A Mortgage Market for the UAE

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The population of the UAE (as in the GCC countries and MENA region) is demographically young and fast growing, putting pressure on the housing market. In addition, there is a large and continuous influx of expatriates attracted by the current economic boom, with strong job growth and remuneration. Population in the UAE has been growing steadily in recent years at a compound annual rate of 7.4%. In the booming GCC economies, the reforms of property laws allowing foreigners to own property has also fueled investment in real estate and the property market and with higher income and wealth have increased the demand on mortgages from both the local and expatriate community. However, low and middle income groups have limited access to housing finance facilities, while the availability, sources and instruments of housing and property finance have been lagging in the GCC countries. Traditional lending institutions, such as commercial banks and finance companies, remain the only source for finance facilities. In the booming UAE real estate market, for example, such institutions have become increasingly exposed to the real estate market or are facing maturity mismatching between the short-term sources of funds available, such as deposits, and the long-term funding of real estate and housing. The creation of a liquid mortgage market, through securitization, would reduce the risk and exposure of real estate developers and lending institutions, provide additional funding to the housing finance market and give strong impetus to the financial markets as an engine of economic growth and its sustainability.

Characteristics of Mortgages

In theory, a saleable debt instrument should be standardized, have large denominations to appeal to institutional buyers, a low cost method of assessing credit risk and good collateral. By contrast, individual mortgages have non-standard, relatively small denominations, unique size, with high and costly credit risk assessment. Further, though they may have good collateral, standard length maturities and interest rates; they are still generally difficult to sell in a secondary market.

In order to improve marketability and create a mortgage market, several structural steps need to be taken. First, 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 the investor. Second, 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. Third, and most essential, is to overcome the high cost of assessing the credit risk of the 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; however implementing them would reduce the expected economic return

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and attractiveness of the issue. We will discuss later in this article how this hurdle is overcome in developed markets, and the recommendations for developing a UAE mortgage market.

Securitization

Securitization is the process of transforming individual illiquid and non-tradable loans or mortgages in this case, into marketable securities. This is performed by transferring these loans into a specially created entity or trustee called a *Special Purpose Vehicle (SPV).* The SPV would then issues securities backed by the asset pool to the financial markets. In other words, securitization is a form of financial intermediation. The securities issued by the trustee or the SPV are called Mortgage Backed Securities (MBS).

The market for securitized assets is the largest in the world and the fastest growing. The US has a deep, broad and active secondary market for mortgages, unlike most other loan types. In large part, this is because the government is heavily involved in the single family secondary mortgage market to promote securitization. Securitized debt, in the US in 2006, stands at $8.6 trillion, divided between Mortgage Backed Securities (MBS) at 6.5 trillion and Asset-Backed Securities (ABS) at $2.1 trillion, compared to Treasuries at $4.3 trillion, while total outstanding U.S. bond market debt is $27.4 trillion[1].

Historically, the growth of the mortgage market is mainly due to government support and sponsorship with an objective of supporting socio-economic stability by promoting home ownership through accessible housing finance via the mortgage market. In the US, three agencies, either government-owned or government-sponsored, were historically created to be instrumental in the mortgage securitization process. Informally they are known as Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).
For example, rather than provide direct financing for mortgages, GNMA will guarantee payments on mortgage pools that are created by private pool organizers, given that mortgages in the pool conform the GNMA requirements. By doing so, GNMA a government-owned agency, reduced the transactions costs associated with credit risk assessment and provided its own credit rating to the pool.
FNMA, or Fannie Mae, purchases packages of mortgages from banks and financial institutions. It finances these purchases by issuing its own securities mainly MBSs. Even though FNMA was privatized, it still benefits from an emergency line of credit from the US Treasury in case of an emergency. This line of credit and explicit government support contribute to investors' perception that FNMA is a government-sponsored entity. Indeed, the rating of Fannie Mae bonds is AAA.

There are three forms of MBS – pass-through security, collateralized mortgage obligation (CMO), and mortgage-backed bonds (MBB).

In pass-through security, the pool organizer simply passes through all mortgage payments made by the homeowners to the holders of the pass-through securities on a pro-rata basis. Payments are thus monthly, and are variable based on how many homeowners pay off their mortgages early. The pool organizer usually provides insurance for the mortgages

[1] The Securities Industry and Financial Markets Association(SIFMA), http://www.bondmarkets.com/

in the pool. Default risk is not generally a worry for a pass-through security holder (such as a GNMA pass-through). However, these securities carry substantial pre-payment risk.

Collateralized Mortgage Obligations (CMOs) were created to allow investors to better choose and control the level of pre-payment risk they face. CMOs can be considered as multi-class pass-throughs with different payment classes called tranches. Each tranche or slice has a different guaranteed coupon, allocating all prepayment risk to only one class of the bond holders. The multiple classes or tranches allow investors to better choose the level of pre-payment risk desired, and choose their preferred return/risk mix.

Mortgage backed bonds (MBBs) are bond with mortgages pledged as collateral. The MBBs are similar to regular corporate bonds. In fact, issuing MBBs is not technically a securitization since the issuer does not remove the mortgages from their balance sheet; the issuer just pledges the pool of mortgages as collateral for the MBB. Issuing MBBs would not provide most of the benefits of securitization to the lending institution.

Benefits to Financial Institutions

Securitization brings many benefits to financial institutions, mainly lending institutions. First, the sale of mortgages and removal from the financial institution's balance sheet hedges the credit risk and eliminates the direct exposure to the housing and real estate market. Second, the ability to sell the loans improves the liquidity of the bank's loan portfolio. The cash generated from the sale of the mortgages would be available for immediate spending or investment, such as issuing more mortgages. Third, considering regulatory capital requirements under Basel II, loans carry a substantial risk weight in calculating capital requirements. If the loans are sold without recourse, the amount of capital that the financial institution must hold can be reduced and additional growth in total assets may be possible for a given level of capital. Fourth, once the financial institution sells the pool of mortgages, the level of profits has now been locked-in and can be realized immediately (instead of remaining uncertain and accruing over time). Fifth, by tapping into the financial market, banks can achieve more efficient funding terms than through traditional direct borrowing. This is especially true when the gap between the rating of the bank and its receivable is wide. Finally, in most instances, securitizing mortgages continues to generate fee income for the financial institution; it usually retains the servicing contract for which it receives a fee from the mortgage holder.

The Necessity of a Mortgage Market for the UAE

Currently the UAE housing finance market is relatively small, but rapidly growing, with a total size of AED11.5 billion, up from AED2.9 billion in 2004. The market is dominated by Amlak and Tamweel which currently account for 35% and 25% of the market respectively, the remaining 40% being accounted for by a number of banks providing housing finance products.[2]

The property market in the UAE continues to grow, with an estimate, in Dubai alone, of 69,000 units to be delivered in 2007 and some 139,000 units in 2008, assuming no

[2] UAE - Housing Finance. EFG Hermes report, 11 January 2006

delays[3] . This puts pressure on the housing finance market. Real estate developers and financing companies do not have access to retail deposits, the traditional low cost source of funding of lending institutions. They resort to alternative sources of funding to alleviate funding constraints, such as bond or Islamic Sukuk issues, investment deposits and real estate funds.

Securitization can and should play a bigger role in the whole region and in the booming UAE real estate market. In addition to the above mentioned benefits of MBS, securitization would provide a major new source of funding for lending institution facing increasingly tight funding needs. It would also allow banks and lending institutions concerned with exposure to the real estate market to unload exposure from their balance sheets and transfer it to investors or institution that have the appetite for that risk. Moreover, since securitization allows the unbundling of the activities such as the funding or lending role from the loan origination and servicing, many banks that have refrained from entering the property market due to their high risk aversion, would be willing to generate mortgages and immediately unwind them from their balance sheets by either securitizing the pools (if the pool size is large enough) or by selling to institutions that can do so. Doing so will increase the competition in the market, more loans will be originated; mortgage spreads would decrease, and would contribute to the increase of the overall economics activities. The time to act is now.

The Market-Enabling Role of the DIFC

The DIFC has been active in 2006 in creating the instruments and conditions to support the development of funding for the real estate market and the emergence of a mortgage market. The DIFC has issued a Collective Investment Law (CIL) - DIFC Law no. 1 of 2006, which permits both the domicile of funds in DIFC and or distribution of existing foreign funds (both public and private funds). The flexible legislation permits a variety of recognised investment vehicles. Importantly, the CIL permits the operation of various types of funds including, but not limited to: property funds, Islamic funds, hedge funds, private equity funds, and fund of funds. In turn the DFSA issued legislation to regulate the managed funds industry within the DIFC that is compliant with the IOSCO Principles for Collective Investment Schemes. The regulation of fund operators rather than funds leaves room for product innovation and minimizes regulatory burden, and permits appropriate delegation and outsourcing.

Similarly, the DIFC Investment Trust Law- DIFC Law no. 5 of 2006, introduced legislation permitting the setting up of Collective Investment Funds in the form of an Investment Trust. In particular, for the first time in the UAE and the MENA region, rules to permit the operation of real estate investment trusts (REITS) within the DIFC have also been introduced. REITS have become the most favoured method for attracting public ownership in property investments. They provide a convenient form for listed and tradable property ownership with transparent pricing and liquidity. Under these rules it will be possible to issue and trade REITS for the first time in our region, utilizing the facilities of the DIFX. It will add a significant new dimension to the UAE's property market.

[3] United Arab Emirates (Dubai) - Real Estate, Dubai or not to buy, EFG Hermes report, 18 December 2006

Importantly the DIFC Collective Investment and Investment Trust legislation also supports the development of Shari'a compliant finance. DIFC has set clear procedures for authorising Shari'a compliant institutions and aims to be the global market for Shari'a compliant finance. The DIFC Authority (DIFCA) has set-up an Islamic Finance Advisory Council (IFAC). DIFCA, DFSA and DIFX have streamlined the listing of Shari'a compliant financial instruments; the aim is to provide the main regional platform for a secondary market in Sukuk and Shari'a compliant funds; already the DIFC has become the largest global Sukuk market. We will be supporting the build-up of a government Sukuk market to finance infrastructure and to mainstream Sukuk as a public finance instrument, as well as the set-up of a Shari'a based mortgage market to support housing finance in the UAE and the region

A Fannie Mae for the UAE?

While the DIFC's legislation and market institutions will support the emergence of a mortgage market, a number of additional mortgage market building structural steps are required. The establishment of a government-owned or government-sponsored entity or entities can jump start the securitization process. These entities can play the role of buying the mortgages, pooling them, and then issuing the MBSs; such is the case with Fannie Mae. Or they can adopt the model of Ginnie Mae, by providing lending institutions the insurance facilities and packaging of the pools of mortgages. Except from the setup phase, such institutions have proven to be profitable, efficient, and required little if no direct financial assistance form the government. And as is illustrated in the US case, they can be privatized.

Securitization is an essential financial transformation process that needs to be adopted not just to create a mortgage market, but also to help finance infrastructure in the region. Infrastructure and privatization projects can be financed through the issuance of securities backed by the cash flow from users' fees or project receivables, and hence infrastructure projects become self-financing projects.