Building Mortgage Markets for a Revival of GCC Real Estate

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Excellencies, Distinguished Guests, Ladies and Gentlemen:

This conference on the "Real Estate Environment Post Global Economic Downturn" is not only timely but also provides an opportunity to discuss the challenges faced by the sector and propose new policy initiatives that can revive the sector. Allow me to congratulate the Dubai Land Department and RERA on convening this important conference. This is the time for action at a time of continuing global and regional turbulence and uncertainty. The DIFC is proud to be supporting this event.

During the past decade, the real estate sector has been a major contributor to economic growth in the GCC region, especially in the UAE and Dubai. However, the global financial crisis brought an end to the property boom. With low credit growth and without a resumption of bank lending, the strains in real estate and directly linked sectors such as the construction industry were destined to worsen. Without adequate financing, real estate will continue to be a drag on economic recovery, leading to lower growth than in other emerging market economies.

The demographic factor plays a key role in understanding the importance of the real estate sector in our region. The population of the MENA region is demographically young and fast growing, putting pressure on the housing market and on core infrastructure. In addition, there is a large and continuous influx of expatriates attracted by the economic opportunities. We should harness this demographic dividend to the advantage of our economies!

Pre-crisis Scenario

Pre-crisis, the reforms of property laws and higher incomes and wealth in the GCC economies increased the demand on mortgages from both the local and expatriate

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communities. However the availability, sources and instruments of housing and property finance have been lagging with only traditional lending institutions, such as commercial banks and finance companies, remaining the only source for finance facilities. In the previously booming UAE real estate market, for example, such institutions became increasingly exposed to the real estate market and faced maturity mismatching between the short-term sources of funds available, such as deposits, and the long-term funding requirements of real estate and housing.

The impact of the global crisis on the GCC manifested itself in plunging equity and real estate markets and a restructuring of real estate developers and companies. Real estate prices and rentals fell significantly, leading to a large reduction in yields on real estate investment and the correction was more pronounced in Dubai, where prices had risen more sharply.

While lower real estate prices and rentals are leading to a new equilibrium in the market through an increase demand, this can be a long and painful process. They are not a substitute for structural reforms and new policy initiatives. What we need is an upward shift in the demand curve in order to absorb the new supply coming on the market in 2011-2012 and beyond. The major issue that needs to be addressed is the lack of housing finance.

Need to Create Liquid Mortgage markets in the MENA/ GCC/ UAE

MENA mortgage markets are miniscule in comparison to international markets where the mortgage market as a % of GDP ranges from 93% in Denmark, 78% in the US, Spain at 62%, to 59% in Singapore, but only 13% and 6% in China and India respectively. Among the MENA countries, Bahrain tops the list at 15%, with Qatar and Kuwait at 8% and 6% respectively. UAE at 5% is comparable to Lebanon while Saudi Arabia is closer to the bottom of the pile at only 2%.

This variation across markets is a reflection of the underdevelopment of debt markets but also of different structural conditions and issues relating to restrictions on and lack of adequate protection of property rights (limited ownership rights, lack of transparency on property rights, large number of transactions conducted outside the formal deeds registration system), lack of transparency on the relation between property ownership and the right of residence, a weak or non-existent financial

information infrastructure (lack of credit bureaus, weak foreclosure systems), and a shortage of long-term finance (lack of securitisation and long term secured financial instruments, lack of liquidity facilities) among others.

A developed mortgage finance market allows households to smooth consumption, while easier access to housing finance leads to an increase the demand for housing. In order to improve marketability and create a mortgage market, several structural steps need to be taken.

1. To be able to market an issue to buyers, the mortgage security has to have standard terms (maturity, size, and interest or Shari'a compliant equivalent) that are familiar to market participants.
2. The small and variable denomination of individual mortgages needs to be addressed. One way to overcome such a handicap is to pool mortgages (with similar characteristics) together to create a standard large denomination.
3. Most important is to overcome the high cost of assessing the credit risk of individual mortgages. This task is not inherently complicated; however the credit risk analysis of the many individual borrowers in the pool would be costly and would severely limit the usefulness of the pooling process if not alleviated. To reduce transaction costs the issuer can seek third party insurance for the whole pool, or limit the mortgage pool to mortgages that are privately insured, or increase the loan-to-value ratio.

All of these steps are feasible. We have undertaken an initial feasibility study[2] for a Mortgage Securitization Project based on the long and successful experience of the Danish market model. The basic principles are as follows:

- **Balance**. The amount of mortgages and the amount of bonds in circulation used to fund those mortgages should always match each other.
- **Pooling**: Mortgages with same characteristics regarding maturity, interest rate, amortisation profile and risk profile are pooled together, and they are securitized by issuance of big series of mortgage bonds with characteristics corresponding to the mortgages.

[2] With VP SECURITIES A/S and Soros Fund Management

- **Mortgages are serviced by mortgage credit institution** which originated and is the issuer of the mortgages
- **Pre-Payment**. The Borrower is at any time entitled to make a full or partial prepayment of the mortgage
- **Separation of credit risk and interest risk.** An important consequence of using these principles is a complete separation of credit risk and interest risk, with credit risk remaining with the issuer of the mortgages

To take matters forward, we will be issuing a White Paper to raise awareness and for public comment.

Developing the primary mortgage market would provide financial resources to enable primary lenders to grant more loans at fixed rates and for longer tenures; help primary lenders to narrow the gaps between the maturity structure of the housing loans and the source of funds; promote sound lending norms (eligibility criteria); allow smaller lenders to access long term funding, foster competition as well as lower the cost of long term funding.

Given the continuing deleveraging in the banking sector, the development of an active mortgage market through mortgage securitization would provide liquidity relief to commercial banks while providing long term investment opportunities to institutional investors. A mortgage market would contribute to the broadening and deepening of the bond markets in the region, giving a strong impetus to the financial markets as an engine of economic growth. Similarly, the creation of an active and liquid mortgage market would help to reduce the risk and exposure of real estate developers and lending institutions.

The case for the creation of a liquid mortgage market is clear: the initiative will accelerate the pace of recovery not only in the real estate sector but also in the UAE and regional economies. The DIFC with its well developed legal and regulatory framework to support real estate financing including REITS would be fully supportive of such an initiative.

The Case for Establishing an Emirates Mortgage Guarantee Corporation

There is another policy initiative that should support the set-up of the mortgage market, namely the creation of an Emirates Mortgage Guarantee Corporation (EMGC).

Banks in our region are reluctant to lend due -among other reasons- to the difficulty of evaluating the credit worthiness of clients in an environment characterized by uncertainty and where information on credit history is sketchy or absent. These credit information and assessment problems are compounded by the lack of the typical tools and institutions available in developed countries and many emerging markets, which allow risk mitigation and risk pooling, thereby reducing individual bank exposure to adverse events. In particular, the GCC/MENA countries lack institutions providing insurance against mortgage defaults by individuals experiencing economic hardship or adverse events. This kind of institution is increasingly common across the world: the time has come for the UAE to establish an EMGC.

The objective of the EMGC is to provide insurance coverage to eligible institutions, banks and specialised mortgage credit providers in full compliance of regulatory and prudential requirements, of a maximum percentage amount of the total mortgage value. It would guarantee (against the payment of a premium fee) the "top tier" of the loan, bearing the first portion of the loss in case of default. As discussed above there would be standardized mortgage contracts (both conventional and Shari'a compliant) to allow efficient packaging of risk and efficient risk management. To allow wide coverage, specific provisions would be devised for Islamic banks, as the mortgage is backed by a real asset generating a stable cash flow. A typical borrower would put up initial equity (e.g. 10% to 20%), with a mortgage loan provider providing a loan to cover the balance (e.g. up to 80% to 90%), of which the EMGC would cover the top tier (e.g. 30%). For example on a AED 1,000,000 mortgage, the borrower would put up AED 200,000. A bank or mortgage provider would lend AED 800,000 of which AED 300,000 would be guaranteed by the EMGC, lowering the bank's exposure to AED 500,000.

The EMGC could be founded as a private-public partnership with initial seed capital provided by public entities, insurance companies, banks and by private investors and non-bank financial institutions. Mortgages, both conventional and Shari'a compliant,

could be repackaged into Mortgage Backed Securities (MBS). The mortgage backed securities could form the basis of the mortgage market discussed above. Liquidity could also be enhanced by arranging for repo operations with the central bank.

Clearly, the mortgage insurance scheme is more effective when the broader legal framework is based on stable principles and follows established practices. In particular, ownership rights must be clearly defined and easily enforceable; the bankruptcy and the foreclosure process should be transparent and swift and mortgage renegotiation should be attempted before triggering the foreclosure process; and in general delinquency management should be made accountable. In a nutshell, the mortgage insurance scheme is a special form of credit insurance that protects lenders against loss from borrowers' default on mortgage loans caused by economic adversity.

Conclusion

Sustained recovery of the real estate sector is essential for revival of growth in the region, whose underlying economic fundamentals and demographics are positive. Reform and development of housing finance are necessary elements to support medium & long-term recovery of real estate sector. Structural reforms should focus on the legal and regulatory framework - clear and transparent property and creditor rights, including foreclosure, rights of ownership and residence.

There is an imperative need to develop new markets and institutional structures for housing finance. We have proposed the set-up of a workable mortgage securitisation mechanism to create a mortgage market similar to the Danish mortgage bond market. This would be supported by an Emirates Mortgage Guarantee Corporation to become an effective foundation for a revival of housing finance.