Deloitte.

Saudi mortgage laws
A formula for a well-functioning market?

87 Eighty seven years in the Middle East

Introduction and background

Over the last five years the Government of Saudi Arabia has continued to invest considerable amounts of oil revenue into the public sector and in initiatives designed to enhance the life of Saudi nationals.

A key part of this program has been the implementation of the finance law, a package of related legislation comprising five laws. It is useful to examine these laws before looking in more detail at their impact on the development of a functional primary mortgage market in the Kingdom.

The 'Enforcement' Law	This law provides for judges to hear enforcement disputes and insolvency actions. Judges may decide on the order of enforcement in a way that guarantees swift repayment; however, it remains to be seen whether judges will allow the foreclosure of properties. If judges are to allow foreclosure, the procedure will need to be compliant with Sharia'a principles. Until fully tried and tested, this issue may influence the size of a well-functioning mortgage industry.
The 'Real Estate Finance' Law	This law provides the regulatory architecture for the authorisation and licensing of banks and finance companies to enter the real estate market. In particular: • Banks will be allowed to own real estate for the purposes of real estate finance - a key factor of Islamic financing products; • The Government will publicise real estate market activity and financiers will be granted access to courts and notary registers; and • A credit check will have to be conducted against borrowers through one of the authorised credit bureaus.
The 'Registered Real Estate Mortgage' Law	This law requires the registration of real estate mortgages, which includes the following provisions: • The pledged asset must be fully described in the mortgage contract to avoid uncertainty or fraud; • The ability to have second ranking mortgages; • The mortgagee may transfer the mortgage to a third party; • The right for mortgagees to object to and even apply to court to prevent any matters that may reduce the value of the collateral; • Allowance for finance providers to request further security should the value of the collateral fall below the debt value through fault of the borrower; and • The lender shall have priority over other creditors in receiving their debt upon the sale of the real estate in accordance with their ranking.

The ‘Finance Lease’ Law	This law prescribes the rules surrounding finance leasing and specifically outlines: • The responsibilities of the Lessor and Lessee in a Sharia’a compliant manner, placing asset risk on the Lessor during the lease term but making the Lessee responsible for the relevant use; • The transfer of leased assets is permitted to the Lessee upon maturity of the lease term; and • The Lessor is permitted to request payments of future rentals if the Lessee is in payment default, provided the number of such payments is not greater than the number of late payments.
The ‘Finance Companies Control’ Law	This law provides a regulatory and supervisory framework for Sharia’a compliant finance companies to provide real estate financing, including other Saudi Arabian Monetary Agency (SAMA) approved forms of financing. However, regulations surrounding items such as capital adequacy, Loan To Value (LTV) ratios, transaction costs and consumer rights have yet to be announced.

Prerequisites for the development of a functional primary mortgage market

In order to arrive at a well-functioning mortgage system, laws and regulations governing this industry should provide stakeholders, in particular banks (lenders) and households (borrowers), with a reasonable degree of comfort and confidence in the system. Within this brief paper, we highlight the potential concerns of these stakeholders, and provide our own observations in relation to these concerns.

Lenders’ potential concerns

Security against debt

Key to lenders offering a competitive mortgage product is the ability to demand, secure and require maintenance of assets pledged against a debt. The finance law reforms seek to address this, allowing mortgage providers to have the right of first refusal on the home against which a debt is secured. More significantly, however, is the ‘enforcement law’, which prescribes judges the power to hand ownership of a property to the mortgage provider should a borrower default.

However, a key determinant to the efficacy of this process is whether the law will be applied as it is written, or whether Sharia’a Law will continue to impact rules and regulations. Will courts allow recourse against late payers and non-payment and the resultant imposition of fines and the seizure of property? There is little precedent in KSA for the courts to seize properties, in particular if they are the primary family home. A consistent approach will have to be adopted for finance providers if they are to have the necessary confidence to offer mortgage competitive products in the market place.

Ability to service debt

The significant majority of home financing products currently on offer in the KSA market are salary-linked, thereby ensuring the lender is paid prior to the individual receiving their salary. Given the current constraints on lending, the primary beneficiaries of these are government-employed Saudi nationals.

However, what remains to be seen is whether the reforms will allow self-employed individuals and those earning at lower salary levels to be able to apply for mortgages. In developed markets, third party credit bureaus allow lenders to assess the credit worthiness and appropriate risk profile of an individual, whether they are salaried or self-employed. Hence, the "real estate finance" law will lend itself to this purpose, requiring the further establishment of centralised credit agencies and the need for all mortgage applications to obtain a credit check.

Demand for mortgages vis-à-vis other opportunities

Should the finance law reforms allow the development of a fully fledged mortgage market, it is likely to drive investor appetite for packaging and securitisation of mortgages. This will allow lenders to reduce their balance sheet exposure and free up capital for further underwriting.

> The sustained growth of Saudi Arabia's economy is likely to lead to increased demand, growth and development in the property market

Consumers' potential concerns

Economic stability

The stability of Saudi Arabia's economy presents a number of potential issues for borrowers. Currently, the Kingdom is registering an unemployment rate of 12.2% (Saudi Central Department of Statistics and Information), which is considered by a number of economic observers to be higher than expected, given the Kingdom's strong, sustained economic growth. It is often attributed to a surplus of expatriate workers who are willing to work for more competitive wages than Saudi citizens. These economic, and, to a certain extent, demographic issues surrounding employment may constitute a concern for borrowers; if a Saudi citizen were to take out a mortgage on a property, and then subsequently become unemployed, they would no longer be able to meet repayments. However, government policy aimed at increasing Saudi employment should help to alleviate some of these concerns.

The sustained growth of Saudi Arabia's economy could also be of considerable interest to lenders. Theoretically, economic growth is a driver of growth in rental and capital values for all real estate use classes; higher growth generates more opportunities for employment and greater availability of finance, which translates into increased demand, growth and development in the property market. To a certain extent, this could attract astute home-buyers keen to capitalise on escalations in property values.

Despite this, the affordability of housing remains a major concern for lower income purchasers. As a result, Saudi Arabia's flourishing economy, and subsequent real estate market growth and development may also serve to further decrease the number of properties available to these purchasers as property prices continue to rise.

As is the case even in highly mature and developed markets, the provision of affordable housing continues to present a major challenge.

Cost of mortgages verses rental price

Consumers could be concerned with the cost of taking out a mortgage against a property in comparison to renting. Lenders' concerns, such as those mentioned previously, may give rise to an increase in risk premiums, particularly in the case of first time buyers (which, in the case of Saudi Arabia, is likely to make up a large proportion of the market). This could drive higher interest rates and thus, higher repayments; which, coupled with the sustained growth in capital values described above, could put mortgages for certain properties out of reach for low and middle income families. As a result, renting, rather than purchasing, could remain the most financially viable option.

Ultimately though, with residential villa and apartment rents rising in Saudi Arabia, due to high demand and a supply shortage (particularly for affordable accommodation), many Saudis may look to mortgages as an affordable alternative to renting. Whether this proves to be the case will be a key concern of borrowers.

Ensuring confidence in the mortgage system between lenders and borrowers is imperative

Further concerns

Ensuring confidence in the mortgage system between various stakeholders is imperative. In addition to addressing the concerns discussed previously, transparent practices, fair treatment for lenders and borrowers and equivalent protection of their rights are key factors in providing comfort.

Transparency of the real estate market and fair protection for ME stakeholders are key success factors

Transparency

Transparency of the real estate market is fundamental to increasing stakeholders' comfort in the mortgage law and the success of this initiative. The Kingdom will have to take practical steps to promote the availability of information, this being of particular importance to the valuation of properties that will eventually become collateral for issued mortgages. It is also crucial that banks and real estate valuers have access to the title and lien registries in order to be able to collect reliable information on properties under consideration.

Establishing a centralised real estate database that keeps an accurate and timely record of market transactions, as well as an organised and standardised deeds registry practice (allowing access to interested parties), are examples of initiatives that would serve to enhance lenders' and borrowers' confidence in the system.

Protection

The proposed law is expected to provide fair protection measures for both lenders and borrowers. Ideally, these measures would include the following:

- An established credit rating system to evaluate the credit worthiness of the prospective borrowers. This proactive, protective measure is of paramount importance to the lender, as it helps identify qualified borrowers, which in turn mitigates the risk regardless of default rates.
- Consistency in the application of court judgements in the instance of default by borrowers in order to protect the lender's right to receive contractually agreed mortgage payments.
- As the mortgage system is being introduced for the first time in Saudi Arabia, it would be helpful to launch training courses with the aim of educating potential borrowers as to the functionality of the mortgage system. In more established markets such as the UK and USA, mortgage providers insist that first time buyers, in most cases, complete 'homebuyer education courses' to ensure that borrowers are adequately informed about the fundamental aspects of financial management relating to home-ownership. By ensuring that consumers are well-informed and prepared, lenders can offer a form of consumer protection which will, in turn, help to ensure mortgage market stability and lower default rates.
- Current consumer protection regulations relating to, for example, creditor discretion and minimum information to be communicated to borrowers do not include housing loans. In order to ensure the customer has confidence in the protection of his/her rights (repayment plans, terms and conditions and pricing), the Kingdom has incorporated new measures as part of the Finance Reform Laws.

Overall, regulators will need to strike a balance between providing adequate consumer protection, whilst ensuring that lenders do not feel overly restricted, in order to develop a healthy and stable primary mortgage market.

Fairness

Increased clarity of governing laws and regulations would allow less room for judicial interpretation, which would, in turn, help legal principles to be followed and not altered on a case by case basis. As a result the law would theoretically be equally and fairly applied to all stakeholders - a crucial factor in creating peace of mind and trust between lenders and borrowers.

Are the new laws enough?

Saudi Arabia is making significant steps towards the creation of a mortgage industry and is opening up to finance providers. However, the transformation will not occur overnight, not least because two of the five laws are yet to be completed.

After considering over 2,000 feedback notes received on the mortgage law package from the public and specialists, the implementation of three of the five laws was completed on the 24th of February, 2013.

However, the final intricacies of the remaining laws; the Enforcement Law and the Registered Real Estate Mortgage Law, are still to be resolved and the laws enacted.

In principle, the multi-dimension reforms appear to be sufficient to develop a functioning mortgage market

In principle, the multi-dimension reforms appear to be sufficient to develop a functioning mortgage market; however, fundamental to this is whether they are executed in their entirety, or whether there is any uncertainty as to their exact definition.

Robin Williamson
Managing Director
Saudi Arabia & Head of Real Estate
Tel +966 54 154 3725
rwilliamson@deloitte.com

David Stark
Managing Director
Reorganisation Services
Tel +971 50 658 4057
dastark@deloitte.com