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The mortgage law - what comes next?

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In any economy, enactment of a mortgage law is a critical milestone in the path toward large scale home ownership. However for Saudi Arabia, enactment of the mortgage law will not flip a magic switch that will automatically turn renters into homeowners.

In order for the Saudi mortgage system to deliver on its long-term objective of increasing home ownership in the Kingdom, the mortgage law must be supported by effective regulation that capitalizes on lessons learned from other markets and developers must be given incentives to build homes for middle market home buyers.

Sound regulation

Regulation is the key ingredient that takes legislation from concept to practical application. Its effectiveness will be the primary measuring stick of the law's success. In the case of the Saudi Arabian mortgage law, regulation will serve to direct all relevant parties - courts, ministries, financiers, buyers, sellers, etc. — concerning the exact procedures and guidelines they must follow in order to comply with the mortgage law.

For example, the ability to foreclose and gain possession on a defaulted mortgage asset is expected to be the key objective of the mortgage law. Regulations that support the law will delineate the procedures, paperwork and timelines that the financier must follow in order to foreclosure. At the same time, these regulations should entail provisions that ensure consumers are allowed due process in foreclosure proceedings.

Over regulation through stringent oversight, impractical standards and capricious procedural requirements can stifle the industry. At the same time lax regulatory standards can lead to an unstable real estate market with far reaching economic repercussions. By delivering balanced regulations that recognize the business needs of financiers and protect consumers against potential abuse, policy makers can set the industry on a successful course for years to come.

Lessons learned

Saudi Arabia can benefit from an objective and critical analysis of other markets' experiences in order to create a mortgage system that is right for Saudi Arabia. For example, in Dubai the government failed to create an effective regulatory regime because its housing goals were unclear from the onset. Policy makers were conflicted as to whether their objective was to promote home ownership or to create a real estate investment industry. In Saudi Arabia, the government should be consistent and clear that its policies will promote home ownership first. This implies that regulations need to cover a variety of criteria including purpose of purchase, limit on resale, and funding limits for investment properties.

The lessons learned from the US subprime crisis can be instrumental in preventing a similar result in Saudi Arabia. In the US, the public policy objective of promoting home ownership eventually trumped the importance of adhering to sound underwriting practices. Lawmakers were so focused on increasing home ownership that they failed to create regulations which would control risky lending practices. When real estate market fundamentals began to change, subprime borrowers were unable to meet their obligations and wholesale defaults ensued. Saudi Arabia can avoid these series of events by maintaining regulations that underscore affordability as the key standard for home financing eligibility.

Bridging the gap

In order to increase the rate of home ownership in Saudi Arabia, affordable housing must be made available to the middle and lower income market. Until now developers have focused on building homes that cater to upper class home buyers who are able to purchase homes on a cash basis. This is because to date banks have been reluctant to provide home financing in Saudi Arabia.

Internationally recognized Basel II banking guidelines mandate that banks must avoid becoming overly saturated with any one asset class. A recent study published by Banque Saudi Fransi confirmed the banks' concerns with becoming overly exposed in the real estate market. According to the study, banks will have a limited appetite for mortgage assets and will enter the market slowly even after the mortgage law passes.

The presence of specialized mortgage finance companies in any market is a critical factor in sparking home ownership. Unlike banks, which offer multiple lending products, are mainly motivated by capturing a consumer's deposit relationship, and are restricted by overexposure to real estate, mortgage finance companies operate on a more targeted business strategy. As both real estate and finance specialist, mortgage companies drive a singularly focused business objective which involves working with and educating developers on the profile of its pre-approved customer base of middle market home buyers. Moreover mortgage companies' underwriting decisions for home financing are predicated upon establishing a healthy ratio between monthly income and monthly mortgage obligations. Underwriting decisions are not manipulated by the prospect of establishing a bank account in order to capture deposits through payroll funds.

Because of their specialized focus, mortgage finance companies become the critical link that connects prospective buyers to developers. Once developers are able to rely on the purchasing power created by mortgage finance companies for middle market participants, they will build more homes that are affordable for the average Saudi home buyer.

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