon
Jordan
Brazil
India
Mexico
Tunisia
Chile
Kuwait
UAE**
Morocco
South Africa
Malaysia