Housing Finance in the

United Arab Emirates

Mark Boleat

**Report commissioned by Barclays Bank
and the same has been endorsed by
the Central Bank of the UAE**

November 2004

Contents

Foreword

The United Arab Emirates (UAE) has a very rapidly growing population and economy, and living standards that are among the highest in the world. 80% of the population of the UAE comprises non-nationals who, until recently, had not been permitted to purchase property. That situation has changed, particularly in Dubai, and to a lesser extent in some of the other Emirates, in the last few years.

The Emirates have given considerable help to their nationals to enable them to own their own homes so there was little need for significant provision of housing finance. The opening up of the market in Dubai has changed that position dramatically. Over the last few years there has been a significant increase in lending for house purchase and construction, some of which has been by newly established institutions.

This development has naturally raised some questions about the nature and direction of the housing finance market, particularly as the legal issues relating to the ownership of freehold property by non-nationals have yet to be settled.

This study was commissioned to provide a broad overview of the current state of housing finance in the UAE from an international perspective.

The study has been commissioned by Barclays Bank and the same has been endorsed by the Central Bank of the UAE as a contribution to knowledge about the development of the market.

The author is grateful to Barclays Bank and to the Central Bank of the UAE for the considerable they gave in organising his visit to the UAE and for providing information. Particular thanks go to Mark Petchell, Group Country Manager for Barclays for the UAE, and to Habib Kazim, Senior Manager, Banking Supervision and Examination Department, Dubai and the Northern Emirates, of the Central Bank, who accompanied the consultant throughout his visit.

The views expressed in the report are those of the author alone and should not be taken to represent the views of the Central Bank of the UAE.

Mark Boleat
November 2004

Executive summary

Housing finance systems in industrialised countries
In industrialised countries, people purchase housing with the help of loans secured by mortgage for up to 80% or more of the purchase price at an interest rate about two percentage points over the cost of funds. The housing market is mature and characterised by a strong secondary market with new house building being a relatively small part of the market, sufficient to meet the net increase in demand. Regulation, easily accessible data on housing market activity and a network of professionals facilitate transactions and help ensure adequate protection for consumers.

Political and economic framework
The UAE is a federation of seven states, each of the states having substantial autonomy and to some extent competing with each other for business.

The population is 4,061,000 and has been increasing at 6% a year. 80% of the population are non-nationals.

Thanks to oil, the Emirates are very rich with income per head among the highest in the world. They have also been growing rapidly as they have attracted both business and population from other countries.

The banking structure in the UAE
The UAE has a well developed banking structure with both local banks and branches of international banks. The larger local banks also have an international presence. Banks are soundly regulated by the Central Bank of the UAE. The volume of lending secured on residential property is tiny by international standards.

Housing and housing finance for UAE nationals
In effect, the government has provided most UAE nationals with their housing. Any UAE national is entitled to a plot of land and is then given further financial support in the form of a grant or an interest free loan to enable them to build their home. Personal loans may be used to top up state provision but granted land cannot be mortgaged.

The opening of the market in Dubai
In 2002, the government of Dubai announced that in specially designated areas foreign nationals would be able to own housing. The announcement has been followed by a huge increase in demand from long term residents who had been renting, from people seeking an investment and also from people, particularly from the Middle East, seeking a safe home for their money as well as a good investment. The demand has been matched by a massive increase in house building, through three State backed companies. The market has been driven by speculation with most properties being sold before they have been constructed, many to speculators who often have sold subsequently at a profit.

The uncertainty over land ownership made the banks reluctant to finance house purchase, so two of the major developers set up their own companies, Amlak and Tamweel. In practice, even those paying the full price have often provided cash. Where they have needed loan finance the loan to value ratio has been comparatively modest. Both lenders operate on an Islamic finance basis which gives them additional security.

The mainstream banks are now entering the market having seen the experience of Amlak in particular. They will take an increasing market share. As the volume of business and competition increases the spread between the cost of funds and the mortgage rate should fall.

Consumer protection issues

The opening of the market in Dubai has raised a number of consumer protection issues that need to be addressed –

- The legal position on ownership and residence by non-nationals needs to be settled. The immediate priority is for title to be registered by the Dubai Lands Department.
- Greater protection is needed for purchasers in respect of payments made prior to completion and remedying defective building work.
- Real estate agent must be regulated and arrangements introduced to ensure that properties are fairly and consistently described.
- Appraisal, legal and insurance services should develop as the market grows.
- The arrangements for service charges should be within an accepted framework through a code of practice in the short term and legislation in the longer term.
- There is a need for greater transparency in the market which will be assisted by the collection and dissemination of market information.

Wider economic and policy issues

There is a risk that the boom in Dubai, like any other boom, will turn into a collapse. There is little that the authorities can do to regulate this aspect of the market; the developers alone have the ability to seek to moderate the market and reduce speculation.

Developments in the open market in Dubai have implications for the whole of the market in Dubai and for the other Emirates. A common approach on some issues throughout the Emirates is desirable.

Supervision of housing finance

There are accepted international standards for the supervision of mortgage lending which allow for a reduced risk weighting. Banking supervisors also need tools to assess the quality of a lender's portfolio and must put in place arrangements for mortgage securities that prevent regulatory arbitrage but give certainty to market participants.

The Central Bank of the UAE has had little need to regulate mortgage lending because there has been little such lending. It needs to put arrangements in place in advance of the market developing and should also play a part in increasing understanding of the operation of housing markets in the UAE.

Chapter 1

Housing finance systems in industrialised countries

The UAE is a rich state with a standard of living on a par with that in industrialised countries in Europe and North America. There is only a limited informal economy and the banking system is long established and widely used.

In such a market, a major part of the financial structure would normally be a very active housing finance market, the volume of outstanding loans being substantially higher than other loans to individuals. In Western European countries mortgage debt per capita averages $11,200, although the range is from $3,000 in Italy to $30,000 in Denmark.

People buying properties would expect to be able to borrow at least 80%, and in some countries 95%, of the purchase price by means of a long term loan, typically for 25 years, at a very fine margin over the cost of funds, typically around two percentage points, compared with the average spread on banking business generally of around four percentage points. The fine margin is possible because the loan is secured on the property with the result that the bank is very well secured. In effect, the bank is lending on the security of the borrower's income and the property and may well also have some additional security such as life insurance on the borrower and insurance of the mortgage debt itself.

In a mature economy, most houses sold are existing rather than new. New house building is needed only to accommodate an increase in the number of households which in most industrialised countries is very modest. New houses are typically built by developers on a speculative basis, that is the builder builds houses, sometimes in large estates, sometimes single dwellings, and seeks to sell them either when they have been completed or at a fairly late stage in the construction process. A small number of houses are built to order, generally by better off individuals, and in a rapidly rising market and in special circumstances, apartments in particular may be sold "off plan". There are arrangements in place to protect purchasers from the builders subsequently failing to deliver their side of the bargain.

The property market is facilitated by a network of professionals. Conveyancers, generally lawyers, are responsible for ensuring that the house purchaser gets good title and that the sale and the mortgage are properly completed so as to protect all parties. There is a generally accepted mechanism for valuing properties based largely on the prices achieved by comparable properties which in turn is possible only because of a very active market with second hand houses comprising most of the market. The task of valuers is made easier by the collation and publication of house price data, both at the national level and at the local market level. The sale and purchase of properties is handled by real estate agents who are subject to regulation either by statute or by well established professional bodies, although it has to be said that in most economies the scope for malpractice by real estate agents remains large.

Chapter 2

Political and economic framework

Political framework
The United Arab Emirates was formed in 1971 by seven formerly independent sheikdoms.

	Population 2003
Abu Dhabi	1,591,000
Dubai	1,204,000
Sharjar	636,000
Ajman	255,000
Ras Al-Khaimah	195,000
Fajairah	118,000
Umm-Al-Quiwan	62,000
Total	4,061,000

Source: Ministry of Planning.

The country is a true federation with the individual Emirates having a great deal of autonomy. Indeed, they are sometimes viewed as “City States”. They compete with each other to attract business and in a number of respects have different characteristics.

Each of the Emirates is run by its ruling family with no parliamentary system. The result, however, has been a very stable political structure combined with well run government services, both of which have been essential to attract international business.

Population
The key feature of the Emirates is that the population is predominantly non-nationals. Emirate nationals comprise just 20% of the total population. The population has been growing rapidly at around 6% a year, almost entirely as a result of immigration. Foreign nationals are recruited to work in all parts of the economy, from construction to transport to financial services.

Economy
The UAE’s GDP in 2004 is forecast to be AED311 billion. (The UAE currency is the Dirham, abbreviated either to AED or Dhs. The exchange rate is fixed at AED3.67 to the US dollar.) Oil accounts for 23% of GDP, industry for 25%, agriculture for 4% and services for 48%. The economy has grown rapidly, if erratically, the fluctuations largely resulting from movements in oil prices and are reflected more in the Government’s finances than in the real economy. Inflation has been under 3% for the last five years. The general level of interest rates is low. The three month interbank rate has been under 2% since 2002 and bank lending rates have fallen to under 6%.

The following table shows key economic variables.

UAE key economic indicators 1998 - 2003

	1998	1999	2000	2001	2002	2003
Nominal GDP AEDbn	177.4	201.8	258.0	254.2	261.4	293.1
Growth (%)	(5.5)	13.8	27.8	(1.5)	2.8	12.1
GDP per capita ($)	17,041	18,117	21,636	19,844	18,958	19,751
Growth (%)	(11.5)	6.3	19.4	(8.3)	(4.5)	4.2
Population (m)	2.8	3.0	3.2	3.5	3.8	4.0
Growth (%)	6.9	7.0	7.1	7.4	7.6	7.6
Inflation (%)	2.0	2.2	1.4	2.7	2.9	7.0

Source: UAE Central Bank and National Bank of Dubai.

Chapter 3

The banking structure in the UAE

Formal housing finance is generally provided by banking institutions and accordingly it is useful to describe very briefly the banking structure in the UAE.

The UAE is a major international financial centre and accordingly is well served by banks.

Banking supervision has recently been reviewed in a financial system stability assessment by the International Monetary Fund (2003). The following summary is taken from this objective study. Under the Banking Law 1980, the Central Bank of the UAE (CBU) has jurisdiction over commercial banks and other financial institutions.

The central conclusion of the IMF study was that "The financial sector is dominated by a well-established banking industry, which is effectively supervised." There are 21 domestic banks which between them have 353 offices. The major banks have branches in each of the Emirates and a number also have international operations.

UAE largest banks, end-2003

Bank	Base	Established	Offices	Total assets AEDbn
National Bank of Dubai	Dubai	1963	33	31,070
National Bank of Abu Dhabi	Abu Dhabi	1968	57	30,374
Emirates Bank International	Dubai	1977	26	27,366
Abu Dhabi Commercial Bank	Abu Dhabi	1985	35	25,717
Dubai Islamic Bank	Dubai	1975	17	21,866
Mashreq Bank	Dubai	1967	32	20,595
Union National Bank	Abu Dhabi	1982	29	15,270
All banks			**353**	**222,221**

Source: Central Bank of the United Arab Emirates.

Of the 20 national banks, 14 have some UAE or Emirate government ownership although none is wholly owned.

There are 25 foreign banks with between them 112 branches of which 39 are in Abu Dhabi and 42 are in Dubai. The two largest in terms of branches are HSBC Bank Middle East and Standard Chartered.

Three commercial banks operate as Islamic banks, but the demand for Islamic banking services is considerable and some non-Islamic banks offer selected Islamic banking products.

No new bank licences have been granted since 1982.

The commercial banks are considered to operate both efficiently and profitably. The average interest rate spread (the difference between interest rates on local deposits and loans) is around 4.5% - about the average of OECD countries.

A feature of the banking system is that loans secured on real estate are negligible. At the end of 2003, the banking sector had outstanding credit to both residents and non-residents of AED226 billion of which real estate mortgage loans were just AED10.5 billion. This figure includes, and probably largely comprises, commercial rather than residential loans. Also at the end of 2003, personal consumer loans totalled AED21.4 billion in 407,000 accounts. Most of these loans were held by expatriates; nationals tend to borrow only for car purchase. A small proportion of the loans have been used to finance house purchase. The small amount of personal lending contrasts with deposits by individuals in excess of AED90 billion.

Nevertheless, the position remains that, very unusually for an advanced industrialised country, the volume of loans secured by mortgage is very small and much smaller than personal consumer lending. The reasons for this are explained in the next few chapters.

Chapter 4

Housing and housing finance for UAE nationals

UAE nationals comprise just 20% of the total population. The UAE is also a very rich country which has the resources to look after its residents. In practice, most nationals have been housed by the State and nationals have had little need to borrow large amounts to fund their housing.

The State, at both federal and Emirate level, has built housing directly and given it to nationals. However, it has found that the housing is better looked after if title is formally transferred to the individuals. This does not mean that the properties can be subsequently sold on the open market. The circumstances in which they can be resold are severely restricted.

Low and middle income people are entitled to a very generous form of assistance to help them build their own homes. Basically, each national is entitled to a plot of 15,000 sq ft "granted land". Those earning under AED120,000 a year are entitled to a grant of AED500,000. They can use this to pay for the design and construction of a home. Technical assistance is given to help people do this. People can, if they prefer, buy a completed house but this is less good value as they will be paying for the land and any profit element in the value of the property.

With the rise in construction costs over the last few years, AED500,000 is now often not sufficient. Some less well off people have taken advantage of the option to hand back their plot of land and entitlement to AED500,000 in exchange for a property on a plot of 8,000sqft. Better off people are able to borrow in order to build a better property for themselves. Such borrowing is generally through personal loans, on which there is a limit of AED250,000, with there being no formal mortgage on the property. Granted land also cannot be mortgaged. People are subsequently free to extend or improve their property as they wish.

For nationals with incomes in excess of AED120,000 there is a different scheme operated on behalf of the government by the Emirates Bank. They are entitled to an interest free loan over 25 years of between AED500,000 and AED750,000. They can top up this loan with personal loans from commercial banks.

It can be seen that UAE nationals have little need for long term loans on commercial terms from formal financial institutions. Their housing is provided for them directly or indirectly by the State and loan finance is needed simply to top up what the State provides. Because there is no provision for property to be mortgaged, any loans that are used to finance housing construction or improvement are recorded as personal loans. This helps to explain the relatively high figure for outstanding personal loans described in the previous chapter.

The effect of the government policy is in practice to give people a house which would, if there was an open market, be worth perhaps AED1 million. Because foreign nationals have not been allowed to purchase there has been a very strong demand for rented accommodation. A property valued at AED1 million could easily command a rent of AED200,000 and, with normal practice being to pay two years rent in advance, it has been very tempting for the recipients of government grants to immediately use their property to obtain a tax free sum of AED400,000. Technically this is not permitted and some of the Emirates do take steps to try to prevent it happening. However, it is understood that as many as 25% of units that have been financed in this way are being rented out.

The current arrangements are generous to UAE nationals. However, they have only been in operation for a limited period of time and the full implications are not yet clear.

It is understood that there is a long waiting list for housing and grants. This is not surprising, given that they have no cost. Although the number of UAE nationals in the Emirates is only 20% of the population, there is substantial scope for an increase in demand for granted land and finance. Some of the demand comes from extended families with children and perhaps even parents taking advantage of the grants to house themselves or even to build accommodation that can then be rented out. Those living in housing constructed in previous years by the State also wish to take advantage of this scheme so as to improve their housing conditions.

Longer term, it will be necessary to consider the restrictions on ownership, particularly in respect of the ability to sell, and also the ability of people to determine what happens to their property in the event of their death.

Consideration will also need to be given, particularly in Dubai, to the relationship between the market for non-nationals and the market for UAE nationals. Currently, non-nationals are able to buy houses only in designated areas. UAE nationals can also buy in those areas as well as occupying housing reserved for nationals. It is a political matter as to whether this differentiation should continue and more a matter in relation to policy on non-nationals. This is considered in more detail in Chapter 7.

Chapter 5

The opening of the market in Dubai

Until recently, it was not possible for non-nationals of the UAE (and with some restrictions nationals of other Gulf Co-operation Council countries) to own property. Accordingly, non-nationals, that is 80% of the population, had no choice but to rent. There has been some experimentation with long leaseholds, banks taking an assignment of the lease as security for any lending. However this form of tenure did not prove attractive in the marketplace.

In 2002, the government of Dubai announced that non-nationals and non-residents would be allowed to own housing on a freehold basis. The announcement has been followed by a dramatic take off in the housing market with both demand and supply rising very rapidly. The way that this has happened and the way that house purchase has been financed is probably unique in the industrialised world and is the main focus of this report.

This initiative by Dubai needs to be seen in the context of the Dubai economy generally. The Government is planning a massive expansion of the economy including new facilities for trading, tourism and financial services. There is a liberal business environment, combined with low taxes, all designed to encourage entrepreneurial activity. The population is planned to increase from the current1.2 million to over 2 million by 2010.

Demand

In 2002 there was a huge pent up demand among long term non-national residents in Dubai to purchase their properties. Many had been living in Dubai for years and fully intended to make it their home for life. They had been paying rents at a very high level which would have paid for the cost of their housing perhaps several times over. To these people the opportunity to own was gratefully received and many were among the initial purchasers of properties.

At the same time, a number of other factors contributed to make Dubai an attractive place in which to own a property and to have residency. An important point here has been that ownership and occupation of property automatically gives residence, although on a rolling three year basis rather than for life. As a direct consequence of 9/11 much money owned from within the Middle East was repatriated from the United States and other foreign markets and was looking for a home. The Dubai property market has provided such a home. Dubai has also been attractive to nationals from the Middle East, particularly Iran, and the Indian Sub-Continent, as a result of its strength as a business and financial centre, low tax regime, good quality of life and physical location.

There was therefore a surge in demand from people who perhaps previously had had no connection with Dubai as well as from long term residents. With a limited supply, this demand fuelled rapidly rising prices as a result of which speculators came into the market seeking to buy up properties as they were released with the expectation of reselling them at a profit subsequently. Generally, it was necessary only for the speculator to put down 10% of the purchase price in order to benefit from 100% of the property appreciation. Almost all units that have been sold have immediately gone to a premium against the offer price.

Supply

The government did not confine itself to stimulating demand. It also took positive steps to provide a supply of housing to meet the demand. The tactic has been to designate large zones as being available for housing to be owned by non-nationals. Three developers, all effectively backed by the State, Emaar Properties, Nakheel and Estithmaar, have led the developments on the designated zones. They have had the benefit of land being "gifted" to them by the State. The table below shows how their activities have developed and are forecast to continue developing.

Value of real estate to be delivered in Dubai (AEDm)

Year at December	2004E	2005E	2006E
Emaar Properties	6,882	4,689	2,929
Nakheel	5,000	5,000	9,500
Estithmaar	1,709	1,709	0
Total	9,991	11,399	12,429

Source: Shuaa Capital Equity Research, March 2004.

On some of their sites, the main developers have brought in sub-developers but, as will be explained subsequently, have effectively taken responsibility for the relationship with their customers.

The developments are not of single units but rather of massive estates comprising both apartments (particularly in the coastal areas) and villas, together with all the supporting infrastructure and facilities such as golf courses, marinas, shopping malls and restaurants.

It is helpful to note some of the major developments and also the pricing of them.

Emaar's projects include –

- Dubai Marina, described as a "city within a city", comprising 1,026 apartments and 64 luxury villas. The apartments' prices range from AED488,000 to AED1,050,000. Eventually there will be 19,000 units at the Marina.
- A number of developments under the general heading of "Emirates Living". These include the prestigious Emirates Hills development comprising 640 single family detached villas, together with a golf course, and four other developments: The Lakes, The Greens, The Meadows, and The Springs. These developments will have a total of 9,000 units.

- Arabian ranches, a luxury development of villas and town houses, priced from AED1 million. The first phase comprised 1,300 units; there will be 6,900 units eventually.
- Burj Dubai, which will be the tallest tower in the world. The apartments will be in six towers and provisionally prices range from around AED600,000 for one bedroom apartments to up to AED2 million for the largest apartments.

Estithmaar has just one development, Jumeirah Beach Residence, which comprises 36 residential towers with 6,400 apartments and four hotel towers with 4,000 rooms. Prices range from AED315,000 up to AED1,200,000 for four bedroom apartments.

Nakheel Properties is best known for its offshore projects, built on reclaimed land. The Palm Jebal Ali has already been completed, villas and town houses having been sold at prices ranging from about AED2 million to AED5 million. The Palm Jumeirah is a similar development. Nakheel has recently announced the Palm Deira, with extensive advertising in the British press. The World comprises a series of 260 islands, positioned strategically to form a map of the world. The individual islands will be for sale and the purchasers can then do what they like on them. Nakheel is also building Jumeirah Village, comprising 7,000 villas.

The prices quoted need to be seen in the context of other markets seeking to attract wealthy people (the south of France, Spain, the Caribbean etc). They are relatively modest in this respect.

Almost all of the developments are sold out almost immediately they go on sale and generally well before construction has started let alone been completed. In 24 hours in September 2004, Nakheel sold all 7,000 villas in Jumeirah Village. The developers differ to some extent on their requirements for deposits and stage payments. Nakheel requires a 15% deposit and then regular payments during construction. Emaar requires most of the purchase price to be paid on completion. Estithmaar has required four payments of 25% at various stages of the process.

However, as yet, no land law has been enacted in Dubai and, with perhaps one or two exceptions which may be accidental, purchasers are not able to register title to their property and cannot raise finance to purchase the property by means of a conventional mortgage loan. It is therefore a very interesting question as to why the market has taken off.

The developers clearly trust that the market will continue booming as they are still involved in massive developments. On the whole, house buyers trust the major developers as they are in effect part of the State. The developers give a “certificate of beneficial ownership” and run their own title registration services, in co-operation with the official Lands Department. There is total confidence that the developers will not go out of business and that they will not treat purchasers badly. This trust has been well placed. Where a developer uses a sub-developer then the main developer will take steps to ensure that the house buyer is as well protected, for example by providing that deposits are paid into an escrow account. In the unlikely event of a sub-developer, themselves substantial companies, defaulting, there is little doubt that the main developer would step in.

There is a further element of trust in that there is a general belief that the law will be changed so that the purchasers of property will have full legal title and not just the security of a sale and purchase agreement with a developer.

Finally, and perhaps most importantly, purchasers have absolute confidence that the market will continue its rapid rise and that they are bound to make a substantial profit. This confidence in the market, combined with trust in the developers, has been more than sufficient to outweigh what are regarded as legal technicalities which will soon be put right.

The normal pattern is for developments to be sold off plan with the purchaser putting down just a 10 - 20% deposit. With the expectation that prices will continue rising, this has resulted in many speculators coming into the market, buying blocks of properties and then reselling them at a significant profit. Some of the developers are sufficiently concerned about this that they have taken steps to deter it, for example by increasing the deposit, by requiring more prompt payment of the full purchase price even in advance of completion of the property or by preventing resale within two years. It has been noted that on completed developments there are very few lights on in the evenings, suggesting that most of the properties are owned by people not living in them.

Financing house purchase

In an advanced industrialised economy such as Dubai it would be normal to expect that commercial banks would finance house purchase as part of their mainstream business. However, banks, particularly international banks, have a particular mindset when it comes to financing house purchase. The basic requirement is that the bank should have a mortgage on the property such that if the borrower defaults then the bank has the property as security and can recover its loan. Banks also seek other reassurance, for example that if the developer defaults during construction the borrower is protected, that there are accepted appraisal standards to ensure both that the purchaser obtains value for money and that if the bank realises its security it will be sufficient to recover the debt, and also that the necessary legal processes and procedures are in place to ensure that the purchaser has good title to the property and that the bank's rights as mortgagee are protected.

None of these conditions were fulfilled and therefore the commercial banks were unwilling to finance house purchase other than through a limited amount of personal loans which in any event can be for no more than AED250,000.

In practice, there has not been a huge demand for loan finance. Many of the developments have yet to be completed and accordingly in some cases only the initial deposit has been paid. Most of the properties have been bought by speculators who have not needed to borrow. Where people have bought for their own occupation, they have often done so precisely because they have had surplus funds. It is probably the case that for properties bought for occupation fewer than 20% have required loan finance and where loan finance has been needed this has been for less than 60% of the purchase price.

Because Dubai is an entrepreneurial economy the reluctance of the banks to provide loans to finance house purchase quickly resulted in alternative mechanisms, mainly in the form of specialist finance companies established by the developers.

Islamic financing techniques

Before analysing the various lending institutions it is helpful first to discuss the issue of Islamic financing techniques. The Islamic religion does not allow for either interest or mortgages. Alternative techniques have been developed which have much the same effect. There are three main techniques. The following descriptions are taken from Tamweel's website.

Murabaha is essentially a re-sale contract, where the buyer identifies the property he wishes to purchase and agrees a price with the vendor. Once the purchase of the property has been approved by the financier, the financier will purchase the property in its name and resell it to the buyer against either immediate or deferred payment. The financier is entitled to profit, which is the difference between the price it pays to the vendor and the price at which it re-sells to the "buyer".

Ijarah means "to give something on rent" or to transfer the "right to use" of a property to another individual in exchange for rent claimed from him. Ijarah is like a conventional operating lease, where the buyer identifies the property he wishes to purchase and agrees a price with the vendor. Once the purchase of the property has been approved by the financier, the financier will purchase the property in its name and lease it to the buyer for a specified monthly (or otherwise) rental payment and lease term.

Istisna'a mortgages are financial products widely used by Islamic banks to finance the construction of buildings and/or industrial assets. Under Istisna'a, the price is fixed with the consent of the parties and the specification of the house or building to be constructed, is fully agreed. If the customer has his own land and he seeks financing for the construction of a house, the financier may undertake to construct the house on that open land, on the basis of "Istisna'a". If, however, the customer has no land and wants to purchase the land, the financier may undertake to provide him/her a constructed house on a specified piece of land.

The profit rate for the Murabaha contract is similar in characteristics to interest rate. For Tamweel's variable rate loans the profit rate is actually a fixed percentage above the six month Emirates inter-bank offer rate.

A key difference between Islamic financing and conventional mortgage financing is that the purchaser of the property does not actually own it until all the payments have been made. The lender is therefore very well secured, particularly so in the Dubai environment where legal mortgages do not yet exist.

Amlak

Recognising the need for loan finance, Emaar took the initiative to establish its own mortgage lending company, Amlak. The company was established in 2002 and is licensed by the Central Bank to offer finance facilities but not to raise deposits. The company has obtained all of its funding from its parent, Emaar Properties, although it plans to raise funds from other sources as well. In 2004, the company floated through an initial public offering in which 55% of the shares were offered to the public, the remaining 45% being retained by Emaar. This increased its issued share capital to AED750 million. Its share price has subsequently risen by 50%. In October 2004 the company was capitalised at AED2,295 million.

Purchasers of houses built by Emaar Properties are directed towards Amlak although they are free to borrow from other sources. It is estimated that Amlak finances about 10-20% of all Emaar sales but probably about 90% of those which require loan finance. Amlak's outstanding loans at the end of 2002 were AED128 million. By the end of 2003 the figure had increased to AED531 million. Shuaa Capital (2004) in a research note estimated that Amlak's loans outstanding would increase to AED1,524 million in 2004 and AED3,237 million in 2005.

Amlak has provided fairly conventional loans for house purchase, its average loan to price ratio being around 60-65%. Amlak is in the process of transferring its entire mortgage business to an Islamic basis.

Amlak requires its customers to open a bank account with the Dubai Bank (another subsidiary of Emaar) and where the loan is high in relation to the purchase price the customer's salary must be paid into this account.

Amlak was first in the market and probably accounted for well over half of loans to finance house purchase in 2003. Its market share can be expected to fall over time as other financial institutions enter the market. It is seeking to diversify its mortgage business and will now lend to purchasers of developers other than Emaar.

Amlak has ambitious plans for the future. The issuing prospectus states that the company believes there are opportunities to expand its mortgage business into new geographical markets in the Gulf Co-operation Council and Middle East regions. In September it announced that it would be setting up a mortgage finance company in Turkey in conjunction with a Turkish real estate firm, Korfez, which in turn is a subsidiary of the Kuwait Finance House. It is also assisting a Sudan institution, Al Salam Bank, in which it has a 5% interest, with its initial public offering. In September 2004 it announced that it would issue an AED500 million mortgage backed Sukuk (a bond structured to accord with Islamic banking principles). It is also diversifying domestically; auto loans are its latest product.

UAE mortgage market forecasts (AEDm)

Year at December	2004	2005	2006	2007	2008
Total projects delivered	7,000	13,000	11,000	10,000	3,000
Mortgage financed portion (%)	50%	55%	60%	65%	65%
Size of mortgage market (cumulative)	3,500	10,650	17,250	23,750	25,700
Amlak market share (%)	40%	29%	20%	17%	15%
Amlak loans (gross)	1,397	3,091	3,364	4,038	3,855

Source: Shuaa Capital Equity Research, January 2004.

This forecast shows a steady increase in the proportion of buyers requiring loans and a stead decline in Amlak's market share as other lenders enter the market.

Tamweel

Tamweel is similar to Amlak in many ways and was set up by Nakheel which has a 50% shareholding. The remaining 50% is owned by the Dubai Islamic Bank. Tamweel was established in 1997 and currently has AED270 million capital. The company is intending to make a public offering of its shares.

Although it was established by Nakheel, it will lend on properties built by any of the developers.

Tamweel operates entirely on the Islamic principle. Its main product is the Home Owner Product which is a Murabaha contract. This requires a down payment of at least 20% and loans are for a maximum period of 25 years. The profit rate is fixed throughout the period. It also offers a lease to own product, an Ijarah contract, and a homebuilder product, an Istisna'a contract. Unlike other lenders, Tamweel does not require the purchaser to transfer his bank account. This is considered to be a useful selling point. Tamweel intends to use securitisation in the future.

Dubai Islamic Bank

The Dubai Islamic Bank is the fifth largest bank in the Emirates with total assets at the end of 1993 of AED22.3 billion. The bank offers a housing finance scheme available to UAE nationals only. It has a specific scheme, Sakan, a shari'a compliant scheme for UAE nationals who have obtained home grants and granted land. The maximum financing amount is AED350,000 and the repayment period is a maximum of nine years. The bank also provides finance for other UAE nationals up to a maximum period of 15 years.

HSBC

HSBC is the first of the international banks to come into the home loan market. It has done so in restricted terms however. HSBC will lend only for the purchase of properties constructed by Nakheel. Interestingly, it will also lend for the purchase of properties in one of the other Emirates, the Hamra Village development in Ras Al Khaimah. HSBC currently operates on a variable interest rate basis and will make advances of up to 70% of the purchase price in Dubai and 60% in Ras Al Khaimah. HSBC state that they take a first legal charge over the property. To give it additional security, HSBC offers a discount to customers who agree to transfer their salaries to the bank. HSBC intends to launch a shari'a compliant mortgage product in the future.

Other banks

Two locally based mainstream banks have also entered the house purchase market, Rak Bank, which is the national bank of Ras Al Khaimah, will lend for the purchase of Emaar properties in Dubai. Mashreq Bank lends on all properties.

Securitization

There is considerable interest in securitization of mortgage loans. The Dubai Islamic Bank, Istithmar and Island Capital Group (based in the USA) established the Emirates National Securitization and Finance Corporation (ENSFC) in January 2004 with the objective of issuing mortgage backed securities to be traded on the international markets. Initially the focus will be on commercial rather than residential mortgages. The first issue of securities was expected within six months but has not yet materialised. Amlak has announced the issuing of a mortgage backed bond, although details are not yet available.

How the market will develop

The housing finance market in Dubai can be expected to go through a period of evolution that can probably be predicted with reasonable accuracy. Because there was a huge demand for housing finance that the banks were unwilling to meet, other institutions, Amlak and Tamweel, were established to serve the market. They have demonstrated that there is a big market and that the lending so far at least is safe and secure notwithstanding the unsatisfactory legal framework. The mainstream banks recognise that this is a market they cannot afford not to be in and that they might risk losing their customers to banks that provide housing finance services, particularly given that it is a common practice for banks to require that salaries are paid into an account with the bank as a condition of making a housing loan.

Not surprisingly, the mainstream banks are now looking at entering the market and a number of banks, particularly HSBC, have taken positive steps. It is to be expected that the banks will continue to take market share, particularly if the issues on property law and residency are resolved satisfactorily. Amlak, in particular, has already demonstrated its desire to diversity both internationally and domestically and can be expected to become more like a mainstream bank. Both Amlak and Tamweel will move away from their close links with particular developers. Through the IPO, Amlak has already done this to some extent and Tamweel intends to go in the same direction. It is possible that the mainstream banks will consider an alliance of some form with either Amlak or Tamweel.

Assuming there are no great shocks in the market, it is reasonable to predict that within five years or so the bulk of new funding for home loans will come from mainstream banks with specialist lenders having niche positions in the market.

As the market expands, and if the legal issues are satisfactorily resolved, then the mortgage rate can be expected to decline. At present the 6.5% variable rate for mortgage loans looks high in relation to the cost of funds. It should fall if bad debt experience is minimal and as unit administrative costs decline with the rising volume of business. Shuaa Capital is forecasting that Amlak's cost income ratio will fall from 32% in 2003 to 10% in 2007, a good indication of how a rising volume of business reduces costs.

Chapter 6

Consumer protection issues

The opening of the market in Dubai has raised a number of consumer protection issues. These issues are generally accepted by the market participants and there is a willingness to deal with them. The Dubai Property Group and the Real Estate and Development Group of the Dubai Chamber of Commerce and Industry are already involved in addressing some of the issues. None of the issues is in itself critical at present but all need attending to so as to provide a reasonable element of protection in a market where the amounts involved, and therefore potential detriment, are very large.

Ownership rights
The rather complex legal position has been usefully summarised by a local legal expert, Dr Habib Al Mulla, writing in the *Gulf News* on 12 September 2003 –

> "Article 121 of the Constitution vests legislation, in the area of real estate ownership, with the federal government. Although there are several articles in the UAE Civil Transactions Code 1985 "the civil code" which deal with certain aspects of real estate ownership, the federal government has not passed any legislation which restricts the ownership of real estate in the UAE to UAE nationals. There is also no local legislation to this effect found in the laws of the individual emirates. Restricting ownership of real estate to UAE nationals has merely been a long established administrative practice. The rules of laws between the federal and local legislation prescribes that individual emirates may issue laws in areas that the federal government has not exercised its right until federal legislation has been passed. Accordingly, one is correct to assume that until such time where federal legislation is passed, the matter of ownership of real estate shall be vested with the local emirates."

People have bought on the promise that they will own their property on a freehold basis and with this goes the expectation that they will have full ownership rights including the right to raise money on the security of the property, to sell the property to anyone they choose and to bequeath the property to anyone they choose. These rights need to be protected through ownership being registered with the Dubai Lands Department and title deeds being issued. At present the land is registered in the name of the developer who in turn issues a "certificate of beneficial ownership" to the owner. The major developers are performing a quasi-title registration system themselves so as to ensure that purchasers of their properties, including purchasers on the secondary market, are adequately protected. They work closely with the Lands Department which should ensure a smooth transition to a more proper arrangement when the necessary administrative action is taken.

It may be possible to deal with the administration of title issue by administrative action, that is the Lands Department being instructed to issue certificates of title to purchasers. Other issues, such as inheritance rights and the rights of mortgagees in the event of default, can be addressed subsequently by legislation.

Residency rights
There is no clarity as to the residency rights that go with freehold ownership by non-nationals. Currently, those who buy and occupy are given a residency permit for three years. This is not satisfactory and exposes purchasers to a risk that they will not be allowed to occupy their house after three years and that they will have difficulty in selling because of the lack of residence rights.

Protection against developer defaulting
Buyers of new houses typically pay by instalments, comprising an initial deposit (generally in the range of 10-20% of the value of the house) and then stage payments either at regular intervals or to coincide with set milestones in the construction process. Half completed houses have little value so the purchaser is always in the position of having paid out more than the value of the property until the property is actually completed. Houses are purchased with a view to them having a long life. However, structural defects mean that a property can quickly lose value. The purchaser may have a legal right of action against the developer but this is of no value if the developer has gone out of business and even if he has not the individual home buyer is not well placed to pursue legal action against a developer.

Recognising these points, in most countries there are provisions to protect house buyers imposed either by law or by custom and practice. These arrangements generally comprise protection of deposits during the construction phase and a guarantee against major structural defects for 10 or so years. If the builder is unable to meet these obligations then a central protection fund takes the responsibility. The arrangements are usually, but not always, structured as insurance companies.

The arrangements in the UK usefully illustrate the protection that buyers have. While it is not a legal requirement developers in practice can sell houses only if they are covered by one of two schemes – an industry mutual scheme run by the National House Building Council (NHBC) and a commercial scheme run by Zurich insurance. Lenders will give mortgage loans only on properties covered by one of the schemes. The NHBC scheme, known as Buildmark, covers 85% of all new homes in the UK. 18,000 builders are registered under the scheme. The NHBC sets standards and inspects houses in the course of construction to ensure that they are complied with. There are three main elements to the cover –

- If due to insolvency or fraud the builder does not complete the job, NHBC reimburses all of the money paid to the builder that cannot be recovered from him. The NHBC may pay for the property to be finished to its standards.
- For the first two years after construction Buildmark covers any physical damage caused by a defect which results from the builder failing to meet NHBC standards. This is the responsibility of the builder. The NHBC provides insurance if the builder cannot meet his obligations.
- Between years three and ten Buildmark provides cover against major structural defects.

The scheme is funded by premiums paid by builders, relating the sales value of the home. In Dubai, as has already been explained, these risks are greatly reduced because the new developments for the open market have all been constructed by one of three state backed developers or by sub-developers for whom the primary developer accepts responsibility. Houses also have a one year guarantee. There is sufficient trust in the three developers to re-assure people that they will not lose out by the developer going out of business. The position in respect of subsequent defects is less clear. It is as yet early days and there is little evidence of major structural defects. If these subsequently emerge the cost will fall on the purchaser unless they can recover the costs through the courts from the developer.

More effective arrangements are needed, covering all developers, and formalizing and extending the present level of protection given by the three developers.

Property descriptions

Real estate agents are well known for their expansive and innovative use of language, and home buyers treat words such as “exclusive” and “stunning” with some caution. However, house buyers are entitled to expect that factual information is correct, for example in relation to the size of the property, service charges and facilities. A particular issue is how square footage is measured, for example whether it includes hallways and corridors and balcony areas. In many countries there is an accepted practice so that in fact all developers are working on the same criteria. In other countries the matter is covered by legislation, either general legislation on misleading advertising or specific legislation in relation to housing.

After relying on custom and practice for many years Britain enacted a Property Misdescriptions Act in 1991. The 1991 Act makes it an offence to make false or misleading statements about specified aspects of land (which includes buildings) offered for sale by those in estate agency or property development business. There is no general requirement to disclose information. But where information is given, it must be accurate and must not be misleading. The legislation lists the aspects of property for which misdescription is an offence.

Appraisals

House buyers wish to know that they are obtaining value for money. This is normally done through commissioning an independent appraiser to value the property. The lender will also want a valuation to determine how much it will lend. The valuation is done on an open market basis, that is by examining the prices paid for comparable dwellings in the area. This cannot be done in Dubai as there is no normal market; prices are set by the developer at some stage in the construction process but may be altered to meet changes in market conditions. To the extent that lenders are lending a set percentage of the value of a property they use the actual purchase price paid rather than a valuation. There is no alternative to this given the current stage of evolution of the market, but as the secondary market develops so both lenders and buyers will require professional appraisals.

At present there is little capacity to undertake such valuations and no generally accepted standards. These need to be developed as the market evolves.

Real estate agents
In active real estate markets, housing transactions are handled by real estate agents. They generally act on behalf of vendors and take a commission for so doing. The nature of the business is such that there is substantial scope for malpractice and rich rewards for doing so. Typical problems include –

- The estate agent misleading the vendor about the value of the property, particularly where the vendor is vulnerable, for example a widow selling a house shortly after the death of her husband. The estate agent says the property is worth \$100,000 when it is actually worth \$120,000. The agent then buys it through a related company for \$100,000, promptly reselling it for \$120,000.
- The agent does not pass on offers unless the purchaser is prepared to buy related services, such as arranging insurance, from him.
- The agent misleading potential purchasers about alternative offers – often to the benefit of the vendor if this succeeds in driving the price up.
- The agent misdescribing the property or failing to reveal problems which affect the value.
- The agent imposing onerous terms in small print, such as requiring a commission to be paid if the house is sold without any help from the agent or even if the house is not sold at all.
- Agents sabotaging their competitors' business, for example by removing their for-sale signs.
- Agents pressurising vendors to accept a low price when a higher price could reasonably be obtained.
- Agents misappropriating client funds placed with them.

These problems do not easily lend themselves to solutions and countries have grappled with the problem for many years. A regulatory framework can comprise a number of different features. In the UK there is statutory regulation of estate agents through the Estate Agents Act 1979. The Act requires that estate agents must give clear written information to clients including –

- Details of how much clients will be charged and when payments are due.
- Details of any charges that are in addition to fees, which may include how much will be charge if the property is taken off the market without a sale.
- If exact charges are not known, how the cost will be worked out.
- If additional charges are made - such as for the cost of a 'for sale' board and advertising - these must be stated.
- Technical phrases mean including 'sole selling rights', 'sole agency', and 'ready, willing and able purchaser' must be explained.

Clients must also be told in witing -

- Of all offers that are made on the property .
- If the agent or someone connected with him, such as a relative or a business partner, wants to buy the property.
- If the agent or someone connected with him owns or has an interest in the property.

Agents must not discriminate against a prospective purchaser who does not want to take up other services or misrepresent the details or existence of any offer or the existence or status of any purchaser.

In addition to the various legislative requirements real estate agents may belong to a professional or trade association which gives an additional measure of protection.

These measures are not fully effective and never will be given the state of the market. However, they give a measure of protection and are better than nothing.

Currently real estate brokers in Dubai are required to have a licence but there are few conditions and licences are granted almost automatically. A New Brokers Law was enacted in 2003 but it does not cover everything and has not been fully implemented. The Dubai Property Group operates a code of practice which covers some of these areas, but membership is voluntary and the more dubious real estate agents do not volunteer to be regulated.

Legal services

The sale and purchase of a house is a financial transaction and in most countries it is normal for the parties to be separately legally represented or for a single qualified legal person to oversee the transaction. In Dubai most transactions take place without legal advice. This partly reflects the fact that in the absence of a proper land law and title registration the normal legal processes cannot take place. Again, this is not a major problem while most sales are by one of the three major developers. However, as the market generally expands and the secondary market develops legal services need to be available.

Service charges

Almost all the new developments, including self-contained villas, are subject to service charges. They range from about AED500 a month for small apartments up to AED2,250 a month for large villas. Normally, no charges are payable in the first year or two of ownership.

There are a number of concerns about service charges. The concept is a new one and it remains to be seen if charges have been pitched at the right level, so as to be able to meet maintenance, repairs and refurbishment costs. From the consumer's perspective there must be a concern that services charges can be increased with no opportunity to challenge. Given the fact that many units will have absentee owners there may be difficulty collecting the service charge. In the short term a code of practice can deal with some of these issues. In the longer term a proper commonhold law is needed.

Insurance

The retail insurance markets in Dubai are relatively underdeveloped. Mortgage finance generally leads to markets for life and family protection insurance, property insurance and also mortgage specific products such as payment protection and mortgage guarantees. These products help to protect both investors and borrowers. These products should develop through market forces, particularly when the legal issues surrounding ownership are resolved.

A credit reference bureau

In most industrialised countries retail lenders share information either on delinquent loans or on all retail loans. This benefits lenders by helping to ensure that their borrowers are credit-worthy and it also protects some people from over-borrowing. As with insurance a credit reference bureau should develop as a natural consequence of the growth of mortgage business.

Transparency generally

Markets work best when reliable information is available to all market participants. In Dubai there is a general lack of information, not surprising given the speed with which the market has developed. The fact that title for properties in the new open market is not being registered removes one potential source of high quality information.

Potential buyers and sellers, real estate agents and the regulatory authorities will all be assisted by the compilation, analysis and publication of data on trends in the housing market including the number of sales, price movements, rents and subjective views on attitudes to home ownership and likely future trends in the market. High quality analytical studies will also serve to increase transparency. In other markets the Central Bank is generally one source of such studies given the importance of housing finance for the economy and the banking system. Representative bodies for mortgage lenders and real estate agents and also stock market analysts are other sources of information. The Central Bank could usefully take the lead in improving the quality of market information in the short term.

Chapter 7

Wider economic and policy issues

The private housing market in Dubai is booming; this chapter consider the wider economic implications of developments in Dubai.

The nature of the boom

In any market where prices are rising rapidly there will be a debate about whether a crash will inevitably follow or rather whether the boom is justified by the economic fundamentals and that a soft landing will be the worst than can be expected. The current boom in Dubai is no exception.

Prices do not seem expensive in relation to comparable markets and rental yields remain high suggesting that house prices are not "too high". The fact that new developments are rapidly sold out and that properties attract a premium on the secondary market suggests a strong demand and perhaps also that developers are deliberately underpricing their developments in order to get the psychological benefit of a rising market. As there are only three major developers their pricing policies are crucial to the market. In a fully competitive market developers seek to obtain the highest price that they can get for each property sold. In Dubai there is probably a longer term objective of stimulating a private housing market. In the short term this can be pursued by developers underpricing the houses to ensure a strong demand and to fuel a secondary market in which prices rise, therefore enabling higher prices to be charged on the next development.

However, the Dubai boom is not fuelled by people buying for their own occupation but rather by speculators buying in the expectation of making a quick profit when they resell. It is estimated that over 80% of recent sales have been to speculators who are buying and selling on the basis that prices will continue rising. It is this nature of the boom that is most disturbing from a financial stability perspective and suggests that it cannot continue for long.

What if the market collapses?

In any booming market a subsequent collapse is possible if not probable. The Dubai boom is particularly vulnerable given the absence of strong domestic demand to underpin the market and the fact that most new developments are bought by speculators. Booms can turn into collapses without a trigger point, although often there are such points such as a rise in interest rates or an external shock such as terrorist activity. There is no current sign in Dubai of a collapse but it would be prudent not to rule one out in the future.

What would be the consequences of a collapse? There would be some unhappy buyers but in itself this has few financial implications. More importantly, confidence in Dubai would be knocked which would trigger a further reduction in demand and hence fall in prices. Arguably, prices would only need to fall by a modest amount before a new group of buyers emerged, encouraged by the fundamentals, who would effectively underpin prices.

Falling prices would certainly leave some speculators with their fingers burnt. In itself that is no bad thing as speculators must take the rough with the smooth. However, the speculators may react by unloading properties which would further depress prices. Developers react to falling prices by cutting their prices and also cutting back on supply. However, in Dubai this may be difficult given that most schemes are large and cannot easily be stopped-midstream.

Normally, banks are vulnerable in a property collapse as many have a large proportion of their loan portfolios in loans to house buyers and to developers. Even though the loans are secured by mortgage this may not be sufficient to prevent losses being made. In the case of Dubai this is not likely to be a problem. The developers are all financially strong and there has been very limited lending to individuals secured on mortgage. All this suggests that any downturn in property prices should not have a significant effect on the banking industry.

Should action be taken to try to control the boom?

Other things being equal, the authorities would probably prefer a more orderly housing market, if only to minimize the risk of a subsequent downturn. However, the tools available to the authorities do not enable fine tuning; rather, they are likely to have a major and unpredictable effect or no effect at all.

Normally, the banking regulator can influence the market by tightening the prudential regulation of mortgage lending, for example by changing capital, exposure or provisioning requirements, or simply warning banks about the perceived risks. However, as bank lending for house purchase is so modest this would be ineffective.

The authorities could limit demand by creating uncertainty as to the future status of purchasers and the implementation of appropriate legislation but this could risk having too great an effect. The authorities could also release more land for development and allow more developers into the market as in the medium term an increase in supply will moderate prices.

In practice the best way to reduce speculation is through action by the developers. They can require higher deposits and payments at regular stages in the construction process rather than relying on an initial deposit with the remaining payment being made at completion. Some developers have moved in this direction, and it is understood that they wish to reduce the element of speculation and encourage more sales to occupiers.

Perhaps this matter is best left to the developers in the short term. They have most to gain from an orderly market in the long term and most to lose if there is a collapse in prices. They have to make fine commercial decisions in respect of supply, pricing, marketing strategy and payment requirements, and they are best placed to judge what policies and practices are most likely to produce a healthy market in the long term.

The wider market in Dubai

Dubai now has three distinct housing markets –

- The market for nationals, largely served by state provision. Some of these properties to rented out to the expatriate market but generally there is limited secondary market activity.
- The rental market to expatriates – the largest market at present. Rental yields remain high – in the 8 – 11% range.
- The new market for owned property for expatriates.

While supply into the three markets may be strictly segregated demand is not. Some nationals buy or rent on the open market and to the extent that there is some underpinning of the demand for owned property on the open market it is though demand from those currently living in rental properties for whom purchasing looks a more attractive option. A consequence of the booming market for owned properties has been a fall in rental yields as would naturally be expected, although the data do not exist to enable this to be accurately quantified. The extent to which the markets should remain segmented is a political matter. However, any decisions should be taken on the basis of a good understanding of the current inter-relation between the three markets and how this might develop in the longer term.

The Emirates generally

Developments in Dubai are being watched closely in the other Emirates and some have taken tentative steps to open up their markets. It would be sensible for the framework for an open market to be broadly similar throughout the UAE so that that individual buyers and investors will have greater certainty about the nature of the transactions they are entering into. It is also easier for lenders if mortgage security is broadly similar throughout the UAE.

One area where this would be particular helpful is in respect of enforcing security. The IMF Financial Stability Assessment specifically commented on this –

> "81. **The taking and enforcement of security is complicated and uncertain with respect to both real and personal property.** Enforcement is regarded as problematic, uncertain and time-consuming. The procedures appear to differ between emirates, debtors and assets. Execution of a court judgment essentially involves a second hearing before the court that handles execution of judgments. This entails further delay and the method of enforcement is generally outside the control of the creditor. Where land is taken as security, it may be freely sold in all emirates except Abu Dhabi. However, the procedures are often unclear. The UAE would benefit from adopting a single law that specifically provides for the ownership of real estate, the manner of transfer, and the regime governing execution of mortgages over real estate. Doubts concerning the ability to recover collateral have led to the widespread use of personal and government guarantees. Although the use of foreign choice of law provisions is common, this is somewhat unsatisfactory given that evidence suggests that it is difficult to persuade domestic courts to enforce foreign judgments."

Chapter 9

Supervision of housing finance

House purchase loans can be made by banks or by non-banking institutions. The regulatory regime for the two types of institution can legitimately differ but they need to be constructed in a harmonious way so that there is no opportunity for regulatory arbitrage.

The Basel principles
In most countries there is now a well established framework for the supervision of mortgage lending by banking institutions based on guidelines produced by the Basel Committee of Banking Supervisors. Although the rules apply to international banks the principles are widely accepted as the benchmark for banking supervision. The current set of rules is known as Basel 1. Earlier in 2004 agreement was reached on Basel 2 which will supersede Basel 1 over the next few years.

Supervision of bank lending for house purchase should be regulated as part of the normal prudential supervision of banks. This assigns risk weights to various categories of assets. Loans generally carry a 100% risk weighting for which an 8% capital requirement is considered the minimum. Government securities carry a much lower risk weighting reflecting the security they offer. Because loans secured on residential property are more secure than bank lending generally, under the current Basel rules loans to house purchasers carry a 50% risk weighting. Under the new Basel 2 rules the risk weighting is reduced to 35%. The full text from the Annex to the new rules is set out below –

"Claims secured by residential property

> 15. Lending fully secured by mortgages on residential property that is or will be occupied by the borrower, or that is rented, will be risk-weighted at 35%. In applying the 35% weight, the supervisory authorities should satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules. Supervisors should increase the standard risk weight where they judge the criteria are not met.
>
> 16. National supervisory authorities should evaluate whether the risk weights in paragraph 15 are considered to be too low based on the default experience for these types of exposures in their jurisdictions. Supervisors, therefore, may require banks to increase these risk weights as appropriate."

The Basel 2 rules require that when qualifying residential mortgage loans are past due for more than 90 days they will be risk-weighted at 100%, net of specific provisions. If such loans are past due but specific provisions are no less than 20% of their outstanding amount, the risk weight applicable to the remainder of the loan can be reduced to 50% at national discretion.

National regulators will make their own rules within this general framework. The British Financial Services Authority is proposing to apply the 35% weight to the proportion of a loan up to 75% loan to value ratio with a 75% weighting thereafter. It also considering allowing companies that do not have systems in place to use this framework to weight all residential mortgages at 45%.

This lower risk weighting than for normal loans is justified on both theoretical and empirical grounds. The theoretical grounds are that –

- Unlike most commercial loans the income earned to repay the loan does not derive from the investment financed by the loan. Loans are repaid out of income earned by borrowers and borrowers prioritise loan repayments because failure to do so might mean them losing their home.
- If borrowers lose their income then other means may be available to repay the loan, including income from other family members, savings, income from renting out part of the property, social security payments and in some countries the proceeds of insurance policies.
- If borrowers are unable to repay their loans the lender still does not lose any money because he can possess the property with vacant possession and sell it. The lender is likely to be able to recover the loan from the proceeds because the security is readily marketable (unlike the security for many commercial loans), the loan will have been for no more than 80% of the value of the property, the chances are that house prices have risen since the loan was taken out and insurance may cover any loss that the lender may make.

Empirical evidence also shows that residential mortgage lending is safer than other forms of bank lending. This is demonstrated not only by the loss experience but also by the willingness of lenders to make residential mortgage loans at a narrow spread over the cost of funds. In developed economies this is typically under two percentage points.

It is important to note that the reduced risk weighting follows from the theoretical points in this section, backed up by empirical evidence on the loss ratio. If this supporting evidence is not available in an economy the reduced risk weighting cannot be justified.

Supervision of the quality of a mortgage lender's portfolio

Banking regulators also need to consider the quality of a bank's overall portfolio of mortgage loans to assess whether the capital it holds is adequate or put another way whether the risk weighting is appropriate. If a portfolio is relatively risky then the regulator can legitimately require a higher capital requirement. The following factors are all relevant to the security offered by individual mortgage loans and to the quality of the mortgage loan portfolio of a bank –

- The loan to value (LTV) ratio. Empirical evidence shows that this is a particularly significant factor in determining the likelihood of mortgage defaults and resultant losses. A loan with an LTV of 75-80% has a four times greater expected loss than one with an LTV of between 60-65%. A market has also developed for mortgage insurance (see below) which insures the top slice of the loan and, in a mature market, may allow a loan to exceed the maximum ratio.

- Loan to income ratio. Other things being equal, the higher the loan to income ratio, the greater the risk of default. This spread of risk, for example large exposures, the geographical spread of lending and the spread of lending between types of home buyer.
- Insider lender, in particular lending to purchasers of properties the construction of which the bank has financed or which the bank itself owns, for example have taken them into possession.
- Appropriate credit checks on the borrower.
- Any guarantors, for example a relative or an employer.
- Mortgage insurance. In many countries there are arrangements by which lenders can insure the "top slice" of a loan. Such arrangements might, for example, provide that in exchange for a premium an insurance company will meet any shortfall up to, say, 20% of the value of the loan in the event of the borrow defaulting, the lender repossessing the property and selling it but being unable to recover its debt. There are a number of other types of mortgage insurance. The institutions which can provide such insurance include commercial insurance companies and governmental agencies. Mortgage insurance schemes can also be a means by which other lending requirements can be enforced. For example, mortgage insurance might be available only if loans meet certain requirements, such as a maximum LTV.
- The interest rate risk that the lender takes.
- Term mismatch.

Supervision and secondary market activity

Where mortgage lenders intend to use mortgage securities then an appropriate supervisory regime must be developed. The basic principle is that if a bank wishes to remove mortgage loans from its balance sheet so as to reduce the need for capital backing then the bank must carry no residual risk, for example a buy-back arrangement for defaulting loans. Securities backed by mortgage loans do not achieve this. Sales of portfolios of loans and issuing of securities backed by mortgages may do so but only if they are properly structured so that the whole of the risk passes to the purchaser.

Supervision of mortgage lending in the UAE

It has already been explained that until recently there was no mortgage lending in the UAE. Even now there is little lending secured by mortgage although an increasing amount of lending for house purchase. Given the nature of the security in Dubai it would be wrong for the Central Bank to allow loans for house purchase to have anything other than a 100% risk weighting and this is the current practice.

As the market develops the Central Bank should consider allowing a 50% or lower risk weighting when –

- The law is changed so that loans to finance house purchase have proper mortgage security.

- There is sufficient experience to demonstrate a low level of arrears and losses.
- There are generally accepted appraisal methods and sufficient market data so that banks know the loan to value ratios of properties they lend on.

In the meantime the Central Bank should be increasing its understanding of the functioning of the housing market in the UAE, playing its part in encouraging data collection and analysis and preparing a framework for supervising mortgage lending and developing a policy is respect of capital backing for mortgage securities.

The Central Bank also needs to have in place a framework for the treatment of mortgage securities so as to given market participants the certainty they need to make the necessary investment in these instruments.

The study

The terms of reference of the study were -

1. To summarise the conditions that are needed to encourage the development of housing finance markets.
2. To analyse the current framework in which the housing finance market in the UAE operates
3. To identify obstacles to the development of an efficient housing finance market in the UAE.
4. To identify options for facilitating the development of the housing finance market in the UAE.

The project began with a review of literature and data on the development of housing finance markets in Dubai and comparable economies. This was followed by a visit to Dubai between 25 and 29 September. The programme was arranged by the Central Bank of the UAE and included meetings with –

- The Governor and senior officials of the central bank of the UAE.
- Barclays Bank
- Amlak Finance
- Tamweel
- Dubai Islamic Bank
- Al Tamini & Company
- Dubai Chamber of Commerce and Industry
- Dubai Municipality
- Cluttons
- The Corporate Office
- Sheikh Zayed Housing Programme

Bibliography

Amlak, *The prospectus*, 2004.

Dubai Chamber of Commerce and Industry, *Real Estate Sector in Dubai*, 2004.

Dubai Property Investment Guide, Cross Border Legal Publishing, 2004.

IMF, U*nited Arab Emirates: Financial System Stability Assessment*, IMF Country Report No 03/20, 2003.

Shuaa Capital, *Amlak Finance*, Equity Research 2004.

Shuaa Capital, *Emaar Properties*, 2004.

The author

Mark Boleat has over 25 years' experience in trade associations in the housing and finance sectors in the United Kingdom. Between 1986 and 1993 he was Director General of the Building Societies Association. During this time he was responsible for a demerger which created the Council of Mortgage Lenders, of which he was also Director General, and he was Secretary General of the International Housing Finance Union and Managing Director of the European Federation of Building Societies from 1986 to 1989. From 1993 to 1999 he was Director General of the Association of British Insurers, the largest trade association in Britain.

He has chaired one of the largest housing associations (organisations which provide subsidized rental housing) in Britain and for five years was a member of the Board of the Housing Corporation, which funds as regulates housing associations.

Mark Boleat is the author of the first ever study of housing finance at the international level *National Housing Finance Systems: a Comparative Study* (1984) and he was the founder editor of *Housing Finance International* (1986 – 89). He has undertaken consultancy work on housing finance for the World Bank, the International Finance Corporation, the OECD, the United Nations, the Government of Jersey and major banking institutions.

He has also published a number of books on trade associations including *Trade Association Strategy and Management* (1996) and *Managing Trade Associations* (2003) and has undertaken consultancy projects for British and European associations.

Mark Boleat is a director of Countryside Properties (a large British housebuilder and developer) and the Comino Group (a software company) and has previously been a director of three life insurance companies. He is also a member of the Gibraltar Financial Services Commission, the British National Consumer Council and the Court of Common Council of the City of London.

Tel: + 44 7770 441377
Fax: + 44 1923 836682
E-mail: Mark.Boleat@btinternet.com
Website: www.boleat.com