CHALLENGES OF AFFORDABLE HOUSING FINANCE IN IDB MEMBER COUNTRIES USING ISLAMIC MODES

ISLAMIC RESEARCH AND TRAINING INSTITUTE
A MEMBER OF THE ISLAMIC DEVELOPMENT BANK GROUP

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بسم الله الرحمن الرحيم

Challenges of Affordable Housing Finance
in IDB Member Countries Using Islamic Modes

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABC	Arab Banking Corporation
ADCB	Abu Dhabi Commercial Bank
ADIB	Abu Dhabi Islamic Bank
AFC	Asian Financial Crisis
ALM	Asset Liability Management
APIF	Abu Dhabi Commercial Bank
APUHF	Asia Pacific Union for Housing Finance
ARB	Al-Rajhi Bank
ARM	Adjustable Rate Mortgage
AUB	Asia United Bank (UK)
AUBB	Ahli United Bank Bahrain
AUBK	Ahli United Bank Kuwait
BBA	*Bayʿ Bithaman ʿĀjil*
BFR	Base Financing Rate
BHCI	Banque de l'Habitat de Côte d'Ivoire
BHU	Banco Hipotecario del Uruguay
BIB	Bahrain Islamic Bank
BLOM	Banque Du Liban Et D'outre Mer
BNI	Bank Negara Indonesia
BNM	Bank Negara Malaysia
BTA	Bank Turan Alem (Kazakhstan)
CAB	Community Auction Board
CBQ	Commercial Bank of Qatar
CDS	Cooperative Development Society
CESJ	Center for Economic and Social Justice
CIT	Countries In Transition
CLT	Community Land Trust
CM	Commodity *Murābaḥah*
CMBS	Commercial Mortgage Backed Securities

Co-BILD	Community-Based Initiatives for Housing and Local Development
COHAB	Companie Metropolitana de Habitacao
CP	Completed Property
CPF	Central Provident Fund
CPO	Crude Palm Oil
CSH	Contractual Savings for Housing
DFIs	Development Financial Institutions
DIB	Dubai Islamic Bank
DBP	Declining Balance Partnership
EIB	Emirates Islamic Bank
EM	Emerging Market
FCB	First Community Bank (Kenya)
FDIC	Federal Deposit Insurance Corporation
FFH	Fundo de Fomento de Habitação
FGTS	The Fundo de Garantia do Tempo de Serviço
FHLB	Federal Home Loan Bank
FICO	Fair Isaac Corporation.
FNB	First National Bank (South Africa)
FRB	Federal Reserve Bank
GAB	Gulf African Bank
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GE	General Electric
GFH	Gulf Finance House
GSE	Government Sponsored Entity
HBFC	House Building Finance Corporation
H4H	Habitat for Hunamity
HDB	Housing Development Board of Singapore
HDFC	Housing Development Finance Corporation
HEC	Homeowners' Equity Corporation
HF	Housing Finance
HMF	Housing Micro Finance
HPF	Housing Provident Funds
HSBC	Hong Kong Shanghai Banking Corporation
HUD	Housing and Urban Development
IBB	Islamic Bank of Britain
IBBL	Islami Bank Bangladesh Limited
ICA	International Cooperative Alliance Housing
ICFA	Islamic Cooperative Finance Australia
ICICI	Industrial Credit and Investment Corporation of India

IDB	Islamic Development Bank
IFSB	Islamic Financial Services Board
IFC	International Finance Corporation
IHC	ISNA Housing Co-Operative Ltd
IIAB	Islamic International Arab Bank (Jordan)
IIG	International Investment Group
IMBT	*Ijārah* Muntahiyya Bi Tamleek
IMBD	*Ijārah* Mawsoofa Bi -Dhimma
IMF	International Monetary Fund
IMFB	Integrated Microfinance Bank (Nigeria)
IRTI	Islamic Research and Training Institute
JIB	Jordan Islamic Bank
KFH	Kuwait Finance House
KHFC	Korea Housing Finance Corporation
KIB	Kuwait International Bank
KIC	Kuwait Investment Company
KPI	Key Performance Index
KSA	Kingdom of Saudi Arabia
KWD	Kuwaiti Dinar
LEPS	Law, Environment, Partnership and Subsidy
LIB	Lebanese Islamic Bank
LIHTC	Low-Income Housing Tax Credit
LILAC	Low Impact Living Affordable Community
LTV	Loan to Value
MBS	Mortgage Backed Securities
MCCA	Muslim Community Co-Operative Australia
MENA	Middle East and North Africa
MFI	Micro Finance Institute
MHOS	Mutual Home Ownership Society
MM	*Mushārakah Mutanaqisah*
MNI	Mandatory Notary Index
MPO	*Murābaḥah* to Purchase Order
MV	Market Value
NBFC	Non-Bank Financial Company
NBFI	Non-Bank Financial Institution
NCB	National Commercial Bank (Saudi)
NGO	Non-Governmental Organization
NPL	Non-Performing Loans
OCR	Ordinary Capital Resource
OECD	Organization for Economic Co-operation and Development
PPP	Public Private Partnerships

PRC	People's Republic of China
PU	Purchase Undertaking
QIB	Qatar Islamic Bank
QIIB	Qatar International Islamic Bank
REIT	Real Estate Investment Trusts
REOC	Real Estate Operating Company
RII	Registry Inefficiency Index
RM	Ringgit Malaysia
RMBS	Residential mortgage-backed securities
SBP	State Bank of Pakistan
SC	Standard Chartered
SEW	Sewer, Electricity and Water
SHB	State Housing Bank
SHL	Saudi Home Loan
SLI	Savings & Loans Institutions
SPA	Sale and Purchase Arrangement
SSA	Sub-Sahara Africa
SU	Sale Undertaking
TII	The International Investor
TOKI	Housing Development Administration of Turkey
TRTC	Treasury Resolution Trust Corporation
UAE	United Arab Emirates
UCP	Under Construction Property
UIF	Unit Investment Fund
UIFC	University Islamic Finance Corp
UK	United Kingdom
UNB	United National Bank
UNCHS	United Nations Commission on Human Settlement
UN	United Nations
UNDP	United Nations Development Programme
USA	United State of America
VSB	*Villes sans Bidonville*

LIST OF GLOSSORY

Aḥādīth	Plural of *ḥadīth*. (For meaning, see below).
Aḥkām	Plural of *ḥukm*. (For meaning, see below).
Amānah	Trust.
Awqāf	Plural of *Waqf.* (For meaning, see below).
Āyah	A verse of Qur'ān.
Bayʿ	Stands for sale. It is often used as a prefix in referring to different sales-based modes of Islamic finance, like *murābaḥah, istiṣnāʿ, and salam*.
Bayʿ al-Dayn	Sale of debt. According to a large majority of *fuqahā',* debt cannot be sold for money except at its face value but can be sold for goods and services.
Fiqh	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, *fiqh* covers all aspects of life, religious, political, social, commercial or economic. The whole corpus of *fiqh* is based primarily on interpretations of the Qur'ān and the *sunnah* and secondarily on *ijmāʿ* (consensus) and *ijtihād* (individual judgement). While the Qur'ān and the *sunnah* are immutable, *fiqhī* verdicts may change due to changing circumstances.
Gharar	Literally, it means deception, danger, risk and uncertainty. Technically it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfil his commitment, or ambiguity in the terms of the deal; thereby, exposing either of the two parties to unnecessary risks.

Ḥadīth	Sayings, deeds and endorsements of the Prophet Muhammad (peace be upon him) narrated by his Companions.
Ḥalāl	Things or activities permitted by the *Sharīʿah*.
Ḥazar	Danger, Caution.
Ijārah	Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.
Istiṣnāʿ (Used as a short form for *bayʿ al-istiṣnāʿ*)	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. As against *salam*, in *istiṣnāʿ* the price need not be paid in advance. It may be paid in instalments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
Māl	Asset. Property.
Muḍārabah	A contract between two parties, capital owner(s) or financiers (called *rabb al-māl*) and an investment manager (called *muḍārib*). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.
Murābaḥah	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. *Murābaḥah* is also referred to as *bayʿ mu'ajjal.*
Mushārakah	Partnership. A *mushārakah* contract is similar to a *muḍārabah* contract, the difference being that in the former both the partners participate in the management and the provision of capital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.

Ribā	Literally, it means increase or addition or growth. Technically it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of *fuqahā'* to be equivalent to *ribā*.
Salam	The short form of *bayʿ al salam*.
Sharīʿah	Refers to the corpus of Islamic law based on Divine guidance as given by the Qur'ān and the *sunnah* and embodies all aspects of the Islamic faith, including beliefs and practices.
Ṣukūk al-ijārah	A negotiable financial instrument issued on the basis of an asset to be leased. The investors provide funds to a lessor (say an Islamic bank). The lessor acquires an asset (either existing or to be created in future) and leases it out if it is not already leased out. The *ṣukūk k al-ijārah* are issued by the lessor in favour of the investors, who become owners of the leased asset in proportion to their investment. These *ṣukūk* entitle the holders to collect rental payments from the lessee directly. These *ṣukūk* can also be made tradable in the stock exchange.
Takāful	An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.
Takhrīj	Deducing rules of *fiqh* from existing and varied sources, i.e., from various schools of thought.
Tamwīl	Financing.
Ummah	The nation of Muslims
Wakālah	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
Waqf	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the *Waqf.*

Foreword

Housing is one of the basic human needs. It provides a place of rest and peace of mind. It is closely linked with the whole economy. Promoting housing sector, promotes growth in the economy through employment creation, consumption and investment. The demand for housing has been increasing due to growth of population, urbanization and increase in income, while a number of constraints, with varying degrees in the IDB member countries, hinder the supply of housing. Consequently, almost all the IDB member countries are facing acute housing shortage.

Although many efforts, from the public and private sectors, have been made for construction of housing, but the supply of housing has been not catching up with ever-increasing demand for housing. The member countries, among others, lack housing finance, have weak primary mortgage market and lack secondary market mortgage institutions. Therefore, a country's own efforts alone are insufficient for the provision of required housing demand by their low income and poor people. This calls for the support of private sector and the multilateral organizations along with the public sector efforts for supply of housing.

The present IRTI-IDB occasional paper on "Challenges of Housing Finance in IDB Member Countries using Islamic Modes" is prepared on the recommendation of Board of Executive Directors, IDB Group. The occasional paper estimates housing needs and the financial gap of each IDB member country. It evaluates the current Islamic housing finance models and practices in the member countries and elsewhere in the world. The paper discusses the niche area where the IDB Group can play its role to promote housing sector in the member countries. It provides the overview and insight around all issues related to housing finance in the IDB member countries and suggests the role of IDB group in this respect. The paper will also be useful for the policy makers of the member countries.

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Prof. Dato' Dr. Muhamad Azmi Omar
Director General, IRTI

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Executive Summary

Housing is one of the basic needs. It is linked with many other sectors of the economy and any change in it affects the whole economy and some time the whole world – a case of US subprime crisis. Promoting this sector consequently promotes employment, consumption and investment in the economy.

Although housing is of tremendous importance for the families, society and for the economy at large, the fact remains that all the developing countries including the IDB member countries have been facing severe shortage of housing. Using UN-Habitat (2006) methodology, indicative estimates suggest that the IDB member countries need around 8.2 million houses per year to accommodate poor and low income urban people. This translates into nearly 22,421 dwellings per day in order to accommodate the expected urban population growth. MENA requires 3.2 million housing units per year followed by ASIA (2.7 million), Sub-Sahara Africa (1.9 million) and Countries in Transition (CIT) (0.4 million). This projected figure of housing needs is expected to increase (at an average of 2.83 percent annually) along with the increase in the urban population in IDB member countries

A number of factors constrain the supply of housing especially in the urban cities. Not only the availability of land, but poor quality of infrastructure also affects the supply of affordable housing. Non-transparent ownership, vague property rights, weak legal and regulatory framework and ineffective foreclosures laws, ineffective land registration system, high transaction costs, and inadequate long term housing finance funds have been the major issues of the housing sector.

The registration and Title transfer of property are cumbersome in most of the member countries. In Brunei, registering a property involves seven procedures and takes 298 days. Saudi Arabia gets rank one in the world for easy transfer of titles with only two procedures, no transfer cost and it takes only 2 days to transfer the title of property. The cost to register a property and title transfer is low in some countries, like Kazakhstan (0.1%), Qatar (0.3 %), and Azerbaijan (0.2 %) compared to other member countries like Syria (27.9%) and Nigeria (20.8%), etc. Foreclosure on property is ineffective in most of the member countries; it takes longer time and involves high costs.

A strong primary mortgage market is needed to finance the ever-increasing demand for housing. To facilitate the primary mortgage providers and solve their liquidity problem, a well-developed mortgage industry that include long term financing institutions and markets is needed. However, this industry is not developed in most of the member countries. Some IDB member countries have recently taken the initiative to establish refinance companies for solving the liquidity problem of the primary mortgage market. In Malaysia, the establishment of Cagamas Berhad (Cagamas) has been very successful in promoting secondary mortgage market. The member countries can learn the best practices of Cagamas for the development of their secondary mortgage market.

Many mortgage instruments- with different interest rates and maturity- are available across the countries to cater for the varying needs of the borrowers and lenders. But all these products are interest based and not suitable for Muslim borrowers. However, lesson could be learned from the widely-practiced traditional mortgages for the development of Islamic home mortgage products. Several Islamic modes of housing finance exist in the market. *Mushārakah Mutanaqisah* (diminishing partnership or Diminishing Balance Partnership; DBP) is the most widely used mode of housing finance followed by *Ijārah* and *Murābaḥah* for completed properties. For property under construction, *Ijārah* Mawsoofa Bi Dhimma (IBMD) is the most widely used followed by DBP and *Istiṣnā* .

The study suggests four models including cooperative model, Compulsory Saving for Housing (CSH) schemes, Real Estate Investment Trust (REIT) and the Public Private Partnership (PPP) model. To implement these models in Sharīʿah compliant manner, appropriate tool or product is needed that allow for adjustment to different circumstances, across markets and within customers' needs, and provide multiple liquidity and exit strategies. The study proposes DBP model. The DBP is considered optimal model, which gives investors control over the real estate in environments with weak mortgage laws. This also gives maximum flexibility to manage client needs and client difficulties. The *Mushārakah* base allows for easier monetization compared to other methods, indeed, it creates more tools facilitating securitization.

To overcome the challenges and issues faced by the IDB MCs, the paper proposes that MCs change manual registration of property to electronic registration, which will make the registration process simple by reducing the number of processes and make the costs of transactions reasonable. MCs may allow the registration department to certify the documents rather than involving notaries. This will also cut the procedure involved in and the cost associated with it. They may empower their financial institutions to foreclose the mortgage property without recourse to court, which will reduce the foreclosure time and cost. Furthermore, MCs may promote secondary mortgage market to enhance liquidity in the mortgage market.

The housing sector is too large for any financial institution or government to finance alone. Many of the constraints highlighted above may be addressed with the assistance of multi-lateral development banks including the IDB. Their core competencies include providing guarantees, funding long term infrastructure, and even providing support to nascent capital market. The IDB being a multilateral development bank can play a great role for the development of the housing sector in its member countries through utilizing Islamic modes of finance. In the past, the IDB has financed several housing projects in IDB member countries, partly under the real estate, education, water, sanitation and urban services and social services sector. Since its inception, the IDB has financed 38 housing or housing related projects worth around US$740.79 million.

IDB can encourage and strengthen the housing finance providers through equity. It can help the member countries for establishing and strengthening the secondary market through securitizing the housing finance provided by the funding institutions. The IDB may facilitate developers through creating a special fund for housing projects in the selected member countries and the successful experience, if obtained, be extended and replicated for housing projects development in other member countries.

IDB may further develop Islamic products, which cater for varying needs of the customers. IDB can assist the member countries through providing technical assistance in areas of prudential regulations, mortgage guidelines and mortgage laws.

To overcome the information problem in long term housing finance, the IDB may encourage its member countries to gather information related to different housing events, best practices, reforms and other steps, if any, taken by them and made available to all member countries for the sake of learning and implementation.

CHAPTER 1

1.1 Introduction

Housing has remained one of the basic needs throughout the human history on the earth. The earliest human beings protected themselves from the wild animals and weather in natural caves and rock overhangs[1]. Overtime, they learned and improved their livings. Slowly and gradually, human beings made a tremendous progress in this front and started living in the main land outside the natural shelters. Housing is a blessing from Allah. Quran says "And remember when he made you successors after 'Ad (people), and gave you habitations in the land, you build for yourselves palaces in plains and carve out home in the mountains. So remember the graces (bestowed upon you) from Allah, and do not go about making mischief on the earth". [Al-A'raf: 74]. In other place in the Quran, it has been narrated, "It is Allah who made your habitations homes of rest and quiet for you…" (Al-nahl:80).

Housing plays a very important role not only in the individuals' life but also it brings benefits to the society. Homeownership brings positive specific social benefits which include household stability, social involvement, local political participation and activism, environmental awareness, child outcomes, shaping of health, crime, and community characteristics (Dietz, 2003). Furthermore, housing provides physical, economic, and social security to the poor[2].

Housing and real estate sector are strongly related with the overall development of the economy. This sector is linked with many other sectors and any change in it affects the whole economy[3]. Promoting this sector

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[1] See Freeman, G.D (2006)

[2] See interim poverty reduction strategy of Pakistan (IPRSP), 2001.

[3] The USA subprime crisis not only affected the domestic economy but also affected the global economy. "Crisis led to increase in the supply of homes for sale, depressing their

consequently promotes employment, consumption and investment in the economy. In the USA, 25-30 percent of personal expenditures are allocated for housing rent and utility expenses. Moreover, residential investment represents 20-30 percent of total investments and 4-8 percent of GDP[4]. Housing accounts for 15-40 percent of the monthly expenditure of households worldwide and investment in housing represents 15-35 percent of aggregate investment. Housing construction and housing-related sectors constitute about 9 percent of the labour force worldwide[5].

Although housing is of tremendous importance for the families, society and for the economy at large, the fact remains that all the developing countries have been facing severe shortages of housing. The same is true for the IDB member countries. According to UN-Habitat[6], now more than 1 billion people are living in slums. More than 2 billion people will be added, over the next 25 years, to this growing demand for housing and basic infrastructure services. The situation will be serious in Asian countries, where urban population will double and reach to 3.4 billion between 2010 and 2050. Every day Asian cities will need to accommodate 120,000 new residents, which equates to a daily housing demand for at least 20,000 housing units.

Based on the estimates produced by UN-Habitat concerning housing needs for 2010-2020, the total housing needs for IDB member countries is set to be around 8.2 million units per year.[7] This translates into nearly 22,421 dwellings per day in order to accommodate the expected urban population growth. Bangladesh, Indonesia, Nigeria, Turkey and Pakistan are countries that will require the most housing for the next decade, set to be around 3.9 million units per year. Regionally[8], MENA will require 3.2 million housing units per year followed by ASIA (2.7 million), SSA (1.9 million) and CIT

prices and negatively affecting construction, sale of durable goods and consequently manufacturing sector. The economic contraction in America, affected its trading partners through decrease in trade, investment and remittances. In case of financial sector, the decrease in value of underlying collateral of mortgage has resulted in loss in market value of more than $ 290 billion of bonds associated with subprime mortgage, devastating the capital base of major financial institutions"(see Ebrahim, S. M, 2009).

[4] See Buckley Robert et al (2009)

[5] See Nenova, T (2010),

[6] See United Nations Human Settlements Programme (UN-HABITAT), 2011.

[7] This projection is mainly based on the urban population. Thus, the figure will be higher if rural population is included in the projection. We extrapolated the figure for IDB member countries based on the global estimate of UN-Habitat for developing countries.

[8] MENA region consists of 19 IDB member countries, ASIA 8, Sub-Sahara Africa (SSA) 22 while Countries in Transition (CIT) consist of 7 IDB member countries.

(0.4 million). This projected figure of housing needs is expected to increase along with the increase in the urban population in the IDB member countries at an average rate of 2.83 percent annually.

One of the challenges is to provide and allocate sufficient financial resources for financing the housing needs. Based on the UN-Habitat projected cost for the developing countries, the IDB member countries will require approximately US$15.5 billion per year. As expected, Bangladesh, Nigeria, Turkey, Indonesia Iran and Pakistan are required to provide the most financial resources in order to accommodate the rising needs for housing. Regionally, MENA financial resource requirement will be US$6 billion to meet the housing needs, followed by Asia (US$5.2 billion) and SSA (US$3.7 billion), while CIT will requires the least financial resources (US$0.7 billion). However, this challenge is amplifed by the high degree of slum formation in major cities of IDB member countries.

No government is in a position to cope up with the current housing situation satisfactorily. A number of factors constraint the supply of housing especially in the urban cities. The non-availability of affordable land for the low-income housing in the big cities is a major problem. The economic growth and fast urbanization has pushed up the land prices. Not only the availability of land, but also poor infrastructure affect the supply of affordable housing. The issues related to housing and housing finance, especially in developing countries and particularly in IDB member countries, are complicated. Non-transparent ownership, vague property rights, weak legal and regulatory framework, ineffective foreclosures laws, ineffective land registration system, high transaction costs, and inadequate long term housing finance funds have been the major issues of the housing sector.

The registration and Title transfer of property are cumbersome in some of the member countries. In Brunei, registering a property involves seven procedures and takes 298 days. Other countries like Togo (295 days), Afghanistan (250 days), Bangladesh (245 days) and Suriname (197 days) take longer time to register a property and involve large number (five to eight) of procedures. Nigeria and Algeria involve maximum number of procedures (13 and 10 respectively) among the member countries to register a property, the U.A.E, Saudi Arabia and Oman involve only one and two procedures. Saudi Arabia gets rank one[9] in the world for easy

[9] The ranking on the ease of registering property is the simple average of the percentile rankings on its component indicators. Doing Business (2011) used three indicators, for ranking countries on the ease of registering property, including i) days to transfer property

transfer of titles with only two procedures and 2 days involved to register a property. The registration of property and its title transfer is free of cost.. The cost to r egister a property and title transfer in some countries, like Kazakhstan (0.1%), Qatar (0.3 %), Azerbaijan (0.2 %) and Kuwait is very low compared to other member countries like Syria (27.9%), Nigeria (20.8 %), Senegal (20.3 %), Cameroon (19.2 %) and Guinea (14.4 %).

The efficient laws associated with foreclosure are required for the development of mortgage markets. However, Foreclosure on property is ineffective; it takes longer time and involves high cost. Foreclosure processes takes 260 days across the countries[10]. However, there are many variations in time involved for foreclosure in the IDB member countries. The foreclosure time in Kazakhstan is 55 days, which is the lowest in the World. Foreclosure on property in Tunisia takes the highest time (446 days), followed by Mali (406 days) and Uzbekistan (249 days). The cost associated with foreclosure also varies across the countries. Cost to foreclose in Uzbekistan is the highest (32.35 % of property value), followed by Tunisia (19.22 %), Azerbaijan (15.32 %), Lebanon (14.52 %) and Pakistan (12.33 %). In other countries, it varies from 3.52 % to 7.55 %.

The non-availability of credit information is another constraint on the housing finance. The Lenders are interested to get information regarding the creditworthiness of their borrowers or prospective borrowers in order to determine the risk associated with lending. Similarly,the borrowers are also interested to know about housing finance and associated term and conditions. Such information is helpful for the development of the housing market. For this purpose, most of the member countries have introduced some reforms. They have established credit bureaus or special departments for collecting information on the borrowers. Nevertheless, the information on small retailers, microfinance institution, trade credit data and small loans are excluded and complete information is not available.

The ever-increasing demand for housing cannot be met without strong primary mortgage market. The long-term housing finance maturity and short-term deposits create liquidity risks to the funding institutions. This mismatch could be solved by establishing a deep secondary mortgage market. However, mortgage industry including long term financial institutions are not developed in most of the member countries and such

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in main city, ii) cost as percentage of property value, no bribes included and, iii) and steps to check encumbrances, obtain clearance certificates, prepare deed and transfer title so that the property can be occupied, sold or used as collateral .

[10] See World Bank (2008).

funding facilities are scarce. However, some IDB member countries have recently taken the initiative to establish refinance companies for solving the liquidity problem of the primary market lenders and widening the housing finance risk. In Malaysia, the establishment of Cagamas Berhad (Cagamas), the national Mortgage Corporation, in December 1986 has been very successful in promoting secondary mortgage market and expanding the housing sector in the country. The member countries can learn the best practices of Cagamas for the promotion of their secondary mortgage market.

In the western countries, many mortgage instruments- with different interest rates and maturity- are available to cater for the varying needs of the borrowers and lenders. In countries like Australia, Ireland, Korea, Spain and United Kingdom, variable-rate mortgages often with a short-term initial fixed rate dominate, while short-to medium-term fixed-rate mortgages are the dominant product in Canada, Denmark, Germany, Netherland and Switzerland. In USA, long-term fixed rate mortgages dominate[11]. Lea (2010) further states, "There is no perfect mortgage — the dominant instrument in any country represents a balance between borrower and lender / investor needs. Regulation may have an important influence if it bans or dictates certain features. History too may play a role — an instrument that has been dominant in a market for a long period of time is familiar to both borrowers and lenders and may be difficult to dislodge". Although different mortgage products are available to borrowers across the world including developing countries, all these products are interest based and not suitable for Muslim borrowers. However, lesson could be learned from the best practices of the traditional mortgages for the development of Islamic home mortgage products.

Several Islamic modes of housing finance exist in the mortgage market. Nevertheless, *Mushārakah Mutanaqisah* (Diminishing Partnership or Diminishing Balance Partnership; DBP) is the most widely used mode of housing finance followed by *Ijārah* and *Murābaḥah* for completed properties. For property under construction, *Ijārah* Mawsoofa Bi -Dhimma (IBMD) is the most widely used followed by DBP and *Istiṣnā* . However, there is a need to develop Islamic products, which cater for varying needs of the customers.

The Sharīʿah compliant housing finance has been initiated in many member countries about three decades ago. Sharīʿah compliant housing

[11] See Lea, Michael (2010).

finance is becoming popular across the world and particularly in the member countries. However, presently its share is not more than one-fifth in the total housing mortgages across the member countries. In Malaysia, the share of Islamic modes of housing finance is 17.8 percent in residential properties[12], while this is 21 percent in case of the Pakistan[13]. The Islamic modes of housing financing are expanding in the GCC. In the UK, the Islamic home finance market accounts for about 0.5 percent of the overall mortgage market[14].

The housing sector is too large for any financial institution or government to finance alone. This requires that the financial institutions - public and private- NGOs and the multilateral development financial institutions should come forward to help develop the housing sector through strengthening the primary and secondary mortgage markets across the countries. The IDB, being a multilateral development bank, can play a major role for the development of the housing sector in the member countries.

Although the share of IDB financing in housing sector has been limited, it has played an important role in house financing in its member countries through utilizing Islamic modes of finance. In the past, IDB has financed several housing projects in IDB member countries, partly under the real estate, education, water, sanitation urban services and social services sector. Since its inception, the IDB has financed 38 housing or housing related projects worth around US$740.79 million.

1.2 Objective of the Occasional paper

The focus of this occasional paper (OP) is on financial products and infrastructure innovation for housing finance. The OP will quantify the demand for housing in IDB member countries and estimate the financial requirements. The Paper will evaluate the currently used Islamic house financing models and other traditional housing finance models and products in the IDB member countries and elsewhere in the world. It will also identify niche areas where intervention by the IDB Group can promote the development of housing sector to meet the housing needs in its member countries.

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[12] See Kuwait Finance House (2010).
[13] State Bank of Pakistan (2011)
[14] Kuwait Finance House (2010).

1.3 Methodology Used

The occasional paper utilizes the secondary data and published material[15]. To obtain a comprehensive data on different Islamic housing finance solutions, institutions in nine markets worldwide were surveyed. Since there is no readily available Islamic housing finance database, an internet based search-engine survey adopting a structured convenient sampling method was conducted. In total, 108 institutions in 27 countries were reviewed. The survey had a broad quota of five institutions per country. The sample was identified by searching for multiple key phrases[16] related to Islamic housing finance. Some countries (especially in the GCC) had many Islamic financial institutions that offer variety of solutions. For these countries, the sample includes more than 5 institutions. For the purpose of evaluation and comparison of models, a SWOT analysis has been applied. Similarly conventional and Islamic models are evaluated at scales ranging from '0' to '10' (10 being the most favourable) taking into account the Sharīʿah objectives, efficiency, financial risks, liquidity, return, operational risk, and legal issues. The housing estimates for the IDB member countries are based on UN-Habitat (2006).

1.4 Structure of the Occasional Paper

The occasional paper is decomposed into three parts. Part I discusses affordable housing[17] needs and challenges. It consists of two chapters. Chapter 2 estimates the demand for housing in the IDB member countries, and finds the financial need for the provision of low cost housing. This chapter also highlights the determinants of housing demand.

The IDB MCs face a number of challenges and issues which ultimately constraint the supply of housing. Not only the availability of affordable land, but also many other barriers affect the supply of affordable housing in the big cities. The issues related to housing and housing finance, especially in developing countries and particularly in IDB member countries, are complicated. Non-transparent ownership, vague property rights, weak legal and regulatory frameworks ineffective foreclosures laws, ineffective land registration system, high transaction costs, and inadequate

[15] Material provided in some of the boxes in various chapters is heavily drawn from the source given in the reference in the respective box.
[16] Islamic home finance, Sharīʿah compliant housing finance, Islamic mortgage, Islamic banks etc
[17] The words 'affordable housing' and 'low cost housing' are used synonymously.`

long term housing finance funds have been the major issues of the housing sector. Chapter 3 briefly reviews some of these issues.

Part II of the occasional paper focusses on financing products and models. This part is comprised of two chapters. Chapter 4 discusses the existing practices of Islamic finance for housing in the IDB member countries and elsewhere in the world. It also provides the experience of IDB in housing Finance. Chapter 5 evaluates and compares the models from Sharīʿah perspectives. This chapter further compares the models from efficiency, financial risk, liquidity, return, operational risks and legal and other issues perspectives. Moreover, this chapter recommends for the best innovative products in terms which addresses a number of key goals, the top of which is Sharīʿah compliance, scalability, and ease of implementation An appendix (5) has been added to the occasional paper, which discusses the worldwide housing finance models.

Part III provides 'the way forward'. Chapter 6 suggests housing models and infrastructure requirements, while chapter 7 provides the summary of findings and suggestions.

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PART I

AFFORDABLE HOUSING NEEDS AND CHALLENGES

CHAPTER 2

Housing Demand and Supply in IDB Member Countries

A great number of populations, especially in developing countries, have insufficient access to adequate and affordable housing. Severe housing shortage along with the rapidly growing urban population exist in most of the IDB member countries. According to UN-Habitat (2005), over 2 billion people will add to the growing demand for housing by 2030. Housing and basic infrastructure services will be needed by 40 percent of the world's population (close to 3 billion people). This population growth will require at least 96,150 housing units per day or 4,000 per hour.

The relation between housing finance, housing demand and supply, financial sector development and economic growth has long been recognized by policy-makers in developing countries, and among international development donors. UN-Habitat (2010) finds a strong causal relationship between housing market, finance and economic growth.[18] However, in developing countries, the issues related to housing and housing finance are complicated.[19] On the same note, the IDB member countries are also facing significant challenges in housing sector, albeit with different degrees, which ultimately affect the growth of the housing sector.

The focus of the chapter is to highlight the issues related to supply and demand constraints for housing in IDB member countries. The chapter provides estimates of the housing needs and financial gap for the provision

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[18] UN-Habitat (2010); Glaeser, E.and Sacerdote, B. (2000). "The social consequences of housing".*Journal of Housing Economics,* 9 (1/2), pp.1-23.

[19] Non-transparent ownership, vague property rights, weak legal and regulatory framework, ineffective land registration system, high transaction costs, and inadequate long term housing finance funds have been the major issues of the housing sector.

of housing. The chapter also highlights the challenges facing the housing sector in IDB member countries.

2.1 Housing Demand

The bulk of the research shows that the housing market behavior is remarkably similar from place to place but at different levels and the working of housing markets varies from one place to another. Institutions and constraints, particularly the amount of income available for housing and other goods and services certainly do vary dramatically from place to place. However, these differences in institutions and constraints should not obscure regularities in housing market behavior.

In general, the market demand in the housing sector, among others, is affected by population growth, rates of urbanization, new household formation, property rights, housing finance, subsidies, and macroeconomic conditions while market supply in the housing sector is affected by land availability, infrastructure, building materials, the organization of the building industry, system of property registration, and the scale of private developer initiatives.

2.1.1 Population growth

Population numbers are growing at a fast rate in many countries, creating a huge demand for housing and frequently fuelling urban housing deficits and slum formation or urban informal housing. Some mature cities are experiencing de-population of certain areas but overall urban populations are rising. Understanding the specifics of these population growth dynamics for a given country exposes current and future housing sector needs.

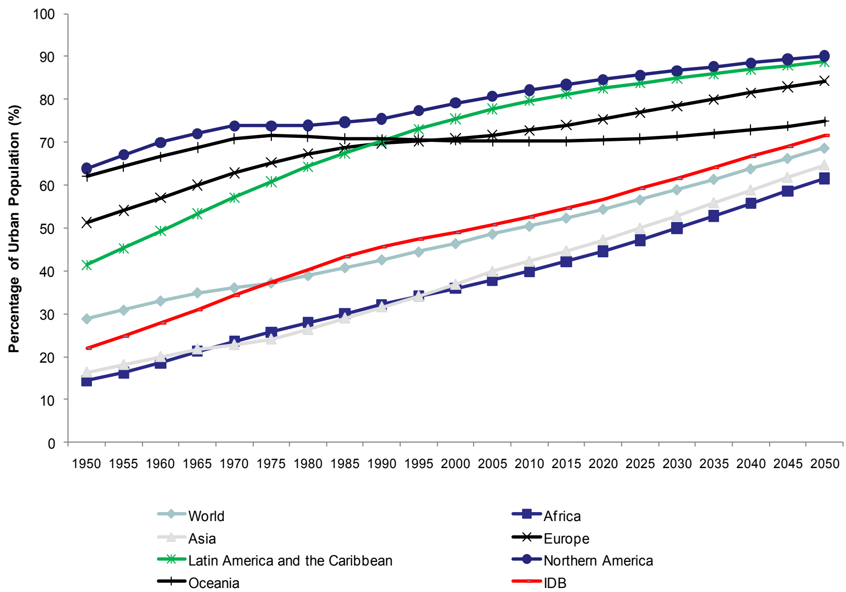
According to the United Nations (2010) the world population will reach 7 billion in 2011, will reach 9.3 billion by 2050, and more than 10 billion by the end of the century. Meanwhile, total population in IDB member countries is projected to grow from 1.6 billion in 2011 to 1.9 billion in 2020, 2.7 billion in 2050, and 3.5 billion by the end of the century (Figure 2.1). Population in the other regional groupings is expected to grow slowly until the 2050s when it will start decreasing gradually. Population in member countries will make up a little more than one-third of world population by 2100. In 2010, the most populous member country was Indonesia (with 240 million people), followed by Pakistan, Nigeria and Bangladesh-all above 100 million people.

2.1.2 Urbanization

Urbanization rates are increasing (but unevenly) globally. In many countries, the main driver behind urbanization is a combination of natural population growth and inter-urban mobility in addition to the on-going rural urban migration. Changes in urbanization will shape changing demands in the housing market. Halfway to the century, the urban population in the developing world is expected to double to 5.3 billion in 2050 (UN-Habitat, 2008).

Combined with some demographic changes, the urban population in IDB member countries is growing at 2.8 percent per year as compared to worldwide average growth of 0.5 percent. An increase of these two factors has resulted in a steady increase in housing demand, thus fuelling the need to scaling up housing finance system and affordability. The total urban population in IDB member countries was 731 million in 2010 representing 53.2 percent of the IDB member countries population (Figure 2.1). The urbanization pressure is also intense in countries such as Uganda and Niger where the percentage of the urban population is low (13 percent and 17 percent respectively) but is increasing at higher rate.

Figure 2.1: Proportion of Urban Population by Regions, 1950-2050



Source: UN Population Division Statistics (2010)

The high growth rate of urbanization which characterizes many cities with urban poverty and inequality has increased the pressure for many countries' authorities to provide sufficient and affordable housing. The other effect of rapid urban growth is also becoming virtually synonymous with slum formation.[20] Slums and squatter settlements (informal housing) are the results of the shortage of affordable housing for low-income urban households in many developing countries. Slum dwellers without legal recognition or rights occupied these unplanned neighbourhoods and are facing a lack of the most basic municipal services such as water supply, sanitation, waste collection or infrastructure. The area of slums thus are always exposed to natural disasters, diseases and crimes. The total backlog current global slum dwellers is estimated at 926 million.[21] In IDB member countries approximately 226 million or 23 percent of world population live in slum. Some of the IDB member countries such as Bangladesh, Indonesia, Nigeria and Pakistan have the highest number of slum population.[22] By economic reality, it is unrealistic to provide a medium- to high-quality housing for the slum dwellers but the authorities can atleast facilitate the provision of low-cost housing with safe and healthy neighborhood and reasonable prospect for upward mobility.

2.1.3 Household Formation and Demography

Information on new household formation and demographic details of the age structure, household size and income of a particular population are important influences of the housing demand. New household formation - who it involves, when it happens in the life cycle of people's lives, reveal important socio-economic and cultural trends that need to be understood. These factors can directly influence the shape of housing demand and offer specific time-bound information on future needs. In 2010, the average total dependency ratio in IDB member countries was approximately 68 percent of the total population mainly representing 58 percent of young population while the population aged 15-64 represents the highest percentage of the population (see Appendix 1).

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[20] UN-Habitat defines slum as contiguous settlements where inhabitants are characterised as having: i) insecure residential status; ii) inadequate access to safe water; iii) inadequate access to sanitation and other basic infrastructure and services; iv) poor structural quality of housing; and v) overcrowding.
[21] UN-Habitat (2006) *Basic Facts on Urbanisation*, Nairobi.
[22] Based on UN Population Division Statistics estimates for 35 IDB member countries slum population.

Some regularity in the pattern of household spending on housing can be observed in most cities of developed and developing countries, in which lower-income households spent a higher proportion of their income on housing compared to more prosperous households. According to World Bank (1993), spending for housing will increase with increases in household income in most urban society. Depending on levels of economic development, the average percentage of income spent on housing increases from about 5 percent to about 30 percent, before it starts to decline again. However, the expenditure allocated for housing increases with the economic progress, which improves the housing conditions.[23]

2.1.4 Property Rights

Issues of security of tenure and ownership are important contributors to housing demand, and affect the strength and reliability in the housing sector. 'Property rights are *sine qua none* of housing market development' because it helps to establish collateral for formal housing loans. In developing countries, the property right is always at the forefront.[24] However, some property rights issues are common among countries, and some issues are specific to some regions or countries. In all cases, complicated inheritance rules, housing subsidies, rental controls, and the level of bureaucracy associated with sale and transfer of housing along with other aspects of property rights always affect housing demand in one way or the others.

Two other areas, which particularly affect the operation of housing and real estate markets, are contract law and land use regulation. Contract law deals with the system that defines and facilitates the transfer of property and property rights, allocates those rights and settles disputes. In most developing countries and in some IDB member countries, the system is not properly in place. Together these two areas of law render operational the notion of ownership, exercise and transfer of right in property. To maximize the social value associated with the rights in real estate, the set of laws and regulations must be transparent and agreed on well-defined consensus as well as enforceable at a reasonable cost or no uncertainy.

According to The Heritage Foundation (2011), on average, the level of property right in IDB member countries is very low. Table 2.1 shows that

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[23] Mayo, Stephen K. and Shlomo, Angel (1993).Housing: Enabling Markets to Works, A World Bank Policy Paper, Washington: World Bank.
[24] Moynihan (1987).

the average property right index for IDB member countries fell to 32.9 in 2011 from 41.6 in 2000. This level of property rights index suggests that in these countries, the court system is highly inefficient, and delays are so long that they deter the use of the court system. Expropriation is possible and property ownership is weakly protected.

Table 2.1: Property Right Index in Selected IDB Member Countries

Country	2000	2011	Changes
Guinea-Bissau	10	20	Improve
Iran	10	10	Neutral
Libya	10	10	Neutral
Albania	30	35	Improve
Azerbaijan	30	20	Deteriorate
Bangladesh	30	20	Deteriorate
Cameroon	30	30	Neutral
Chad	30	20	Deteriorate
Co´te d'Ivoire	30	30	Neutral
Guinea	30	20	Deteriorate
Kazakhstan	30	35	Improve
Kyrgyz	30	25	Deteriorate
Mauritania	30	25	Deteriorate
Mozambique	30	30	Neutral
Niger	30	30	Neutral
Nigeria	30	30	Neutral
Pakistan	30	30	Neutral
Sierra Leone	30	10	Deteriorate
Syria	30	30	Neutral
Tajikistan	30	25	Deteriorate
Togo	30	30	Neutral
Turkmenistan	30	10	Deteriorate
Uzbekistan	30	15	Deteriorate
Yemen	30	30	Neutral
IDB Average	**42**	**33**	**Deteriorate**
Algeria	50	30	Deteriorate
Benin	50	30	Deteriorate
Burkina Faso	50	30	Deteriorate
Djibouti	50	30	Deteriorate
Egypt	50	40	Deteriorate
Gabon	50	40	Deteriorate

Table continues on the next page

Table 2.1 (Continued)

Indonesia	50	30	Deteriorate
Lebanon	50	25	Deteriorate
Mali	50	30	Deteriorate
Morocco	50	40	Deteriorate
Oman	50	50	Neutral
Qatar	50	70	Improve
Saudi Arabia	50	45	Deteriorate
Senegal	50	40	Deteriorate
Suriname	50	40	Deteriorate
The Gambia	50	30	Deteriorate
Tunisia	50	50	Neutral
Uganda	50	30	Deteriorate
Bahrain	60	60	Neutral
Jordan	70	55	Deteriorate
Malaysia	70	50	Deteriorate
Mauritius	70	60	Deteriorate
Turkey	70	50	Deteriorate
Kuwait	90	50	Deteriorate
UAE	90	50	Deteriorate

Note: The property rights measures the degree to which a country's laws protect private property rights in the degree to which its government enforces laws. It also assesses the likelihood that private property will be expropriated and analyzes the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts. The more certain the legal protection of property, the higher a country's index score. Zero (0) is the low score index, whereas 100 is high score index

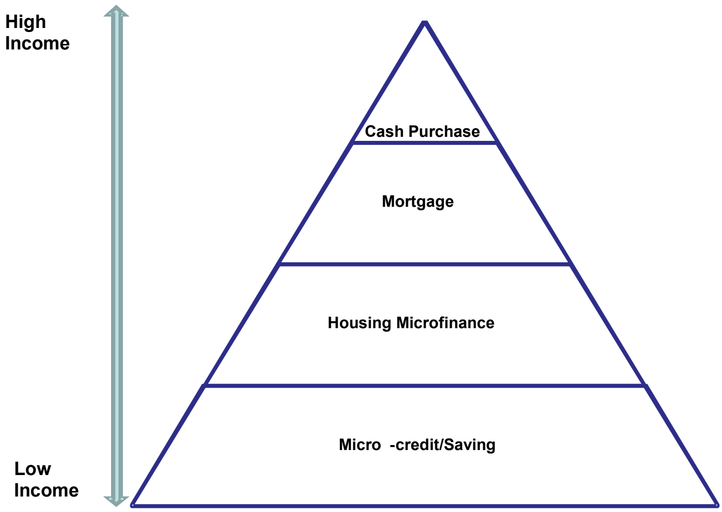
Source: The Heritage Foundation (2011)

2.1.5 Housing Finance

Housing finance systems in many developing and emerging economies share several characteristics such as i) Most housing finance systems are, "institutional patchworks" that comprise private sector lenders as well as several government-managed housing finance institutions or programs (Renaud, 1999), in the form of special government housing "banks" or special housing funds capitalized by payroll taxes; ii) Many government programs use interest-rate subsidies on fixed-rate long-term mortgages; iii) The formal housing finance system only provides mortgage loans for a small proportion of newly constructed houses and home purchases; and iv) Strategies to develop housing finance systems are lagging behind the overall financial development. Many government programs use interest-rate subsidies on fixed-rate long-term mortgages, which have some negative characteristics: i) The funding and cost of special government lending programs to the economy is non-transparent; ii) The subsidized interest-rate programs stimulate debt acquisition rather than savings.[25]

The focus on housing finance is to create well-functioning housing markets and the expansion of a safe and sound housing finance system. Figure 2.2 exhibits the general characteristics of housing financing system. Increasingly, developing countries move towards a more integrated modern housing finance system: i) There is a trend to increasingly rely on capital markets as sources of funds for primary housing finance lenders rather than on depository institutions alone; ii) Assistance to low and moderate income households is necessary, subsidy programs are best designed to allow households to participate in the housing market, rather than provide public housing; iii) Support to moderate income borrowers to acquire loans through the private financial sector has proven to be most efficient; and iv) Social housing funds or lending mechanisms are used that provide shorter-term and smaller loans, at concessionary rates for those households who cannot use the private sector for their housing finance needs, even with special incentive programs.

Figure 2.2: House Financing System

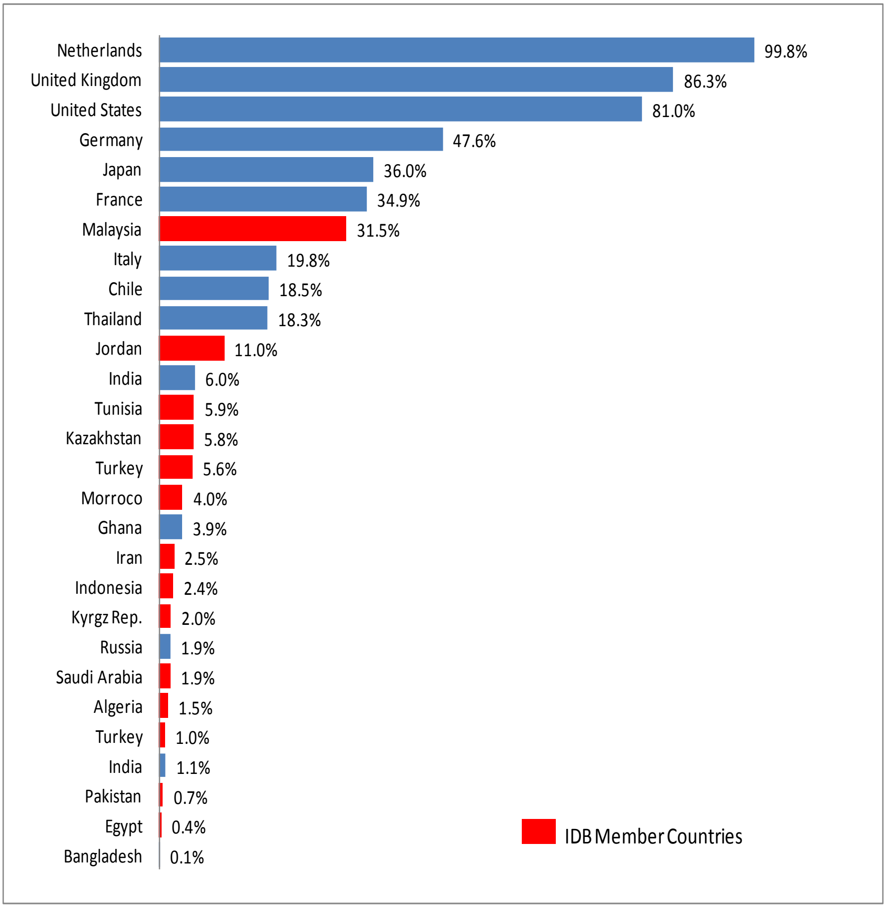


Source: Authors illustration

[25] See Renaud (1999); Hoek-Smit and Diamond (2003), Hoek-Smit (1998) for analyses of housing finance systems in Latin America, Asia and Africa.

The penetration of housing finance has increased dramatically in developed world and developing countries. In the United States, European countries and Japan, residential mortgage markets represent between 50 and 100 percent of the gross domestic product (GDP). In the last decade, outstanding mortgage has increased by more than US$7 trillion.[26].Housing finance has also been developing in more emerging markets, albeit at a different pace and with different outcomes and impacts across countries (Figure 2.3)

Figure 2.3: Housing Finance Depth



Note: Housing finance depth is defined as housing loan to GDP ratio
Source: Various Central Banks, European Mortgage Federation (2009)

[26] Chiquier, Loic and Lea, Micheal (2009) *Housing Finance Policy in Emerging Market,* Washington D.C: World Bank.

Over the last 20 years, housing finance has also reached to significant levels in few middle-income countries (Malaysia and Chile) with residential mortgage amounting to 20-30 percent of GDP. Over the past five years, housing finance also made significant inroads in several other countries (Morocco, Jordan, Kazakhstan, Turkey, and Tunisia) where mortgage markets stand at 6-17 percent of GDP. Although, the housing finance in IDB member countries remained small, some progress can be observed in few of IDB member countries.

The trends in housing finance particularly in Africa, including some of IDB member countries, can be characterized by: i) Very minimal amounts of finance (small mortgages, over shorter terms) are available to very rich clients through a handful of banks; ii) High-income earners usually buy formal housing with cash; iii) The middle classes finance their own housing construction, also usually with cash; iv) Housing process is usually incremental, over time, and often in unplanned areas; and v) Low-income earners finance their housing incrementally, with savings, loans from family and friends, or micro loans, usually on an informal basis and in unplanned areas.

However, to meet increasing demand for housing, a coordinated efforts (from both public and private sector) are required. In addition to that a well-developed mortgage market is needed for the development for financing the housing sector

.

2.1.6 Macroeconomic Conditions

The well-being of the national economy of a given country will directly affect the demand for housing. Macroeconomic conditions can also influence distribution patterns within an economy: Unequal wealth distribution within a growing economy may prevent low-income earners purchasing property and therefore suppress the demand for formal low-income housing as opposed to informal development, or continued slum formation. Affordability is the primary constraint for most potential buyers and residents. The macroeconomic conditions can act as a catalyst or restrictor to the general economy including the housing market. Higher economic growth or income is translated into higher motivation for household to save and in turn influence future consumption of household on housing.

The development of the housing sector is widely recognized as an integral part of economic development. Wider access to housing finance has a significant impact on construction, economic growth and urban development (Renaud, 1999). In addition to the large share that the housing sector occupies in the economy, its importance also arises from the positive externalities and spillover effects, and its impact on the social and political climate, issues of particular importance in developing countries. In most countries, and increasingly so in emerging economies, housing represents a large proportion of a household's expenditure and takes up a substantial part of lifetime income.

2.2 Housing Supply

Despite the very real problems of homelessness in some cities, the percentage of the population without any kind of shelter is typically small and the vast majority of people are housed. However, many people still live in overcrowded quarters or in unsafe shanties and often house prices are too high. The bulk of housing is often produced without direct government assistance as well as vigorously and frequently operated by the informal sector. Recent trends also indicate that housing suppliers in the formal and informal sectors are willing to produce a variety of housing types at all level of affordability to meet the housing needs.

The scale of housing supply is considered fundamental as it affects housing prices and overall housing sector performance that are likely to increase choices and broaden affordability. If housing supply is sufficient, it can also acts as slum prevention and a viable alternative to informal land and housing developments. However, issues around quantity do not only frame the debate but also quality - the socio-cultural aspects of housing supply are important to meet people's needs for not only shelter above their heads but an enhanced quality of life.

2.2.1 Land Availability

Land is the primary means for generating a livehood as shelters, houses, buildings and cities are all built on land. Broadly, the manner and quantity of housing supply is defined by issues surrounding land availability, land ownership, rules concerning sub-division, demolition of old stock, titling and zoning (including the control of density and verticalisation or between residential and commercial areas). The obtaining of land and the issues relating to its use are therefore central to housing supply.

According to Investing across Borders (2010), there is significant variation in term of availability of land information across IDB member countries.[27] On average, only 60 percent of the survey indicate that there is availability of land information, while 30 percent indicate that there is ease access to land information (Figure 2.4). In Morocco, the inventory of available land is publicly available, while in Tunisia the land registry does not provide this information. Similarly, in Nigeria it is easy to find information on land and buildings through the land registry.

Land information is publicly available in Mauritius, but not in Afghanistan. In addition, there is significant variation in the effectiveness of institutions providing lands information (mainly land registries and cadastrals) in which the public land management institutions are not organized well enough to make information easily accessible. Less than a quarter of IDB member countries surveyed have functioning land information systems, and many lack effective and coordinated land management institutions.

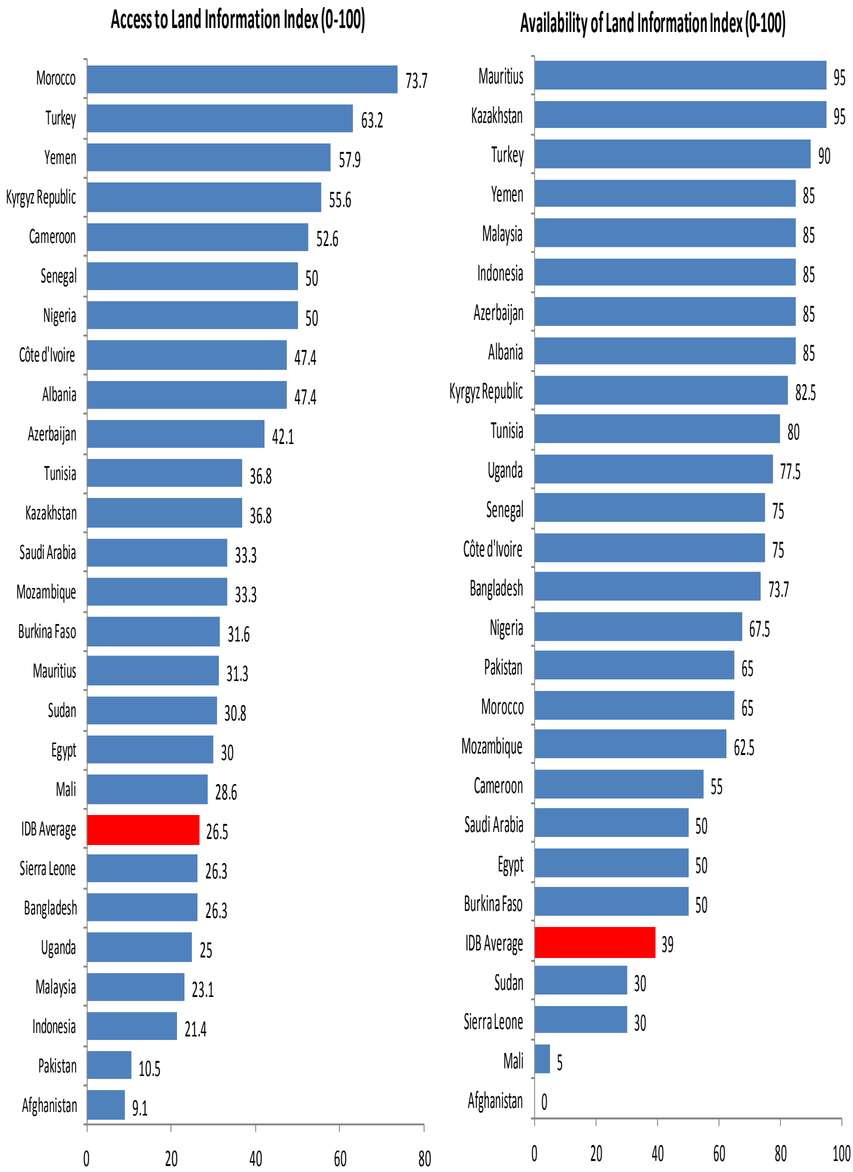
Along the same line of enquiry, Enterprise Survey (2010) conducted by the World Bank also shows that there is high percentage of establishments in IDB member countries which consider access to land a major obstacle for doing business (see Appendix 2).

2.2.2 Infrastructure Quality

Relatively poor infrastructure quality is a serious impediment to attracting scarce investment funds. It also undermines the competitiveness of existing businesses, retards job creation, and acts generally as a bottleneck to growth. Roads, pavements, street lighting, waste collection facilities, water and sanitation systems as well as transportation networks, electrification and provision of market areas and commercial centres near or around residential areas, are all critical to the development of new urban areas and the readiness of the market to supply housing. As most states struggle to

[27] The World Bank reports two important index on land availability: i) the access to land information index compares economies on the ease of access to land-related information through land administration systems - land registries, cadastres and land information systems and also evaluates the modernity of those systems; and ii) the availability of land information index compares economies on the availability of key land-related information to interested private parties through the countries' public land administration institutions. However, the index does not measure an often even more critical factor related to land information - the quality of land information provided by public institutions.

Figure 2.4: Availability and Access to Land Information in Selected IDB Member Countries



Note:. Higher index indicates higher access to land information.

Source: Investing Cross Border (2010)

catch-up with necessary infrastructure to meet rapid urban growth, multilateral development institutions can assist and also be a catalyst for more rapid growth for housing sector in most cities in the developing world. Infrastructure provision is vital to boost housing development and increase supply.

According to the World Economic Forum (2011), general infrastructure quality in IDB member countries, on average, is poorly developed with the average rating of 2.6.[28] Government spending on infrastructure is particularly critical; the lack of basic infrastructure, such as roads, port facilities, and electricity present a major constraint to growth. In 2010, at the extreme spectrum, Chad received the lowest rating of 1.6, while Malaysia received the highest rating of 5.6 (Figure 2.5). Chad infrastructure quality rating is below the expected value of 3.0 and the country lags well behind the IDB rating average.

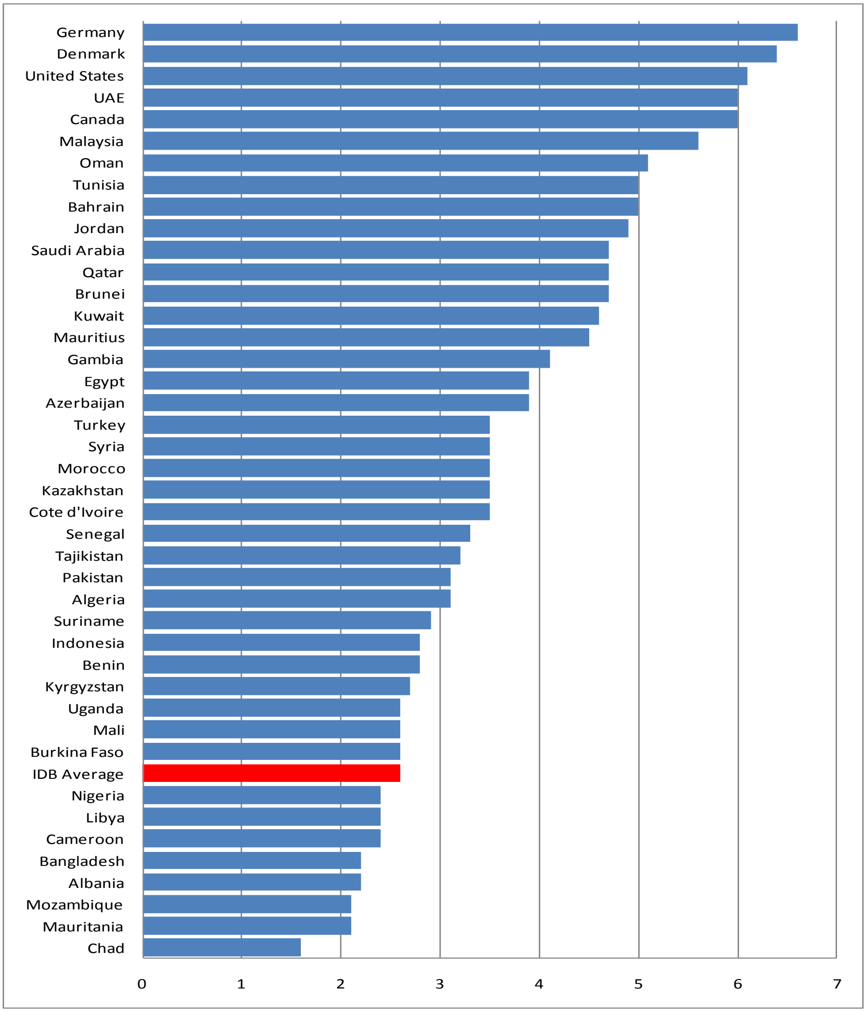
Although urbanization is a healthy feature of structural transformation, a rapid pace intensifies pressure on urban infrastructure and services, underlining the need for the government to allocate a greater share of the budget to capital expenditures and basic services. Furthermore, the poor infrastructure quality (on average) in IDB member countries, can also retard private investment, creates bottlenecks in various value chains, and retards growth in the housing production. Increasing government investment in infrastructure is important for strengthening housing sector growth and to support housing production.

2.2.3 Housing Industry and Materials

As mentioned above, there are at least five specific policy areas which have significant direct bearing on the production of housing and the housing sector's responsiveness to shifts in demand: i) The provision of infrastructure; ii) The regulation of land and housing development; iii) The organization of the construction and materials industry; iv) Labor forces; and v) The involvement of public sector in housing production. The importance of policy in shaping housing sector outcomes based on the findings of data has long been acknowledged.[29]

[28] World Economic Forum compiles an annual index of infrastructure based on a survey of executive opinion in each country. The scale ranges from 1 (poor) to 7 (excellent).
[29] The study based on Housing Indicators Program for 52 Countries by UN-HABITAT and the World Bank, Washington DC, April 1993.

Figure 2.5: Infrastructure Quality in Selected Countries



Note: the index is constructed by the World Bank based on the assessment of general infrastructure quality questionnaire (for example e.g. transport, telephony, and energy) in which 1 = extremely under developed, 7 = extensive and efficient by international standards.

Source : World Economic Forum (2011)

The organization of the national building industry in terms of the different operators (government or private, local or foreign) the characteristics of the operating conditions (monopolistic or competitive) and the regulations under which they operate (open or restrictive) have an impact on market supply and overall housing prices. Greater competition can be created in the building industry by eliminating regulatory barriers to entry, breaking-up monopolies, facilitating equal access of small firms to markets and input, removing constraint to the development and use of local building materials and construction methods and reducing trade barriers related to housing inputs.[30]

Housing production costs depend largely on the cost and availability of inputs - land, labor, building materials and construction equipments. The availability of necessary and suitable building materials is one of the major determinants in production costs that will affect housing supply, as well as the cost of housing.[31] In globalized environment the access to materials, and internationally recognized brands associated with building, occur due to market forces as long as import restrictions do not distort supply. Countries that depend on imported building materials and/or components are subject to changes in exchange rates, import tariffs and other externalities that have a direct impact on housing prices and overall supply. However, externalities such as import restrictions, tariffs, banking blockages as well as poor transport networks can cause major delays and interfere with the efficiency of market supply in the housing sector.

By estimates, 60-80 percent of building projects in developing economies are undertaken without the proper permits and approvals, and many of the buildings erected do not comply with proper safety standards. Thus, to strike the right balance between regulation and cost is a challenge when it comes to developing an efficient housing industry.[32] To measure the ease of doing business in building industry, Doing Business 2011, reports the procedures, time and cost required for a small to medium-size business to obtain all the necessary approvals to build a simple commercial warehouse and connect it to water, sewerage and a fixed telephone line across countries. On average, the whole process of getting construction permit in IDB member countries required 17 numbers of procedures, can take up 196 days to complete each procedure and can costs approximately 533% of income per capita for each procedure.

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[30] If only narrow sections of society are creating the demand then only those groups will be supplied. Often for increased equity and housing supply for low-income households (and as an alternative to informal slum formation), the government needs to organize the building industry to create incentives and support the establishment of specialize social housing organizations.

[31] It also appears that construction costs are considerably higher relative to incomes in the lowest-income countries than in better-off countries. Thus, certainly depresses housing quality in the former.

[32] For example, about 90% of the building in Egypt without proper permits and approvals (de Soto, 2000).

The housing space and quality improve systematically along with the improvement in economic development. However, housing quality in most prosperous countries with comparable levels of per capita income remain significantly different. UN-Habitat (1993) shows that when the the per capita income of the country is higher, the floor area per person generally gets larger. Given the large variation in this indicator between cities in countries with comparable per capita incomes, many other factors may also influence the findings (Table 2.2). Thus, a more precise indicator to explain overcrowding is the floor area per person rather than persons per room indicators.

World Bank (1993) suggests that among the main reasons for differences in housing space and quality are the effective and efficient government housing policies and improvement in countries' income that ensure adequate supply of land, infrastructure, and materials for housing industry and and unconstrained housing finance,[33] For example, although nearly all households in the cities in the mid- to high-income countries are getting water connection to the plot they occupy, the evidence shows that increase in the country's per capita income will increase the proportion of water connection for dwellers in cities.

2.2.4 Property Registration

Establishing landownership, land registration, and titling remain problematic in developing countries including many IDB member countries. Speed, low cost, and simplicity are fundamental to an efficient system for registering property and mortgages and for transferring titles. The security of land rights is also the most important prerequisite for robust housing markets. This includes the framework that regulates and supervises the development and purchase of land, the construction and purchase/sale of housing including time and cost involved in receiving official permission or sanction to buy/sell or build housing/land. It also includes official standards on building, building materials, infrastructure and services and land use and development (for further details see Chapter 3).

[33] Mayo, Stephen K. and Shlomo, Angel (1993).Housing: Enabling Markets to Works, A World Bank Policy Paper, Washington: World Bank.

Table 2.2: Housing Quality

Income Grouping	Floor area per person (m2)	Person per room	% age of permanent structures	% of dwelling units with water connection to their plot
Low-income countries	6.1	2.47	67	56
Low-mid income countries	8.8	2.24	86	94
Middle-income countries	15.1	1.69	94	94
Mid-high-income countries	22	1.03	99	99
High-income countries	35	0.66	100	100

Source: The Housing Indicators Program, Preliminary Findings: A Joint Programme of United Nations Centre for Human Settlements (Habitat) and the World Bank, Washington DC, April 1993.

2.3 Housing Needs and Cost for IDB Member Countries

The efforts of governments and the private sectors to address the challenges of the growing housing need in the country depend largely on the reliability of existing housing statistics combined with having the appropriate framework that will guide the estimation of current and future housing needs. Housing needs estimates are a pragmatic device for shaping and implementing public policies. The formulation of a quantified estimate of housing needs requires many assumptions that intertwine normative and empirical judgments.

The United Nations defines housing needs as the number of conventional dwellings or other suitable living quarters that need to be constructed or repaired in order to bring housing conditions, as of a particular point in time, up to nationally adopted standards, plus the number that need to be constructed, repaired and/or maintained to ensure that housing conditions remain at the standard level over a stated period of time.[34] Estimates are prepared for either of two (sometimes both) essential time periods: i) estimate the gap or deficit by which *current* local housing conditions fall short of a normative standard; and ii) estimate the amount, and characteristics, of new construction required to accommodate the *projected future* population growth. Nevertheless, the final cost of fulfilling housing needs is obviously much influenced by the cost of land, construction and finance for housing construction (including land purchase) and may explain the large differences in housing quality between countries.

Although such estimates for IDB member countries are scarce and make it difficult to make meaningful comparison, there is a significant under supply for affordable middle-income housing in the member countries.[35] UN-Habitat (2006) has produced a global estimate that the total average annual housing needs for the whole world will be about 39 million units (or more than 105,000 units a day) in the following decade (2010-2020).[36] The average cost of fulfilling the projected housing needs for globally is roughly about US$74 billion annually.

Based on the estimates produced by UN-Habitat concerning housing needs for 2010-2020, the total housing needs for IDB member countries is set to be around 8.2 million units per year.[37] This translates into nearly 22,421 dwellings per day in order to accommodate the expected urban population growth.

[34] "Housing need" and "housing requirements" have the same meaning and are used interchangeably throughout the UN manual: United Nations, Methods of Estimating Housing Needs, Studies in Methods Series F. No. 12, New York, 1967.

[35] According to Global Urban Development (Nov, 2008), the current supply satisfies a modest 50% of demand for affordable housing for Asia and the Middle East with annual household spending i.e. rents and mortgage payments, estimated to be $171.4 billion. This undersupply extends its reach to the housing market in Africa as well, where the current supply serves only 44% of the needs with an annual household spending of US$42.9 billion.

[36] Average annual housing need equals: i) the total of the average annual increase in number of households; plus ii) 5 percent of the total number of household inadequately housed in the year 2000; plus iii) 1.5 percent of the total number of adequate housing units in the year 2000. It is important to note that the average annual housing need is affected only to a limited degree by the current scale of housing poverty. This is so partly because two-thirds of the need is due to the increases in the number of household.

[37] This projection is mainly based on the urban population. Thus, the figure will be higher if rural population is included in the projection. We extrapolated the figure for IDB member countries based on the global estimate of UN-Habitat for developing countries.

Table 2.3 shows the estimated housing need for IDB member countries in the next decade. Bangladesh, Indonesia, Nigeria, Turkey and Pakistan are countries that require the most housing needs for the next decade, set to be around 3.9 million units per year. Regionally[38], MENA requires the most housing needs of 3.2 million units per year followed by ASIA (2.7 million), Sub-Sahara Africa (SSA) (1.9 million) and Countries in Transition (CIT) (0.4 million). This projected figure of housing needs is expected to increase along with the increase in the urban population in IDB member countries at an average of 2.83 percent annually.

One of the challenges is to provide and allocate sufficient financial resources for financing the housing needs. Based on the UN-Habitat projected cost for the developing country, average financial cost required per year by IDB member countries is approximately US$15.5 billion. Bangladesh, Nigeria, Turkey, Indonesia, Iran and Pakistan are required to provide the most financial resources in order to accommodate the rising needs for housing. Regionally, MENA requires the most financial resources (US$6 billion) to meet the housing needs, followed by Asia (US$5.2 billion) and SSA (US$3.7 billion), while CIT requires the least financial resources (US$0.7 billion). However, this challenge is amplified by the high degree of slum formation in major cities of IDB member countries. Government alone may not able to satisfy the housing needs, without active participation from private sector. It is important to note that fulfilling the housing need of nation is just one step, but most importantly is to provide affordable and quality housing to fulfill the housing needs of IDB member countries.

In many instances, the problem is not just one of too few housing units but also of the poor quality and lack of basic services in a high proportion of housing stock. The quality and housing condition in any country can be identified into four main aspects[39]: i) Housing quality-its size relative to the number of inhabitant, the quality of construction and the extent of provision for water supply, electricity, sanitation and drainage; ii) Housing tenure-the proportion of households who, as legally recognized owners or renters, have protection against sudden or arbitrary eviction; iii) Quantity of housing; and iv) Housing accessibility-the proportion of people able to buy, rent or in other ways obtain adequate quality housing. However, it is difficult to substantiate statistically whether housing conditions under

[38] MENA region consists of 19 IDB member countries, Asia 8, Sub-Sahara Africa (SSA) 22 while Countries in Transition (CIT) consist of 7 IDB member countries.
[39] UN-Habitat (2010), *A Practical Guide for Conducting Housing Profile: Supporting Evidence Based Housing Policy and Reform*, Nairobi: Kenya.

Table 2.3: Estimates of Housing Needs and Costs for IDB Member Countries

Country	Urban to Total Pop. (%) 2010	Urban Pop. 2010 (million)	Country Share Urban Pop. (%)	Housing Need Per Year	Average Annual Cost (US$ mil)	Urban Growth (2010-2015)
Afghanistan	22.60	6,581	0.90	73,613	139.7	4.68
Albania	51.91	1,645	0.22	18,403	34.9	2.27
Algeria	66.50	23,555	3.22	263,500	500.0	2.29
Azerbaijan	51.93	4,639	0.63	51,900	98.5	1.40
Bahrain	88.61	715	0.10	8,001	15.2	1.85
Bangladesh	28.07	46,149	6.31	516,251	979.6	3.13
Benin	42.04	3,873	0.53	43,325	82.2	4.01
Brunei	75.65	308	0.04	3,445	6.5	2.20
Burkina Faso	25.69	4,184	0.57	46,803	88.8	6.21
Cameroon	58.40	11,655	1.59	130,381	247.4	3.34
Chad	27.63	3,179	0.43	35,558	67.5	4.62
Comoros	28.19	195	0.03	2,180	4.1	2.75
Côte d'Ivoire	50.56	10,906	1.49	122,006	231.5	3.72
Djibouti	76.23	670	0.09	7,496	14.2	1.76
Egypt	43.40	36,664	5.01	410,144	778.2	2.09
Gabon	86.03	1,292	0.18	14,448	27.4	2.13
Gambia	58.15	1,018	0.14	11,388	21.6	3.74
Guinea	35.36	3,651	0.50	40,837	77.5	4.27
Guinea- Bissau	30.00	494	0.07	5,529	10.5	3.00
Indonesia	44.28	102,960	14.07	1,151,765	2,185.4	1.72
Iran	70.75	53,120	7.26	594,228	1,127.5	1.90
Iraq	66.17	20,822	2.85	232,931	442.0	2.59
Jordan	78.53	5,083	0.69	56,857	107.9	1.57
Kazakhstan	58.51	9,217	1.26	103,104	195.6	1.27
Kuwait	98.38	3,001	0.41	33,576	63.7	2.06
Kyrgyzstan	34.55	1,918	0.26	21,451	40.7	1.27
Lebanon	87.24	3,712	0.51	41,523	78.8	0.94
Libya	77.89	5,098	0.70	57,032	108.2	2.07
Malaysia	72.17	20,146	2.75	225,361	427.6	2.44
Maldives	40.10	126	0.02	1,408	2.7	4.24
Mali	35.86	4,777	0.65	53,441	101.4	4.44
Mauritania	41.43	1,395	0.19	15,600	29.6	2.86
Morocco	58.24	18,859	2.58	210,962	400.3	2.15
Mozambique	38.43	8,996	1.23	100,632	190.9	4.02
Nigeria	49.80	78,818	10.77	881,700	1,673.0	3.50

Table continues on the next page

Table 2.3 (Continued)

Country	Urban to Total Pop. (%) 2010	Urban Pop. 2010 (million)	Country Share Urban Pop. (%)	Housing Need Per Year	Average Annual Cost (US$ mil)	Urban Growth (2010-2015)
Palestine	74.14	3,269	0.45	36,572	69.4	3.19
Oman	73.04	2,122	0.29	23,735	45.0	2.27
Pakistan	35.90	66,318	9.07	741,871	1,407.7	3.10
Qatar	95.83	1,445	0.20	16,169	30.7	1.62
Saudi Arabia	82.07	21,541	2.94	240,970	457.2	2.21
Senegal	42.38	5,450	0.75	60,970	115.7	3.25
Sierra Leone	38.40	2,241	0.31	25,065	47.6	3.35
Somalia	37.45	3,505	0.48	39,205	74.4	4.08
Sudan	40.10	17,322	2.37	193,773	367.7	3.74
Suriname	69.38	364	0.05	4,070	7.7	1.45
Syria	55.74	12,545	1.71	140,331	266.3	2.45
Tajikistan	26.32	1,862	0.25	20,830	39.5	2.24
Togo	43.44	2,945	0.40	32,948	62.5	3.86
Tunisia	67.28	6,980	0.95	78,083	148.2	1.54
Turkey	69.65	52,728	7.21	589,843	1,119.2	1.72
Turkmenistan	49.50	2,562	0.35	28,665	54.4	2.20
Uganda	13.30	4,493	0.61	50,263	95.4	4.82
UAE	84.05	3,956	0.54	44,259	84.0	2.32
Uzbekistan	36.25	10,075	1.38	112,702	213.8	1.37
Yemen	31.80	7,714	1.05	86,296	163.7	4.59
World	50.46	3,486,326[1/]		39,000,000[2/]	74.0[3/]	2.27
IDB		731,575[4/]		8,183,809	15.5	2.83
IDB (% of World)		21.0[5/]				

Source: World Urbanisation Prospects: The 2009 Revision, United Nation; UN Population Division Statistics (2011).

Note: 1/This projection is mainly based on the urban population. We extrapolated the figure for IDB member countries based on the global estimate of UN-Habitat for developing countries. 2/World urban population is based on UN Population Division Statistics (2011); 3/World housing needs is based on UN-Habitat (2006) global estimates of 39 million per year; 4/World housing cost is based on UN-Habitat estimates for cost of slum upgrading and providing adequate alternatives to new slum formation is set about average US$74 billion a year; However, these estimates are indicative. For precise estimates, a detailed case study of each country is required. 5/ Total urban population in IDB member countries; 6/ percentage of IDB urban population over world urban population;

these four aspects improved or not. For many countries particularly in IDB member countries there are no reliable statistics on housing, while detailed data from most recent census are still not available.

Although market-based finance with generally affordable terms has spread widely across the world to fulfill the housing needs, it has also moved away from the poverty orientation in term of lending and support to low-income population. Many countries, in which formal housing finance is available, do not have policy, legal, regulatory and housing market conditions hospitable to the development of housing finance. Policy reforms and increasingly broad acceptance of the importance of the private sector role have not been translated into policy-makers treating land as an important input in the provision of housing services. Issues such as lack of title, restrictive zoning and occupancy regulations, large-scale employment in the informal sector, and inability to enforce contracts make housing finance infeasible in many countries and simply fuels housing demand in supply-constrained markets, thereby feeding sharp price increases in housing rather than increases in housing supply.

It is also widely acknowledged that an inadequate supply of affordable housing finance remains a major barrier to improving living conditions and providing affordable housing for the urban poor. There are several major reasons[40]: i) Affordability - low- and middle-income households cannot afford the debt service required to finance a minimum core unit; ii) Standard loan requirements - are not pro-poor. Traditional mortgages often require full legal title as a security; iii) Financial institutions perceive few incentives to lend to the poor. Small loans amounts, high transaction costs, additional work to verify creditworthiness; and iv) Additional risk associated with incremental approach to housing - including potential 'illegality' in terms of non-compliance with building/planning regulation. As a result, low- and middle-income household adopt finance strategies based on savings, family loans and remittances, neighborhood lending and moneylender or pawnbrokers.

IDB, multilateral development institutions, international donor community and private sector have a large role to play in providing shelters or affordable housing to the millions of underserved poor people around the world.[41] It is important to show how the housing or shelter sector is linked

[40] See Ferguson (2004), UN-Habitat (2003) and UN-Habitat (2005).

[41] According to the World Bank (2006) shelter loans have also had one of the most satisfactory outcomes of any sector in the World Bank with more than 83 percent of shelter

to economic growth as well as poverty alleviation. Improving shelter or housing conditions has undeniably desirable welfare effects. In the functioning of financial systems, it can also be a key feature of the investment climate as housing and land account for such a significant share of investment and wealth. When managed effectively, housing policy can be an important source of financial stability and economic resiliency, as well as a major component of the social development agenda, whereas when housing policy is not managed effectively, the housing sector can contribute to financial instability and increased inequality.

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lending and almost 78 percent of shelter projects for the entire 34 years of lending have had satisfactory outcomes.

CHAPTER 3

Challenges and Issues of the Housing Sector

The housing finance system, across the world and especially in the developing countries, is very complex. The system involves the transfer of property rights between the builders, sellers, agents, the house buyers and the financial institutions. The responsibility of each side must be clearly defined and protected. The house-buyers would like to get the title of the house with minimum transaction cost and time, while the financial institutions would like to ensure that finance provided would be recovered. For this purpose well-defined and transparent procedures and regulatory framework are required. However, the issues related to housing and housing finance, especially in developing countries, are complicated. Non-transparent ownership, vague property rights, weak legal and regulatory framework, ineffective land registration system, high transaction costs, and inadequate long term housing finance funds have been the major issues of the housing sector. Housing sector of the IDB member countries has been facing these challenges, of course with different degrees, which ultimately affects the growth of the sector. This chapter is devoted to overview some of these issues.

3.1 Registration and Title Transfer of Property

Most housing lending depends on clearly defined and documented property rights; therefore, clear and transparent property rights are crucial to housing finance. In most of the member countries record keeping of property is vague, registration and title transfer is cumbersome and consequently increasing the time involved in transaction of property and the cost of transaction. The physical identification and demarcation of property is complicated in some of the countries due to the involvement of different government departments and the absence of co-ordination among them. The records are manually maintained which increases the probability of mistakes and the claim of third party on the property, which leads to corruption, increase the time involved in registering property and title transfer[42]. There is no unique and simple procedure for property registration and title transfer in all the countries, rather different procedures have been used for the registration purpose across the countries. This could be due to the practices of the registration system, going through endless red tape, the capacity of the concerned staff and the overall legal system of the country.

Table 3.1 depicts the cost and time involved to register a property in IDB member countries. The Table shows that title transfer is cumbersome in some of the countries, which takes longer time and number of procedures involved to register a property and transfer the title compared to other member countries. In Brunei, registering a property involves seven procedures and takes 298 days. Other countries like Togo (295 days), Afghanistan (250 days), Bangladesh (245 days) and Suriname (197 days) take longer time to register a property and involve large number (five to eight) of procedures. Nigeria and Algeria involve maximum number of procedures (13 and 10 respectively) among the member countries to register a property. Majority of the member countries involves five to seven procedures in completing the title transfers, where U.A.E, Saudi Arabia and Oman involve only one and two procedures respectively. Saudi Arabia gets rank one[43] in the world for easy transfer of title with only 2 procedures and 2 days involved to register a property and transfer of title. Although U.A.E involves one procedure and takes two days to complete the process of title transfer but it stands at rank six among the world and second in the member countries.

Low cost in addition to fewer procedures involved and speed to register a property are crucial for an efficient system of title transfer and for the development of the housing sector. In Saudi Arabia, no cost is involved in title of property transfer. Cost to register a property and title transfer in some countries, like Kazakhstan (0.1%), Qatar (0.3 %), Azerbaijan (0.2 %) and Kuwait (0.5%) is very low compared to other member countries like Syria (27.9%), Nigeria (20.8 %), Senegal (20.3 %), Cameroon (19.2 %)

[42] No clear land registration law exists in Afghanistan; about 70 percent of residents live on unregistered property. (See Nenova, T., 2010).

[43] The ranking on the ease of registering property is the simple average of the percentile rankings on its component indicators. Doing Business (2011) used three indicators, for ranking countries on the ease of registering property, which include i. days to transfer property in main city, ii. cost as percentage of property value, no bribes included and, iii. steps to check encumbrances, obtain clearance certificates, prepare deed and transfer title so that the property can be occupied, sold or used as collateral.

and Guinea (14.4 %). In few countries, title transfer is below five percent of the value of the property and in most of other cases it is in the range of seven to ten percent of the value of property (see Table 3.1). Rationalization of the cost of title transfer may be taken seriously by the member countries for the overall development of the housing sector.

Table 3.1: Time and Cost to Register Property

Country	Registering property (rank)	Procedures (number)	Time (days)	Cost (% of property value)
Afghanistan	172	9	250	5
Albania	118	6	33	11.9
Algeria	167	10	48	7.1
Azerbaijan	9	4	11	0.2
Bahrain	30	2	31	2.7
Bangladesh	173	8	245	6.6
Benin	130	4	120	11.8
Brunei	107	7	298	0.6
Burkina Faso	111	4	59	12.8
Cameroon	154	5	93	19.2
Chad	143	6	44	18.1
Comoros	74	4	30	10.5
Cote d'Ivoire	158	6	62	13.9
Djibouti	148	7	40	13
Egypt	93	7	72	0.8
Gabon	134	7	39	10.5
Gambia	119	5	66	7.7
Guinea	152	6	59	14.4
Guinea-Bissau	179	8	210	10.6
Guyana	104	6	75	4.6
Indonesia	99	6	22	10.8
Iran	163	9	36	10.5
Iraq	98	5	51	6.9
Jordan	101	7	21	7.5
Kazakhstan	29	4	40	0.1
Kuwait	88	8	47	0.5
Kyrgyz Republic	17	4	5	2.2
Lebanon	105	8	25	5.8
Libya	--	--	--	--
Malaysia	59	5	48	3.3

Table continues on the next page

Table 3.1 (continued)

Maldives	152	6	57	16.7
Mali	91	5	29	12.1
Mauritania	59	4	49	4.7
Morocco	144	8	75	4.9
Mozambique	156	8	42	8.7
Niger	86	4	35	11
Nigeria	180	13	82	20.8
Oman	21	2	16	3
Pakistan	125	6	50	7.7
Qatar	37	7	13	0.3
Saudi Arabia	1	2	2	0
Senegal	171	6	122	20.3
Sierra Leone	169	7	86	11.8
Sudan	41	6	9	3
Suriname	170	6	197	13.8
Syria	82	4	19	27.9
Tajikistan	90	6	37	5.3
Togo	162	5	295	13
Tunisia	65	4	39	6.1
Turkey	44	6	6	3.3
Turkmenistan	--	--	--	--
U.A.E	6	1	2	2
Uganda	127	13	48	2.9
Uzbekistan	136	12	78	0.9
Yemen	55	6	19	3.8

Source: Doing Business, 2011, available at http://www.doingbusiness.org

A serious attention is also to be paid by the member countries to reduce the number of steps in the registration process and make it simple.

Table 3.2 reports the mandatory notary index (MNI), registry inefficiency index (RII) and whether registry is manual or electronic in some of the member countries. The MNI indicates the involvement of notaries in registration, while RII measures speed, transparency, cost and accessibility. The value of the indices varies from zero to one. The higher value of MNI indicates higher level of mandatory participation by notaries and the higher value of RII shows greater inefficiency.

Table 3.2: Registering a mortgage and title transfer (mandatory notary index, registry inefficiency index)

Country	Mandatory Notary Index (0-1)	Registry Inefficiency Index (0-1)	Is registry Electronic
Albania	0.75	0.37	No
Algeria	1.00	0.37	No
Azerbaijan	0.50	0.32	Yes
Burkina Faso	1.00	0.38	No
Egypt	1.00	0.37	No
Kazakhstan	0.25	0.35	Yes
Lebanon	0.50	0.06	Yes
Mali	1.00	0.32	No
Nigeria	0.25	0.35	No
Pakistan	0.25	0.27	No
Tunisia	0.75	0.26	No
Turkey	0.25	0.56	No
Uganda	0.50	0.64	No
Uzbekistan	0.50	0.32	No

Source: World Bank (2008)

MNI is 0.1 in countries like Algeria, Burkina Faso, Egypt and Mali, which implies that the involvement of notaries in registration of property is compulsory. Except Albania and Tunisia, where MNI is 0.75, in all other countries value of MNI is low indicating a loose involvement of notaries in the registration process (see table 3.2). The involvement of notary not only delays the process of registration but is also costly. The system can be made simple by allowing the registration department to certify the documents rather than involving the notaries. This will cut the procedure involved in and the cost associated with it.

The inefficiency in the registration system is higher in Uganda (0.64) followed by Turkey (0.56). The most efficient country, in registering property, is Lebanon (0.06) compared to other countries given in the Table. For other countries, RII ranges from 0.26 to 0.37. Most of the countries have not computerised the registration of the property rather they complete the registration process manually. Manual registration has more chances of mistakes and it is very difficult to maintain many registers. The Table shows that except Azerbaijan, Kazakhstan and Lebanon all other countries register property manually. The electronic registration speeds up the process, brings efficiency in the system, is easy to maintain record and is easily accessible at any time. Therefore, there is a need to change the manual registration to electronic one in all such member countries that still depend on manual system.

3.2 Foreclosure on Property

Financial institutions need some information on borrowers for making good lending decisions. They also need to make sure to recover their balance through foreclosure on property in case the borrower defaults. For this purpose, in addition to the credit information on borrowers, efficient laws associated with foreclosure are required for the development of mortgage market. Normally the cost of lending is associated with the efficiency of the system. If the system is efficient and the foreclosure laws are fully implemented and the recovery is certain within a given time framework then the cost of lending is low, otherwise the cost of lending would increase with uncertainties.

Table 3.3 shows the time involved in foreclosure on property in some of the member countries. Time to foreclosure on property is measured in number of calendar days[44]. In practice, however, in some cases, more time is involved in the foreclosure on property. Three steps are involved in the foreclosure process i.e. time for notification of the borrower, time for judgement and time for enforcement for judgement.

On average, the foreclosure process takes on average of 260 days across the countries[45]. However, there are many variations in time involved for foreclosure. The foreclosure time in Kazakhstan is 55 days, which is the lowest in the World. Foreclosure on property in Tunisia takes the highest time (446 days), followed by Mali (406 days) and Uzbekistan (249 days) among the reported countries in the Table. The time for notification is not more than three months in all the cases except Mali (270 day). However, in practice the judgement and the enforcement process involve much time (see Table 3.3).

[44] See data notes World Bank, 2008.

[45] See World Bank (2008).

Table 3.3: Foreclosing on a Property

Country	Time to foreclose on property (Days)	Time for notification (Days)	Time for judgment (Days)	Time for enforcement (Days)
Albania	209	23	54	132
Algeria	--	--	--	--
Azerbaijan	143	15	76	52
Burkina Faso	111	45	1	65
Egypt	190	90	0	100
Kazakhstan	55	34	0	21
Lebanon	225	96	66	63
Mali	406	270	30	106
Nigeria	112	91	0	21
Pakistan	131	58	0	73
Tunisia	446	1	311	134
Turkey	161	63	0	98
Uganda	235	64	0	171
Uzbekistan	249	35	127	87

Source: IFC, World Bank (2008), financing homes: comparing regulation in 42 countries.

The mortgage market is not fully developed in the member countries. However, it is progressing and improvement in the housing finance regulations is being introduced. In some countries,[46] financial institutions are empowered to foreclose the mortgage property (see Box 3.1) without recourse to court, which reduced the total foreclosure time. Financial institutions in countries including Egypt, Kazakhstan, Nigeria, Pakistan, Turkey and Uganda can foreclose on property without intervention of the courts (see Table 3.3).

[46] In case of Pakistan foreclosure laws has been amended. Under section 15 (4) of the financial ordinance promulgated by the government of Pakistan on August 30, 2001, the financial institutions, after expiry of final notice, can sell the mortgage property or any part thereof toward total or partial satisfaction of the outstanding mortgage money, without intervention of any court. In doing so, neither the banking court nor the high court shall grant an injunction restraining the sale or proposed sale of mortgage property, unless courts are satisfied that no mortgage was created or the secured sum has been fully paid or the mortgagor has deposited cash in the banking court (see Government of Pakistan, National Housing Policy, 2001).

Box 3.1: Recovery Ordinance (2001) of Pakistan

Sale of mortgaged property**. -** (2) In case of default in payment by a customer, the financial institution may send a notice on the mortgagor demanding payment of the mortgage money outstanding within fourteen days from service of the notice, and failing payment of the amount within due date, it shall send a second notice of demand for payment of the amount within fourteen days. In case the customer on the due date given in the second notice sent continues to default in payment, financial institution shall serve a final notice on the mortgager demanding the payment of the mortgage money outstanding within thirty days from service of the final notice on the customer.

Execution of decree and sale with or without intervention of Banking Court**. -** (3) In cases of mortgaged, pledged or hypothecated property, the financial institution may sell or cause the same to be sold with or without the intervention of the Banking Court either by public auction or by inviting sealed tenders and appropriate the proceeds towards total or partial satisfaction of the decree. The decree passed by Banking Court shall constitute and confer sufficient power and authority for the financial institution to sell or cause the sale of the mortgaged, pledged or hypothecated property together with transfer of marketable title and no further order of the Banking Court shall be required for this purpose. (Material in this box is heavily based on the following given reference)
Source : Recommendations for Nationwide Provision of "Housing Finance" SBP, 2007

The cost associated with foreclosure also varies across the countries. The cost to foreclose in Uzbekistan is the highest (32.35% of property value), followed by Tunisia (19.22%), Azerbaijan (15.32%), Lebanon (14.52%) and Pakistan (12.33%). In other countries, it varies from 3.52% to 7.55%. These costs include stamp duties, court cost, bailiff fees, expert fees, lawyer fees, notary fees, auction fees, enforcement fees and others. However, not all these costs are applicable in all the countries. Some components of the costs are applicable in one country but not applicable in case of other country (see table 3.4). The stamp duty is very high (17.60%) in Uzbekistan, followed by Tunisia (5.28%), but low (0.01%) in Pakistan. Stamp duty is not applicable in all other reported countries (see Table 3.4). The other major component of the total cost, in some countries, is lawyer fees. It is 13.20% in Azerbaijan, Lebanon and Tunisia. In other countries, it varies from less than one percent to about five percent of the property value. In the foreclosure process, in most of the countries, public auction is required. This is to ensure transparency in the process for liquidating the property[47]. All countries given in the table require public auction for foreclosure on the property Except Azerbaijan, Burkina Faso, Nigeria and Uzbekistan.

3.3 Credit Information

The non-availability of credit information is another constraint on the housing finance. Lenders are interested to get information regarding the creditworthiness of their borrowers or prospective borrowers in order to determine the risk associated with lending. Similarly, borrowers are also interested to know about housing finance and associated terms and conditions. Such information is helpful for the development of the housing market. For this purpose, most of the member countries have introduced some reforms. They have established credit bureaus or special departments and collecting information on the borrowers. Nevertheless, the information on small retailers, microfinance institution, trade credit data and small loans are excluded. Despite all that, complete information is not available.

In case of Bangladesh, the Public Credit Registry collects data on loans exceeding US$ 800. The data are recorded manually and extended only two years back. The Public Credit Information Bureau, in Pakistan, collects data on both consumers and firms (estimated up to 2 million) without a loan or other size limit. The data are computerized and go back several years (see Nenova, T. 2010). The State Bank of Pakistan also provides useful information. The Infrastructure and Housing Finance Department of State Bank of Pakistan presents Quarterly Housing Finance Review. The review includes data on housing finance, collated on a periodic basis from public sector banks, private banks, foreign banks, DFIs and House Building Finance Corporation (HBFC).

It also shows a trend of different parameters like disbursements, outstanding and recoveries (e.g. see Quarterly Housing Finance Review Dec 31, 2010). Similarly, Public Credit Registries and Private Credit Bureaus give credit reports in the MENA regions. However, there is a need to report the data on retailers and microfinance institutions. There is also a need to computerize all such information and making historical data available.

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[47] Private treaty for foreclosure reduces the cost of foreclosure, while public auction increases it. In a study of 42 sample countries, IFC found that foreclosure through public auction than to private treaty increases the cost of foreclosure by 6 percent (World Bank, 2008).

Table-3.4: Cost to foreclosing on property

Country	Cost to foreclose on a property (% of property value)	Court cost	Stamp duties	Bailiff fees	Expert fees	Lawyer fees	Notary fees	Auction fees	Enforcement fees	Other fees	Is a public auction required?
Albania	3.67	0.15	N.A	2.64	0.28	0.31	0.07	0.15	0.07	N.A	YES
Algeria	..	..	..	..	..	..	..	..	..	..	..
Azerbaijan	15.32	0.03	N.A	N.A	0.32	13.2	N.A	1.76	N.A	N.A	NO
Burkina Faso	6.59	N.A	N.A	0.43	N.A	4.4	N.A	1.76	N.A	N.A	NO
Egypt	4.26	2.2	N.A	N.A	0.23	1.39	N.A	0.44	N.A	N.A	YES
Kazakhstan	3.52	N.A	N.A	N.A	N.A	N.A	N.A	2.64	N.A	0.88	YES
Lebanon	14.52	0.44	N.A	N.A	N.A	13.2	N.A	0.88	N.A	N.A	YES
Mali	..	..	..	..	..	..	..	..	..	..	YES
Nigeria	6.19	N.A	N.A	N.A	2.32	N.A	0.07	2.64	N.A	1.16	NO
Pakistan	12.33	0.07	0.01	1.2	N.A	4.85	N.A	1.32	N.A	4.85	YES
Tunisia	19.22	N.A	5.28	0.2	0.42	13.2	N.A	N.A	N.A	0.11	YES
Turkey	7.55	N.A	N.A	0.44	0.22	3.52	0.01	0.04	1.98	1.33	YES
Uganda	5.28	N.A	N.A	N.A	0.44	N.A	N.A	0.44	N.A	4.4	YES
Uzbekistan	32.35	8.8	17.6	N.A	1.4	1.57	N.A	0.88	2.1	N.A	NO

Source: IFC, World Bank (2008) Financing homes: comparing regulation in 42 countries. Note: N.A : Not applicable, .. : not available

Malaysia has made good progress in credit information. In addition to other information necessary for lenders, Bank Negara Malaysia publishes information also for the customers. A guide to consumers is available who wish to know about property financing. It explains the overall processes and procedures involved in getting finance as well as the type of facilities available under Islamic financing. Similar information is available for the non-Islamic mortgages.

3.4. Long Term Financing

The ever-increasing demand for housing cannot be met without strong primary mortgage market, which consists of banks or specialized housing finance institutions. However, the long-term housing finance maturity and short-term deposits create liquidity risk to the funding institutions. This mismatch could be solved by establishing a deep secondary mortgage market. It will improve the liquidity of housing finance; create competition among the institutions, which will keep the cost of lending low and benefiting the borrowers. It can issue its own bonds and open up investment opportunities for long-term investors like, institution of provident fund, pensions and insurance companies.

Mortgage refinance companies are not developed in the member countries and such funding facilities are not available. However, some IDB member countries have recently taken the initiative to establish refinance companies for solving the liquidity problem of the primary market lenders and widening the housing finance risk. In Pakistan, the housing Advisory Group of State Bank of Pakistan (SBP) has recommended the establishment of Mortgage Refinance Company. SBP and World Bank Group are working together on materializing it.

In Malaysia, the establishment of Cagamas Berhad (Cagamas), the national Mortgage Corporation, in December 1986, has been very successful in promoting secondary mortgage market and expanding the housing sector in the country (see box 3.1). The main activities of Cagamas consist of purchase of mortgage loans and hire purchase and leasing debts from primary lenders approved by Cagamas and the issue of bonds and notes to finance the purchases. Cagamas also purchases Islamic financing facilities such as home financing, personal financing and hire purchase financing and funded by issuance of *Ṣukūk*. Cogamas is the leading issuer of triple A debt securities in the country and one of the top *Ṣukūk* issuers of the world. The member countries can learn the best practices of Cagamas for the promotion of their secondary mortgage market. The subsequent chapters will focus on product and innovation for housing finance.

Box 3.2: Cagamas: Case of Islamic House Financing Debts

Cagamas Berhad operates as a mortgage corporation, which enhance liquidity in the mortgage sector. In addition to the purchase of conventional housing loans for the purchase of residential houses originated by the financial institutions, Government and selected corporations, Cagamas also offers to purchase Islamic house financing debts from Islamic banking institutions (IBI) in accordance with the principle of *Bay*ʿAl-Dayn (debts trading). IBI wishing to sell their Islamic house financing debts must execute a Master Sale and Purchase Agreement and a Master Servicing Agreement with Cagamas.

The IBI can sell the Islamic house financing debts to Cagamas for review periods of 3 to 10 years based on a fixed rate basis. Cagamas purchases the debts at an agreed price based on their book value. With the sale of the Islamic house financing debts to Cagamas, the IBI are required to pay monthly instalments, known as Cagamas Instalments, to Cagamas. The instalments payable to Cagamas are computed on the basis of the instalments payable by the respective customers net of the agreed service fee payable by Cagamas to the IBI for servicing the debts and providing the recourse function.

At quarterly intervals, the IBI are required to repurchase debts found to be defective and offer to sell to Cagamas an equivalent amount of Islamic house financing debts to replace the debts repurchased. At the end of the contracted review period, i.e. on the Review Date, the IBI are given the option to repurchase the pool of debts sold to Cagamas or continue the contract for a further review period based on the new service fee agreed upon between Cagamas and the IBI.

Cagamas purchases all Islamic house financing debts at their book value i.e. the principal balance outstanding on a date which is closest to the purchase date but not earlier than the end of the month preceding the purchase date. (Material given in this box is heavily based on the following given reference).

Source: http://www.cagamas.com.my/caga-docs/html-dir/pihou.htm

PART II

FINANCING PRODUCTS AND MODELS

CHAPTER 4

Housing Finance

4.1. Existing Practices of Islamic Housing Finance (in IDB-Member Countries and Muslim Communities in Non-Member Countries)

Housing, a basic human necessity, is met by building, purchasing, or renting a property. As payment for housing normally accounts for a big chunk of personal income it is vital to have financing for this basic need. This chapter focuses on Islamic Housing Finance schemes that currently exist in the market. Since the beginning of the Islamic finance industry in the 1970s, the Islamic housing finance schemes have undergone quite a significant development. As Islamic financing schemes avoid interest, the financing mechanism commonly employs sale based, lease based or partnership based solutions.

To obtain a comprehensive data on different Islamic housing finance solutions, institutions in nine markets worldwide were surveyed. Since there is no readily available Islamic housing finance database, an internet based search-engine survey adopting a structured convenient sampling method was conducted. In total, 108 institutions in 27 countries were reviewed. The details are summarized in Table 4.1.

The survey had a broad quota of five institutions per country. The sample was identified by searching for multiple key phrases[48] related to Islamic housing finance. Some countries (especially in the GCC) had many Islamic financial institutions that offer variety of solutions. For these countries, the sample includes more than 5 institutions.

[48] Islamic home finance, Sharīʿah compliant housing finance, Islamic mortgage, Islamic banks etc

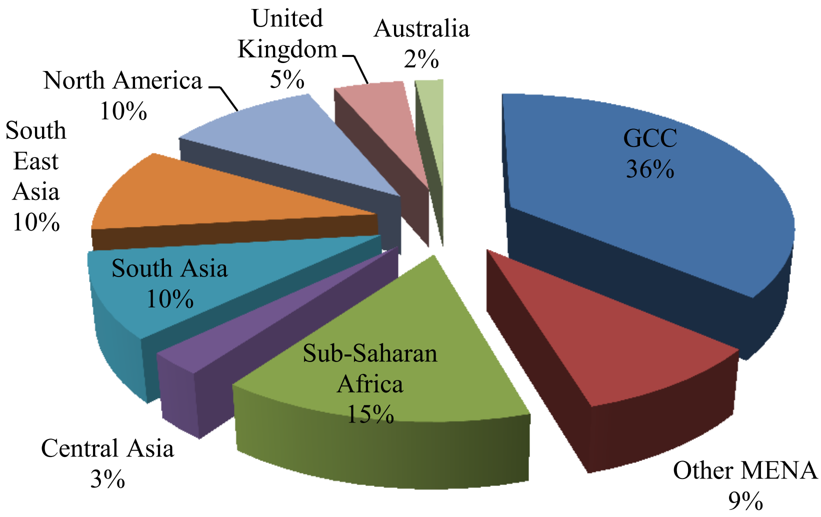
Table 4.1: Countries and Institutions included in the Survey

Markets	No. of Countries	No. of Institutions	Countries
GCC	6	39	KSA, Kuwait, Bahrain, Qatar, UAE, Oman
Other MENA (including Turkey)	5	10	Turkey, Egypt, Morocco, Lebanon, Jordan
Sub Saharan Africa	6	16	South Africa, Kenya, Nigeria, Senegal, Sudan, Ethiopia
Central Asia	2	3	Azerbaijan, Kazakhstan
South Asia	2	11	Pakistan, Bangladesh
South East Asia	2	11	Malaysia, Indonesia
North America	2	11	US, Canada
United Kingdom	1	5	United Kingdom
Australia	1	2	Australia
Total	**27**	**108**	

To obtain a snapshot of the relative distribution of the survey, refer to Figure 4.1 GCC as a group had the highest number of institutions although the number of countries surveyed is the same as the sub-Saharan African countries. South East Asia, South Asia and North America each have a 10% share. Although the GCC as a group seem to have the highest percentage, on an individual country basis, the four most active jurisdictions (Saudi, Kuwait, Bahrain, and UAE) only had 7% share each. Refer to Appendix 3 for details on the number of institutions surveyed in each country.

Table 4.2 and Table 4.3 list the different options offered by the institutions for completed properties and property under construction. These are based on information provided on the website of different institutions. Interviews with a few selected institutions were also conducted to confirm the workings of their products. It is noted that there are far more institutions offering financing for completed properties compared to financing for properties under construction. An institution will be included in the construction finance category only if they specifically mention on their website that they do under construction financing.

Figure 4.1: Total Institutions Surveyed



For institutions that do not clearly specify whether or not they offer Islamic Housing Finance, or do not mention clearly the underlying Sharīʿah principles used, separate categories were allocated. For completed properties, there were 29 institutions that fall into these categories. This brings the final usable sample to 96 institutions. For properties under construction, there are 4 institutions that did not specify the underlying Sharīʿah principles. So the final usable sample for property under construction is 25 institutions. Please notice, the total count for completed properties were 125, which exceed the number of institutions surveyed (108). This is because the counts here are based on the underlying Sharīʿah principles. As highlighted in Table 4.3, there are some institutions that offer multiple solutions. This means, these institutions will appear in a few categories.

With the exception of Pakistan and Bangladesh, institutions in a particular country do not necessarily offer the same solutions. Different institutions choose to offer different solution based on their strategy and business style preference. Only in Pakistan and Bangladesh, all the institutions surveyed were offering *Mushārakah Mutanaqisah*. In Sudan, with the exception of Sudanese Egyptian Bank, there was no information on Islamic housing finance solutions offered by Sudanese banks.

The majority of institutions (88%) offer only a single solution of housing finance for their customers. Only 19 institutions (out of 108) offer multiple solutions. This is highlighted in Table 4.4. Most of them offer (74%)

Table 4.2: Islamic Housing Finance Scheme Offered by Different Institutions for Completed Properties

Completed Properties	Count	Institutions
Murābaḥah	27	ADIB, EIB, Riyadh Bank, Samba, SHB (include incomplete villa purchase), AUBK, KFH, KIB, Ithmaar, KFH(B), AUBB, AUB(UK), QIB, CBQ, Bank Muamalat, Mandir Syariah, Bank Mega Syariah (include renovation), An-Nur Coop (Ontario), Salam Financial (Canada), KFH(M), Dar Assafaa (Morocco), JIB, Kuveyt Turk, Devon, UIFC, LIB, Al-Baraka (SA)
Ijārah	30	ADIB, HSBC (UAE), Hilal (UAE), Tamweel, DIB, EIB, ADCB, Al-Jazira, SHL, Riyadh Bank, SHB, NCB, AUBK, KFH, Al-Baraka, Ithmaar, KFH(B), BIB, AUBB, AUB (UK), UNB (UK), Barwa, BNI (Indon), MCAA, *Ijārah* Loan, IIAB (Jordan), JIB, Devon, UIFC, LIB
Mushārakah Mutanaqisah (MM)	37	EIB, Al-Baraka, IBB, HSBC Amanah, ABC International (UK), Meezan, DIB(P) - include renovation, Al-Falah, Al-Habib, SC(P) - include renovation, Faysal, HSBC (Indon), Bank Muamalat,ICFA (Australia), UM Financial Group, An-Nur Coop (Ontario), Isna Housing Coop (Canada), Ansar Housing (Canada), Citibank (M), SC (M), Maybank Islamic, HSBC (M), KFH (M), Devon, LARIBA, Halal Inc (US), Guidance, Bank Muscat, SC(Bangla), IBBL, HSBC (Bangla), ShahJalal, Prime Bank, GAB (SA), Chase Bank (SA), Jaiz International Bank (N), IMFB (N)
Others: *Wakālah* & Commodity *Murābaḥah*	2	ARB(M) - Commodity *Murābaḥah*, FNB (SA) – *Wakālah*
Offers IHF - but no info on instrument	10	ARB(KSA), Alinma, QIIB, Masraf Al-Rayan (personal finance include renovation), Khaleji Commercial (B), Al-Baraka (E), Al-Baraka (T), Bank Asya (T), Al-Baraka (L), FCB (SA)
Don't do retail or Retail but no HF	7	Anan Real Estate (Kuwait), IIG (wholesale), TII (consumer but no HF), KIC (wholesale), ABC Islamic (B), GFH (investment bank), Absa (SA) - no HF
No specific info if offer IHF	12	Amlak, Warba (Kuwait - not operational yet), Kauthar Bank (Azerbaijan), Al-Hilal (Kazak), BTA (Kazak), Al-Baraka (Sudan), Faisal (Sudan), Tadamon (Sudan), Shamal (Sudan), Al-Salam (Sudan), BLOM Development Bank (Lebanon), Islamic Bank of Senegal
Total	125	

Table 4.3: Islamic Housing Finance Scheme Offered by Different Institutions for Properties Under Construction

Property Under Construction	Count	Institutions
Istiṣnā	4	ADIB, AUBK, QIB, KFH (M)
Ijārah Mawsoofa Bi -Dhimma (IMBD)	9	ADIB, HSBC (UAE), Hilal (UAE), Tamweel, DIB, ADCB, Al-Baraka, BIB, Devon
MM	8	Meezan, Al-Falah, Maybank Islamic, SC(Bangla), IBBL, HSBC (Bangla), ShahJalal, Prime Bank
Others: Commodity *Murābaḥah*, *Murābaḥah* for Construction Material	4	ARB (M) - Commodity *Murābaḥah*, IIAB (Jordan) - *Murābaḥah* for Construction material, Sudanese Eygptian Bank (*Murābaḥah* for Construction material), Devon (Murabaha for construction material)
Did not mention principle	4	ARB(KSA), Samba, Boubyan (Construction material finance under personal finance), Zam Zam International (Ethiopia)
Total	29	

Table 4.4: Institutions Offering Multiple Solutions (Completed Properties)

Multiple Offerings	Count	Institutions
Murābaḥah & *Ijārah*	14	ADIB, EIB, Riyadh Bank, Saudi Hollandi, AUBK, KFH, Ithmaar, KFH(B), AUBB, AUB (UK), Jordan Islamic Bank, UIFC, Devon Bank, Lebanese Islamic Bank
MM & *Murābaḥah*	4	Bank Muamalat Indonesia, An-Nur (canada), KFH(M), Maybank (*Bay*ʿ Al-Inah)
Ijārah & MM	1	Al-Baraka
Total	19	

Murābaḥah and *Ijārah*, followed by *Mushārakah Mutanaqisah* and *Murābaḥah*. Emirates Islamic Bank and Devon Bank even offer *Mushārakah Mutanaqisah* in addition to *Murābaḥah* and *Ijārah*. Only Al-Baraka offers *Mushārakah Mutanaqisah* and *Ijārah*.

Based on the final sample (refer Table 4.5) *Mushārakah Mutanaqisah* is the most widely used Sharīʿah solution offered for financing completed properties. This is followed by *Ijārah* and *Murābaḥah*. Only one institution used *Wakālah* (First National Bank in South Africa) and Commodity *Murābaḥah* (Al-Rajhi Malaysia). For property under construction, *Ijārah* Mawsoofa Bi -Dhimma (IMBD) is the most widely used solution, followed by *Mushārakah Mutanaqisah* and *Istiṣnā* . Ar-Rajhi Malaysia uses commodity *Murābaḥah* to fund construction property as well. To avoid construction risks, a few institutions offer *Murābaḥah* for construction materials (International Islamic Arab Bank – Jordan, Sudanese Egyptian Bank and Devon Bank – US). The next section will examine the different models of Islamic Housing Finance in further detail.

4.1.1. Selected Models of Islamic Housing Finance

This section reviews the different methods of Islamic housing finance available in the market at the time of the survey. The information is derived from information obtain from the websites of different institutions surveyed and from other reference materials. Interviews were also conducted with selected institutions to get more information on the details of their housing finance products. Besides highlighting the transaction flow and the diagram, the strength and weaknesses of the different models are also discussed. Each model will discuss in detail the most widely used approach and then highlight the variations that exists in different jurisdictions. As some institutions offer multiple solutions, some sections (*Ijārah* for example) also provide some insight on different motivations that contributed to this approach. The institutions surveyed are mainly financial institutions (banks and finance companies) and cooperatives. However. when a particular variation is provided by finance companies or cooperatives, this will be highlighted accordingly.

4.1.1.1 *Murābaḥah* Housing Finance

From the final sample, about 28% of the Islamic housing finance models is based on *Murābaḥah* – where the bank buys the property and sells it to the customer. There are two variants of *Murābaḥah* in the market – in the first:

Table4.5: Different Modes of Financing from Final Sample

Completed Properties	Count	%	Property Under Construction	Count	%
Murābaḥah	27	28%	*Istiṣnā*	4	16%
Ijārah	30	31%	IMBD	9	36%
MM	37	39%	MM	8	32%
Others: *Wakālah* & Commodity *Murābaḥah*	2	2%	Others: Commodity *Murābaḥah*, *Murābaḥah* for Construction Material	4	16%
Total	96		Total	25	

variant, the bank does not retain the legal title of the property and takes a mortgage. In the second type, the bank retains legal title of the property and does not take a mortgage. Let's examine the first variant. The transaction flows are commonly as follows

1. The customer selects the property he or she is interested in buying.
2. The customer submits application for financing. Normally customers are required to submit price quotation addressed to the bank. The application should also have full details of the property (plot number, detailed address etc). From a risk perspective, banks usually want a promise to purchase from the customer so they are not exposed to market risk.[49] From the information we have gathered in the survey, the promise to purchase is not normally required in a separate document. AAOIFI, in its Sharīʿah Standard No. 8 (*Murābaḥah* to Purchase Orderer), clarifies that the promise to purchase may be part of the application form and does not need to be a standalone document. Refer Box 4.1 for details. In addition, AAOIFI requires that there was no prior arrangement (either acceptance of offer, agreement, payment etc) between the customer and the seller. Some banks will take additional steps to

[49] IFSB in its Capital Adequacy Standard (IFSB 2) highlights that a bank that has a binding promise to purchase in a *Murābaḥah* to Purchase Order (MPO) is not exposed to price risk since it has a ready buyer with pre-determined price. Refer to para 89 for details and para 105 for summary of risk profile in *Murābaḥah*.

manage these prior arrangements before proceeding with the *Murābaḥah*,[50] while other banks will decline to fund the customer on a *Murābaḥah* basis. They might in turn offer commodity *Murābaḥah* to fund the customer.[51]

Box 4.1: Documentation of the Promise to Purchase

The customer's wish to acquire (an) item does not constitute a promise or commitment except when it has been expressed in due form. It is permissible to prepare a single set of documentation to include both the customer's wish that the institution should buy the item from the supplier and a promise to buy the item from the institution, which the customer signs. It is permissible for the customer to prepare such a document, or it may be a standard application form prepared by the institution to be signed by the customer.

Source*:* (AAOIFI, 2008)*,* para 2/1/3

3. The bank will acquire the property from the owner (be it a sub-sale of existing property from a seller or acquisition of completed new property from a developer). In cases where the bank is not providing 100% financing,[52] customers are required to make down-payment at this stage – normally made directly to the seller.[53] Commonly banks will not register the legal title in its name and only holds beneficial ownership and takes constructive possession.[54]
4. The bank will conclude the *Murābaḥah* contract with the customer, register the property in the customer's name and register a mortgage to secure the bank's claim on the selling price due from the customer.

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[50] Some banks use a novation agreement which puts the bank into the customer's shoe. This document basically informs the seller that the customer will be replaced by the bank. Sometimes this is also called as assignment, where the customer assigns his or her interest in the house purchase agreement to the bank.

[51] Al-Rajhi (Malaysia)'s experience related to this will be reviewed.

[52] In many markets, banks usually do not provide 100% financing. From the survey, Saudi banks seem to offer 100% financing option.

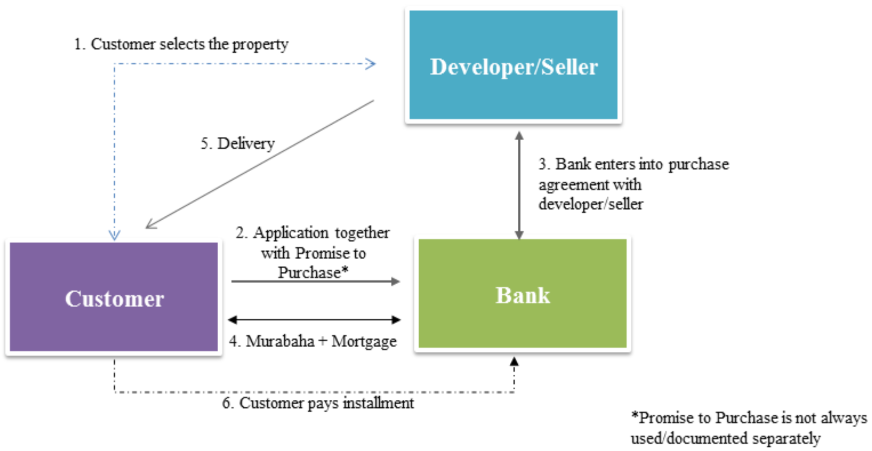
[53] There are some exceptions to this. At University Bank in Michigan, the customers make the downpayment to the bank and not to the seller.

[54] University Bank in Michigan actually registers title in its name before entering into a *Murābaḥah* with the customer. When the bank has entered into *Murābaḥah*, the bank then transfers the title to the customer and takes a mortgage. In the US, there are only a few states with stamp duties and charges to register title vary by county. In many counties, there are no charges to register title twice in a *Murābaḥah* "financing". University Bank (through its subsidiary) offers home finance in the states of Michigan, Ohio, Indiana, New Jersey, Virginia, Maryland and Texas.

5. The customer then takes delivery of the property and starts making the instalment of selling price due to the bank.
6. Upon settlement of the selling price due, the bank will release the mortgage on the property.

Figure 4.2 illustrates the first variant of the *Murābaḥah*. ADIB, University Bank (USA), Devon Bank (USA), and United Bank of Kuwait (UK – now AUB London) adopt this model for example.

Figure 4.2: *Murābaḥah* Housing Finance Method



Source: (SHAPE™ Financial Corporation)

In the second variant of *Murābaḥah*, the transaction steps are similar to those described above, however, when the bank purchases the property from the original owner, it will register the legal title in its name (normally through a subsidiary) and retains the legal title even after it concludes the *Murābaḥah* contract with the customer. The bank retains the legal title as security for the *Murābaḥah* payment due. Upon settlement of the full *Murābaḥah* payment, the bank will transfer the legal title to the customer. Refer to Box 4.2 where Samba explains this concept.

Box 4.2: Retaining Legal Title

Bayt Al-Khair is a Sharīʿah-compliant solution to purchase a villa, an apartment, a plot of land or to construct your own villa. Samba Financial Group will first purchase and own the property that you choose. This will then be sold to you through *Murābaḥah*, after entering into a finance agreement with Samba. Under this agreement you will pay the price (cost of the property plus a profit) to Samba in regular monthly installments. The title of the property will be held through a legal trustee (Al-Adl) and will be transferred to you as soon as all your monthly installments are paid.

Source: (SAMBA, n.d.)

AAOIFI in its *Murābaḥah* standard allows postponing the registration of the title as a security measure. Refer to Box 4.3 for details. However, retaining the title does not mean the ownership transfer is postponed. In Sharīʿah's, payment is not a requirement for ownership transfer. Once the *Murābaḥah* contract is concluded, the customers own the property. The bank holds the legal title in lieu of a mortgage. This model is adopted widely in Saudi Arabia, since mortgages were rarely registered under the old law, and the new mortgage law is untested in the Saudi courts or dispute committees. The Saudi Hollandi Bank also retains the property title for its *Murābaḥah* housing finance.

Box 4.3: Postponing the Registration of Asset in Customer's Name

It is not permissible to stipulate that the ownership of the item will not be transferred to the customer until the full payment of the selling price. However, it is permissible to postpone the registration of the asset in the customer's name as a guarantee of the full payment of the selling price. The institution may receive authority from the customer to sell the asset in the case the customer delays payment of the selling price, in which case the institution should issue a counter-deed to the customer to establish the latter's right to ownership. If the institution sells the asset as a result of the customer's failure to make a payment of the selling price on its due date, it must confine itself to recovering the amount due to it and must return the balance to the customer.

Source: (AAOIFI, 2008), Para 5/4

From Sharīʿah's perspective, *Murābaḥah* application is limited to funding a purchase of completed property as the subject matter must exist. Some banks provide *Murābaḥah* for the purchase of the construction materials, so they could fund a customer who wants to build or construct his or her residential unit. If a bank offers *Murābaḥah* housing finance, upon conclusion of the sale contract, the ownership of the property is transferred to the customer. So the bank ends up holding *Murābaḥah* receivable. This product, although simple to execute, inherits inflexibilities if the customer wants to restructure. The bank may not charge more as this will be considered rib al-Nadia. Depending on how the bank funds itself, it may be exposed to rate of return risk (the cost of funding increases compared to the fixed rate on the *Murābaḥah*). The bank is also restricted in securitizing a portfolio consisting only *Murābaḥah* receivable as Sharīʿah's requires this to be done at par. Nonetheless, since the ownership has transferred to the client, the bank does not have ownership related expenses (maintenance & insurance) like some banks have under *Ijārah* financing.

4.1.1.2 Commodity *Murābaḥah* for Housing Finance:[55]

In the *Murābaḥah* section it was highlighted that if customers have entered into sale and purchase agreement (SPA) with the developer, this is considered as prior arrangement and some banks will not fund the customer on the basis of *Murābaḥah*. In Malaysia, customers have usually entered into SPA and made some down payment. For this reason, Al-Rahim Malaysia was not able to offer *Murābaḥah* to the customers.[56] Thus they offered commodity *Murābaḥah* for their housing finance in Malaysia since early 2007.

Figure 4.3 provides the transaction steps and illustration of the method.
Al-Rahim Malaysia basically buys commodities on a spot basis from a broker and sells it to the customer on a deferred basis. This is the *Murābaḥah* and creates a long term debt due to the bank. However, unlike the *Murābaḥah* we reviewed before, the subject matter for this transaction is not the property itself, rather, it is a delinked good like crude palm oil (CPO), metal etc. The bank also takes a mortgage (security claim) on the house that the customer is acquiring as a collateral. Next, the customer will sell the commodity to another broker on a spot basis and use the cash to

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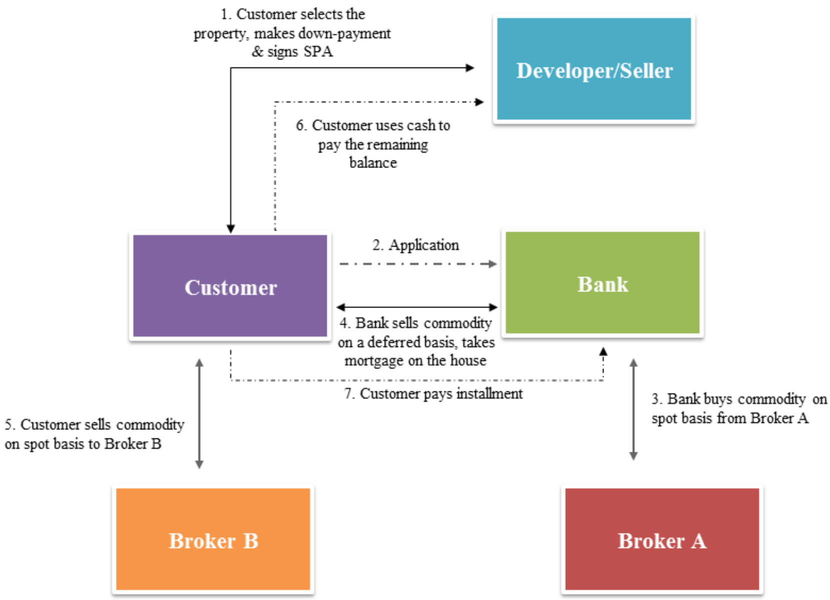
[55] With special thanks to Subitha Bhanu Mohd Hussan, the VP of Product Development (Retail), Al-Rajhi Malaysia.

[56] In the early 80s when Bank Islam Malaysia offered Islamic housing finance in Malaysia, they used a novation agreement like University Bank in the US, to manage the prior arrangement issue. However, as there were many Sharīʿah complaints raised by developer and sellers, Islamic banks in Malaysia resorted to *Bay*ʿAl-Inah and did not continue with the novation approach any longer.

complete the purchase of the property. Upon settlement of the entire instalment, the bank will release the mortgage on the house.

Figure 4.3: Commodity *Murābaḥah* Housing Finance Method



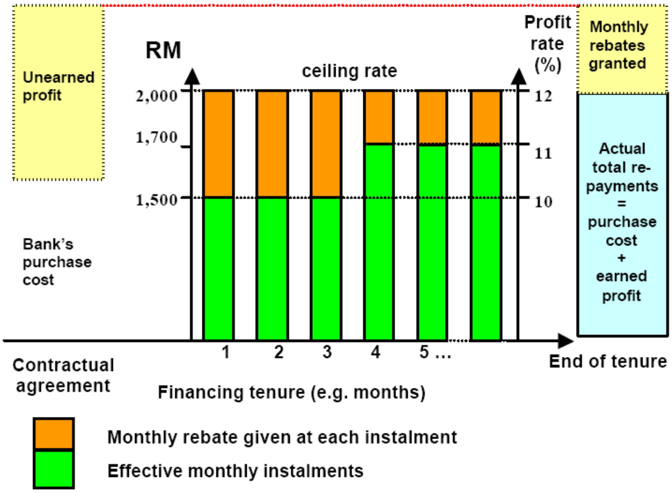
Source: (SHAPE™ Financial Corporation)

In *Murābaḥah* housing finance, only completed properties could be funded. With commodity *Murābaḥah*, even property under construction could be funded since the underlying subject matter is not the house itself. In Malaysia, in 2003, the Central Bank and the industry participants formed a working group to structure an alternative to fixed rate pricing of sale based instruments as the banks were exposed to the rate of return risk. The solution was to use a ceiling rate as the contractual sale price and the bank would provide rebate according to the market rate. The ceiling rate is the sale price and this will not change to avoid *Gharar*. Figure 4.4 shows the graphical illustration of the mechanism.

When Al-Rajhi started offering its housing finance, it went on fixed rate model. Later, Al-Rajhi adopted the variable rate mechanism, to offer a much competitive pricing. Al-Rajhi would only calculate the rebate as and when the market rate moves and not on a monthly basis. In addition, Al-Rajhi also does not provide monthly rebate as highlighted in Figure 4.4. It only makes the necessary accumulated adjustment at maturity.

Since commodity *Murābaḥah* also involves a sale contract, it inherits the same inflexibility as *Murābaḥah* when it comes to restructuring[57] or securitizing the portfolio.

Figure 4.4: Variable Rate Mechanism for Sale based Instruments



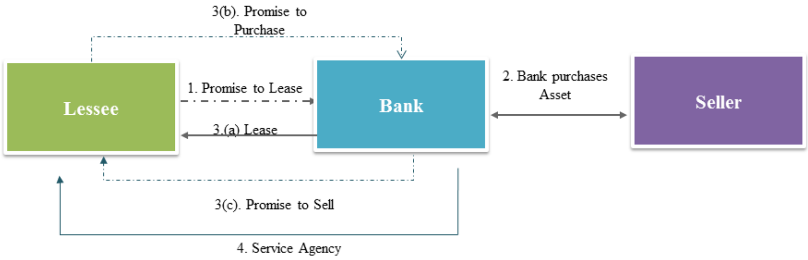
Source: (BNM, 2003)

4.1.1.3 *Ijārah* Housing Finance:

From the sample, about 31% of the Islamic housing finance models (for completed properties) were based on *Ijārah* – where the bank buys the property and leases it to the customer. Let's first examine a basic model of the *Ijārah* model and discuss a few variations in practice regarding security, and how the transfer of ownership takes place. Figure 4.5 provides the transaction steps and illustration of the method.

57 Some banks may allow entering into another commodity *Murābaḥah* transaction while other banks may restrict the application of revolving commodity *Murābaḥah* for restructuring purposes.

Figure 4.5: *Ijārah* Housing Finance Method



Source: (SHAPE™ Financial Corporation)

After approval of the customer's application, the bank will purchase the property from the seller. Similar to *Murābaḥah*, banks may ask customers to provide a promise to lease to avoid market risk. This may be part of the application form instead of a standalone document. If customers have entered into a purchase agreement with the seller, some banks choose to enter into an agreement where the customer assigns his/her interest in the house to the bank.[58] Nonetheless, unlike *Murābaḥah*, AAOIFI allows banks to acquire certain portion of an asset to be leased to the customer. Refer to Box 4.4 for details.

Box 4.4: Acquisition of Proportion of Asset in *Ijārah*

An institution's customer may jointly acquire an asset that he wishes to lease with the institution, and then lease the institution's share of the asset from the institution. In this case, the rental specified as receivable by the institution should only be in proportion to its share in the ownership of the asset, since the lessee is a co-owner of the asset and therefore has to pay rent only on the share that he does not own.

Source: (AAOIFI, 2008), para 3/6

Once the bank has acquired the house it will enter into an *Ijārah* agreement with the customer. Since *Ijārah* agreement alone does not transfer ownership, the bank must have an ownership transfer mechanism in place. The bank may choose to either sell the house or provide it as a gift to the customer at the end of the lease period.[59] Figure 4.5 shows the transaction flow where the bank chooses to sell the asset to the customer at maturity.

[58] Similar effect to a novation agreement

[59] AAOIFI also discusses gradual transfer of ownership in *Ijārah*, but we did not find it in our survey.

Upon entering into the lease agreement (step 3a), the customer will provide a promise to purchase (3b)[60] and the bank will provide a promise to sell (3c).[61] Please note, a promise from the Sharīʿah perspective is unilateral and only binding on the promissor.[62] To ensure these are two unilateral promises (*Wa'dan*), instead of a bilateral promise (*Muwa'adah*)[63] the banks use different trigger events for the promises. The promise to purchase is commonly triggered in case the customer defaults. The promise to sell is triggered at maturity or early settlement for example. Since the dual promises are only promises and not a contract, the bank and the customer will enter into a separate sale agreement at maturity.[64] The sale agreement at maturity doesn't need to be an extensive document. It may be in the form of a simple offer and acceptance.

Refer to Box 4.5 as an example from Saudi Home Loan (SHL) procedure for their ownership transfer for *Ijārah*.[65]

Box 4.5: Procedure for Ownership transfer at SHL

Upon receipt by the Lessor of a purchase request ("Purchase Request") from the Customer in accordance with the provisions of a sale undertaking issued the Lessor ("Sale Undertaking"), provided that the period of the Purchase Request is not less than thirty (30) days prior to the scheduled lease termination date, the Lessor shall, sell the Leased Asset to the Customer and, within sixty (60) days from the date of the Customer's payment of the purchase price, transfer its title, to the Customer, free and clear of any encumbrances and on an "as is where is" basis without any representation or warranty whatsoever whether express or implied, and provided the Customer has settled all amounts due from him to the Lessor in accordance with this Contract.

When the Customer pays off the complete principal balance and pays the "Lease Termination Payment" the title of the property is transferred to the Customer

Source*:* (SHL, n.d)

Not all institutions use dual promises. Some just use a promise to purchase (so it's binding only on the customer), while others just use a promise to sell (so it's binding only on the bank). These are all acceptable under Sharīʿah and thus reflect the business preferences of the different banks.

[60] Also known as purchase undertaking, agreement (consent) to purchase etc
[61] Also known as sale undertaking, agreement (consent) to sell etc
[62] The dotted line represent a promise and not an agreement
[63] Which is considered as contract from Sharīʿah perspective
[64] The price of the sale could be nominal price, the last installment or any price to be agreed by the parties.
[65] The procedure may be simplified as follows – (i) customer submits purchase request, (ii) customer pays the lease termination amount, (iii) SHL transfers title to the customer.

Different banks may use different terms for this product –*Ijārah Muntahiyya Bi Tamleek*, *Ijārah ma'a al-Wa'ad*, *Ijārah wa Iqtina* etc. They are similar in the sense that there is a lease period, followed by ownership transfer (either through sale or gift). If the transfer of ownership is done via gift, conditional upon the customer settling the entire rental due, there is no need to have a separate sale agreement. This is permissible under AAOIFI. Refer to Box 4.6 for details.

Box 4.6: Conditional Gift in *Ijārah*[66]

> In case the *Ijārah* contract is combined, through a separate document, with a gift contingent upon the condition that the remaining rent installments be paid, the ownership to the leased property is transferred to the lessee if the condition is fulfilled, without the need for any procedure to be adopted or a document to be signed. However, if the lessee's payment is short of even one installment, the ownership to the property is not transferred to him, since the condition has not been fulfilled.

Source*:* (AAOIFI, 2008)*,* para 8/4

In an *Ijārah* contract, the bank is still the owner, so AAOIFI requires them to be responsible for ownership expenses (major maintenance, taxes & insurance most commonly). In practice, instead of the banks doing the maintenance, they will appoint the customer as the servicing agent (based on *Wakālah*). The customer will then as agent for the bank take care of major maintenance, taxes and insurance (or *Takāful* where available). These expenses are reimbursable under the service agency agreement. However, the bank will recoup the expenses in the rental charged to the customer.[67]

In *Murābaḥah*, there were two variations; first, the bank transfers the title and takes a mortgage for security. Second, the bank retains the title and takes no mortgage. The same pattern is present in *Ijārah* as well. Banks in Saudi Arabia, USA and, quite a number in GCC prefers to hold the title to

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[66] A conditional gift is valid based on the example of the Prophet (pbuh) that sent a gift to Negus (the former emperor of Ethiopia) on condition that he was alive at the time of the arrival of the messenger. Refer p158 of AAOIFI.

[67] Some banks, SHL for example, let's the lessee undertake the full responsibility at his own cost: "the lessee concurs and undertake to bear full responsibility at his own personal cost without recourse the lesser for the repairs of any damages whatever the nature and/or size of the damage"

the property and not take a mortgage. While other banks let the customer hold the title and take a mortgage against it.[68]

As highlighted in Table 4.4, some banks offer multiple solutions. There are a few motivations behind these multiple offerings:

1. *Murābaḥah* is used for shorter term financing and offers fixed rate solution. *Ijārah* is used for longer term financing with floating rate solution. Refer to Table 4.6 for a few examples. These banks may be comfortable providing a much longer tenure of financing under *Ijārah* as it inherits a few flexibility compared to *Murābaḥah*; the rental may be reviewed, the parties may agree to restructure future rental at any price and the bank may also sell the portfolio to third party investors at any price.

Table 4.6: Comparison of *Murābaḥah* and *Ijārah* Terms for Selected Banks

Bank	*Murābaḥah* Term	*Ijārah* Term
Emirates Islamic Bank	10 years	25 years
KFH (B)	12 years	25 years
Shamil Bank	10 years	25 years

2. Some bank started with *Murābaḥah* because this was requested by the funder/investor. United Bank of Kuwait (London) started their *Murābaḥah* program because a leading GCC Islamic financial institution preferred the investment in the properties be on the basis of *Murābaḥah*. A few years later, they offered *Ijārah* as the investors were prepared to take the properties on their balance sheet. Now, AUB (UK) offers *Murābaḥah* only for “Buy to Let” purposes i.e. where the customers want to buy properties to be rented to third parties.

3. UIFC in the US started with *Ijārah* home finance solution first. In two year time, they had consumed their allocated capital and were

[68] Muslim Community Co-Operative Australia (MCCA), works with conventional non-bank financial company (NBFC) and offers *Ijārah* home finance. The title of the property is with the client and the NBFC has a mortgage on the property.

looking for other funding options. They managed to structure a *Wakālah* acquisition agreement with Freddie Mac,[69] however Freddie decided to only fund *Murābaḥah*[70] since for the *Ijārah* solution, the client does not have title over the property.

4. Other banks, like ADIB for example, offer *Murābaḥah* and *Ijārah* just to provide alternative solutions for their client. There might not be any particular reason driving the multiple offerings.

4.1.1.4 *Mushārakah Mutanaqisah*

The highest percentage (39%) of the sample for Islamic housing finance solution were based on *Mushārakah Mutanaqisah* (declining balance partnership) – where there is co-ownership between the institutions and the customers. This model has a lot of similarities to *Ijārah* because the client will lease the house from the institutions. If the previous models were mostly offered by Islamic banks, *Mushārakah Mutanaqisah* is a popular choice among Islamic cooperatives and non-bank Islamic finance companies. Let's first examine a basic model applied widely by many Islamic banks. We will then review different variations offered by the coops. Figure 4.6 provides the transaction steps and illustration of the method.

The *Mushārakah Mutanaqisah* method as applied by the banks has a lot of similarities with *Ijārah*. The only difference is that there was no co-ownership (i.e. the bank was the sole owner) in *Ijārah*. In *Mushārakah Mutanaqisah*, the bank and the client are the co-owners, and the bank will rent its share to the client. Similar to *Ijārah* many banks also have promise to purchase, promise to sell and service agency agreement.[71] Pakistan and Bangladesh banks in the survey all offered *Mushārakah Mutanaqisah*. These banks, and banks in Malaysia (except KFH – M) let the customer hold the title and take a mortgage of the house. Other institutions (Islamic Bank of Britain, Coop in Canada) prefer to hold title to the house and only release it upon full settlement.

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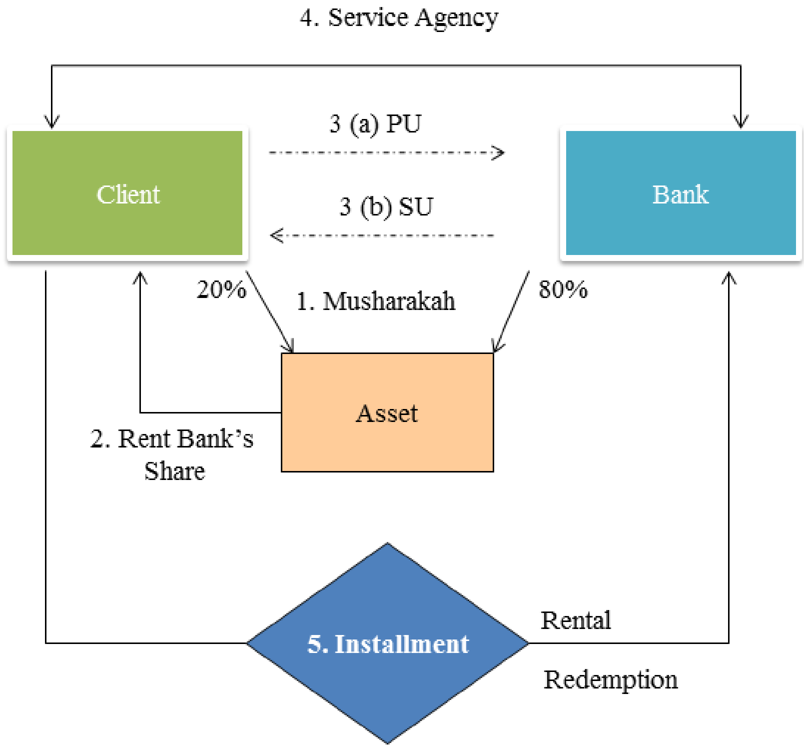
[69] The funding was not based on sale of debt, rather a *Wakālah* arrangement.

[70] It is not compulsory for Freddie to fund the *Murābaḥah*. Freddie has the option to reject the funding.

[71] Not all banks use PU and SU. Some banks only use PU as they would like to avoid the issue of bilateral promises in Sharīʿah. In addition, some banks do not use service agency. One bank in our survey for example pays the insurance on the property and includes the charges in the rental. As for maintenance, the customer will have the right to claim any major maintenance from the bank.

Figure 4.6: *Mushārakah Mutanaqisah* Housing Finance Method-Bank



Source: (SHAPE™ Financial Corporation)

For Islamic Cooperatives in Canada, they offer a slightly different version of *Mushārakah Mutanaqisah* compared to the banks. The members will first have to accumulate shares in the coop up to a certain portion of the house price. The Coop will buy the house and register it in its name. The members will then enter into an occupancy agreement where the members will pay market rental on the share of the coop. In addition, the members will continue buying shares in the coop until it matches the share of the coop in the house. As the share of the member increases, the rental paid will decrease. Members will also get dividend from the shares in the coop. Once the member has purchased coop shares equal to the value of the house occupied by the member, the title will be transferred to the member. Unlike the banks, there will not be PU, SU and service agency. In addition, the members will be responsible for all maintenance, insurance and taxes

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Halal Inc in the USA (non-bank) proposed a model where the purchase of the units will be based on the market value of the property. While this may seem like an innovative experiment to come up with an equity product, one has to keep in mind that the US has a "Fair Lending Law". If the institutions are operating in markets that are experiencing rising market prices, the clients may not be able to ever own the houses as the price of the units keep increasing. A community organization sponsored California Coop established in the late 80s had similar problems as the members filed complaints and the regulators asked the institution to modify its offering. In the US in particular, UFIC, a licensed deposit taking bank, doesn't offer *Mushārakah Mutanaqisah* as they are not allowed by FDIC to do so. Guidance and LARIBA offer *Mushārakah* Mutanqisa because these are not deposit taking institutions. In other markets (Pakistan, Bangladesh, Malaysia, and UK for example), deposit taking institutions offer *Mushārakah Mutanaqisah* as the product is approved and regulated by the Central Banks.

Since *Mushārakah Mutanaqisah* has an underlying *Ijārah*, it inherits all the flexibility that we have in *Ijārah*. In addition, *Mushārakah Mutanaqisah* may also be used to fund properties under construction. The only difference will be, the *Ijārah* component will be based on *Ijārah* Mawsoofa Fi Zhimma during the construction period.

4.1.1.5. *Wakālah*

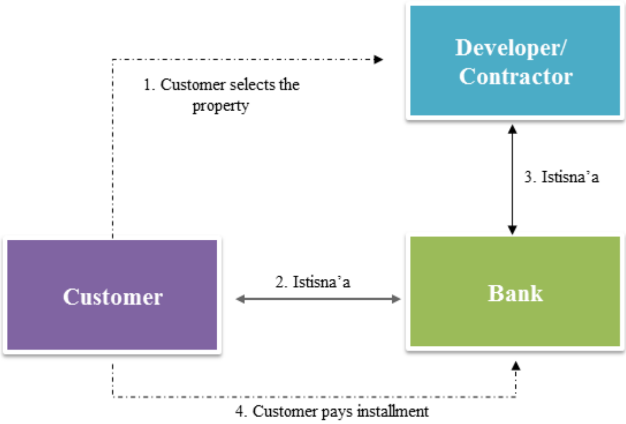
Only one bank in the sample, First National Bank (FNB) – South Africa, offered *Wakālah* based financing where the bank will act as agent for the customer to buy the house and charge a fixed agency fee. Nonetheless, FNB does not allow prepayment, variable fee or funding construction.

4.1.1.6. *Istiṣnā*

Although *Istiṣnā* refers to a construction/manufacturing contract, this was the least used option (16%)[72] by the 25 institutions that offer housing finance for property under construction in our survey. Figure 4.7 provides the transaction steps and illustration of the method.

[72] Only four institutions offer *Istiṣnā*. Four institutions also offer other solutions (commodity *Murābaḥah* or *Murābaḥah* for construction materials)

Figure 4.7: *Istiṣnā* Housing Finance Method



Source: (SHAPE™ Financial Corporation)

In the beginning *Istiṣnā* , the bank will enter into an agreement to construct and deliver the property to the customer. Effectively the bank is selling the property to the customer. In an independent contract, the bank will enter into an agreement with the actual contractor to construct and deliver the property. Effectively the bank is buying the property in the second *Istiṣnā* . In addition to the traditional credit risk, Islamic banks may have construction risk in the parallel *Istiṣnā* structure because if the contractor fails, the bank still has obligation under the *Istiṣnā* with the customer to deliver the property. The two contracts are independent and cannot be linked. Besides construction risk, the parallel *Istiṣnā* results in the bank holding a receivable. Thus, it will have the same inflexibility that was discussed in *Murābaḥah* (restructuring and selling the portfolio to third parties).

4.1.1.7. *Ijārah* Mawsoofa Bi -Dhimma

Most banks offer *Ijārah* Mawsoofa Bi -Dhimma (IMBD) for housing construction finance (36%).[73] This works similar to *Ijārah* for completed property – where the bank buys the property (under *Istiṣnā*) and leases it to the client. However, since IMBDis based on description of the property, the bank does not require a promise to lease as it can already enter into the

[73] IMBD was followed by *Mushārakah Mutanqisa* (32%). Parallel *Istiṣnā* and Others were tied at 16% each.

forward lease contract before entering into the *Istiṣnā* contract with the contractor.

Box 4.7: Entering into IMBD before owning the property

An *Ijārah* contract may be executed for an asset undertaken by the lessor to be delivered to the lessee according to accurate specifications, even if the asset so described is not owned by the lessor. In this case, an agreement is reached to make the described asset available during the duration of the contract, giving the lessor the opportunity to acquire it or to produce it.

Source: (AAOIFI, 2008), para 3/5[74]

Unlike parallel *Istiṣnā* , in this structure, the bank is the owner of the property since it only leased it to the client. Therefore the bank has the flexibility that was discussed in *Ijārah*. So the mechanism to transfer ownership (PU, and/or SU) and the service agency will also be used. There is no need to have two *Ijārah* contracts. Only one *Ijārah* contract is sufficient. The *Ijārah* contract will make clear that during the construction period, if the lessee pays any rental this will be considered advance rental.[75] Although the bank has the flexibility that comes with *Ijārah*, if the bank entered into the *Istiṣnā* with the contractor, the bank still has construction risk. If the construction is not complete and the project is abandoned, the bank has to refund any rental collected during the construction period.[76] Figure 4.8 provides the transaction steps and illustration of the method.

4.1.1.8. IMBD + *Istiṣnā*

Since in parallel *Istiṣnā* and the previously explained IMBD structure the bank has construction risk, the market has further experimented with a new variation. This variation was firstly applied in project finance settings. A few banks then adopted the same approach for housing construction finance. Figure 4.9 provides the transaction steps and illustration of the method. This variation has a lot of similarities to IMBD explained above.

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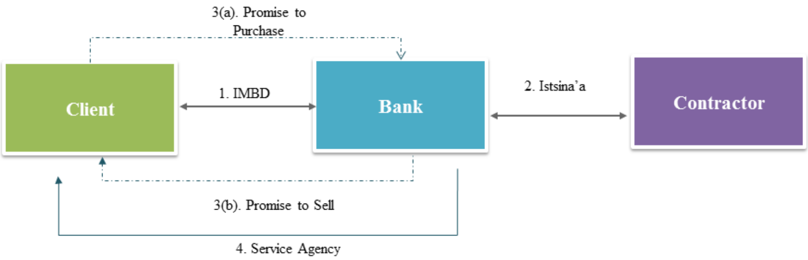
[74] The basis for this permissibility is because it will not lead to dispute. Refer p154 of AAOIFI

[75] Any rental collected during the construction is considered a liability for the bank since the bank has not provided the right to use the asset.

[76] Not all banks collect rental during the construction period. Tamweel and DIB for example do not collect any rental during the construction. HSBC Amanah (UAE) and ADCB collect rental during the construction period.

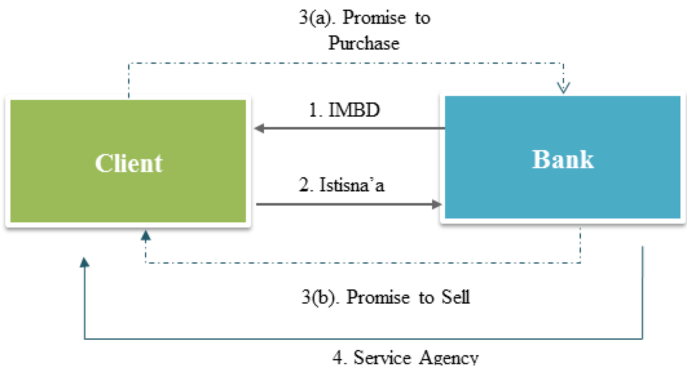
Figure 4.8: IMBD Housing Finance Method



Source: (SHAPE™ Financial Corporation)

The main difference lies in with whom the bank enters into the *Istiṣnā* . Instead of entering into an *Istiṣnā* with the contractor, the bank enters into an *Istiṣnā* with the client. Therefore, the bank is buying the asset from the client and leasing it back to him. This is exactly how a sale and leaseback structure in *Ṣukūk* works. Instead of a completed asset, this is based on asset under construction.

Figure 4.9: IMBD Plus *Istiṣnā* to Manage Construction Risk



Source: (SHAPE™ Financial Corporation)

AAOIFI allows charging a penalty for late delivery (not late payment) under *Istiṣnā* . Refer Box 4.8 for details. On the one hand, under the IMBD the bank is required to refund the advance rental. On the other hand, the bank may charge the client a penalty for late delivery. In practice, the bank will offset the penalty for late delivery with the advance rental. This structure allows the bank to manage construction risk and refund risk.

Box 4.8: Charging Penalty for Late Delivery under *Istiṣnā*

It is permissible for the contract of *Istiṣnā* to include a fair penalty clause stipulating an agreed amount of money for compensating the ultimate purchaser adequately if the manufacturer is late in delivering the subject matter. Such compensation is permissible only if the delay is not caused by intervening contingencies (force majure). However it is not permitted to stipulate a penalty clause against the ultimate purchaser for default on payment.

Source*:* (AAOIFI, 2008)*,* para 6/7[77]

In summary, for completed properties, *Mushārakah Mutanaqisah* was the most frequently used housing finance methodology. This was followed by *Ijārah* and *Murabahah*. There were two main variations of *Mushārakah Mutanaqisah* – first, offered by banks – which include PU, SU and service agency. Second, *Mushārakah Mutanaqisah* offered by Islamic coop; these did not use PU, SU and service agency. *Ijārah* and MM inherits similar flexibility when it comes to restructuring and liquidity management issue as the institutions are the owner of the asset.

For construction finance, *Ijārah* Mawsoofa Bi -Dhimma, was the most preferred. This was followed by *Mushārakah Mutanaqisah* and parallel *Istiṣnā* . Some banks use *Istiṣnā* to buy the property under construction from the client and lease it back to the client under IMBD. This manages construction risk and refund risk.

4.2. Experience of IDB in Housing Finance

Recognizing the importance of housing for the economic well-being of the Muslim *Ummah*, The IDB acknowledged that poverty alleviation can be implemented effectively by providing additional housing units and setting-up a comprehensive housing policy. The challenges are tremendous with more than half of the IDB member population living below international poverty level of US$2 a day. This situation has also exacerbated the formation of slum in many IDB many countries. Although the share of IDB financing in housing sector has been limited, IDB has played an important role in housing finance in its member countries and the Muslim communities in non-member countries through utilizing Islamic modes of finance. Hence, given the significant level of funding required to fulfill the

[77] The basis for this permissibility is because *Istiṣnā* is similar to *Ijārah* in which it is permissible to give a labourer an option regarding wages depending on whether the worker finishes the work in one day or two days. Refer p194 of AAOIFI

housing need in IDB member countries, a coherent intervention from various stakeholders including multilateral development institutions, private sectors and non-profit organizations is essential.

In the past, IDB has financed several housing projects in IDB member countries, partly under the real estate, education, water, sanitation and urban services and social services sector. The housing related projects for IDB member countries were financed from its Ordinary Capital Resources (OCR), Unit Investment Fund (UIF) and *Awqāf* Properties Investment Fund (APIF).[78] Since inception, IDB has financed 38 housing or housing related projects worth around US$740.79 million (see Table 4.7). Of these 38 projects, 10 were financed from OCR, and the remaining from APIF, UIF and special assistance. By the end of 1432H, IDB has financed housing projects in 12 member countries including few non-member countries. Pakistan was the top beneficiary, accounted for 71.7 percent of the total housing financing, while most of the modes of housing financing were based on loan and leasing.

Consistent with its human development and infrastructure strategy, IDB has participated in the financing of social housing in Mali within the Malian Government framework of providing about 10,000 people affordable houses for the low income group of urban population. The project will enable 1,500 low income households to own modern affordable houses with all the basic amenities (i.e. potable water, electricity and sanitation) by the end of 2014. As a pilot project, the IDB has approved a financing of ID12.5 (Euro14.7 million) for the development of Basic Urban Infrastructure. During the three years of construction, the project is expected to create 12,500 direct and indirect jobs. The total cost of the project is estimated at Euro45.7 million.

Similarly, Islamic Corporation for the Development of the Private Sector (ICD), an affiliate of the Islamic Development Bank (IDB), has targeted the lower and middle income housing sector for its importance in improving the living standards of the majority of the member countries populations and due to the shortage of such housing units across member countries. ICD is supporting the sector by providing equity to developers for projects in this sector (also see box 4.9: the successful case of Morocco partnership with developers). As a first initiative, in 2006, it sponsored the establishment of "Ewaan" in Saudi Arabia and attracted private sector

[78] There were few projects related to housing that were financed through the special assistance operation.

Table 4.7. IDB Housing Projects in Member Countries (1997-2011)

Country	No of Projects	Amount (in million US$)
Djibouti	1	8.50
Iran	4	84.90
Kuwait	1	5.00
Maldives	1	12.89
Niger	2	41.00
Pakistan	2	209.24
Palestine	4	94.43
Qatar	3	84.48
Saudi Arabia	4	43.34
Sudan	6	89.30
UAE	6	52.63
Yemen	1	1.00
Non-Member	3	14.08
Total	38	740.79

Source: Data Resources and Statistics Department, IDB.

shareholders to the company (Saudi Economic Development Company and International Investment Bank). Ewaan aims to provide quality and modern housing units in a community environment to the local population. The capital of Ewaan is SR200 million. The company has embarked on its first project in the city of Jeddah and the project will encompass housing units, commercial areas, mosques, schools and other service facilities. As a second initiative, ICD is endeavoring to establish a mortgage finance company also in Saudi Arabia to provide mortgage financing for home-buyers. The company will target mainly the middle income earners by offering housing mortgage for the period of 15 to 25 years.

As a third initiative, ICD has also conceptualized the establishment of a Sharīʿah compliant housing development fund to invest in the development of middle income housing units within selected member countries. The fund will invest in the housing sector, with the core investments in projects which develop affordable housing units in member countries, initially targeting 3 to 5 member countries.[79] The criteria for selecting the initial core member countries includes: i) population size and middle income population as a percent of total population; ii) GDP per capita; iii)

[79] The current pipeline projects are in Jordan, Egypt, Saudi Arabia, Mauritania, Yemen and Indonesia.

availability of raw land; iv) government incentives; v) availability of finance for end users; and vi) developer landscape. The target capital of the fund is USD500 million, and the fund is expected to be incorporated in either Bahrain, or a similar offshore jurisdiction. The term of the fund will be 5 years, extendable by 2 one-year periods. ICD is interested in developing an IDB Group-wide housing program under which the above-mentioned fund would operate. The program would be run by a team from the IDB Group entities and oversee research on affordable housing priorities within member countries, opportunities, and technology transfer, among other things. The program is intended to be an umbrella for other possible initiatives of the IDB Group for the housing sector of member countries such as a trade finance fund for ITFC to finance building materials for housing development projects and project developers, and insurance and investment protection products from ICIEC for cross-border investors in housing projects within member countries who may not be investing in the projects through the ICD fund.

Box 4.9: A Successful Case of Morocco Public Private Partnership (PPP)

The government of Morocco launched a large scale integrated program to clear all the slums in the period 2004-2012 and enabling households to have access to partly subsidized decent housing, with all basic municipal services. This has been the most successful program. The government, working through the Ministry of Housing and Urban Development and its agency Al Omrane, has cleared about 46 percent of the slums which are home to 327,000 households.

The government provided over 3,800 hectares of land at subsidized price to developers to construct 200,000 housing units. The provision of reduced price land was subject to the condition that developers must agree to sell flats for below 140,000 Moroccan dirhams on one third of the allocated land and for 200,000 dirhams on another third. On the remaining land developers are permitted to build other types of properties.

The government has secured sustainable financing for the national housing program. The government share is 40 percent of the cost through the general budget and Solidarity Fund for Housing- FSH (tax on cement which contributes to the slum improvement up to US $ 4800/houshold); the contribution of the beneficiaries households is 30 percent of the cost; the contribution of Al Omrane Group is via cross-subsidy (by the margins made on the sale of housing units to upper-income households); and mobilization of international cooperation funding. The Morocco's Cities without Slums drive concept already being replicated in Egypt and Tunisia. The Moroccan program is widely considered the best of its kind in Africa. (material in this box is heavily drawn from the following given references)

Source:
http://www.joneslanglasalleena.com/ResearchLevel1/JLLMENA_Affordable%20Housing_2011.pdf ; and www.unhabitat.org › ... › Land and Housing › Activities

Some of the main lessons from IDB involvement on housing related projects are that i) the undertaking process is lengthy; ii) political support has been very useful in speeding up; iii) continuous interaction with executing agency is crucial during the preparation and implementation; and iv) implementation arrangements must be clearly defined and understood.

CHAPTER 5

Evaluation and Comparison of Models

5.1. Introduction

This chapter summarizes the different models that were surveyed (see Appendix 5) and evaluates the models from two perspectives:

i. The different aspects of implementation, risk and infrastructure requirements
ii. The adaptability from Sharīʿah perspective and whether or not the solution has been applied in the Islamic finance market

At the end of this chapter, some recommendations will be made for the best innovative products which will address a number of key goals, the top of which will be Sharīʿah compliant, scalability, and ease of implementation.

5.2. Conventional Housing Finance Solutions

5.2.1. Common non-lending Concepts

This section applies a SWOT analysis to summarize the various solutions surveyed (for detail see Appendix 5). Table 5.1 focuses on two non-lending concepts that are widely applied in the conventional market; lease and co-ownership. Conventional leasing is a better fit with Islamic concepts and Sharīʿah rules. There are three conventional leasing options: occupancy only; lease to own (or with option) and ground lease.

Table 5.1: Summary of Non-Lending Concepts Widely Applied in the Conventional Market

Non- Lending Concepts	Strength	Weakness	Opportunity	Threat	Islamic Applicability	Execution in Islamic Context
1. Lease						
Occupancy only	Ease of execution	No transfer of ownership, amounts paid gone forever	Helps most with those who are not ready or cannot yet afford to buy	Rent has no enduring characteristic for tenant	Permissible	Widespread
Lease to Own or Lease with Option	Simple, secure for owner	Customer not on title, limited rights, more complex, not always allowed for banks	Widens potential base of customers	May not be easy to implement, possible tax disadvantages	Adaptable	IMBT
Ground Lease	Simple, separation of land from building ownership. Land owner not responsible for maintenance etc	Building may not have separate title	May be applied in many IDB member countries either in the form of Musataha or *Waqf*.	Not all ground lease may be redeemable	Adaptable	IMBT, Musataha (right to use or build on land owned by others)
2. Co-ownership	Buyer has partial ownership	Complexity	May be applied in coop, restructuring etc	May not be allowed under local law	Adaptable	DBP

The traditional approach to housing is to provide occupancy for limited terms without any rights to acquire the occupied property. As Tim White points out, the goal of ownership is something that needs to be modulated: [80]homeownership below 30% of households may be too low; and, homeownership above 70% may be economically unsustainable. As a result, housing finance which delivers housing for lease occupancy may be the most desirable and easiest area to focus on Leasing for occupancy also has the lease Sharīʿah compliance concerns.

Lease to own products, like lease with option arrangements, are largely informal and therefore not delivered in a formal manner in the conventional market in the same way that they are in the Islamic market.

The channels for delivering these products are also often restricted and sometimes banks are not able to provide lease based products due to restrictions on banks owning real estate.[81] As a result, lease products which end in ownership are typically privately negotiated arrangements in either slow real estate markets, markets which lack sufficient mortgaging opportunities, or cases in which occupants wish to change the prospective position from tenant to owner-occupant.

Another challenge for lease based occupancy arrangements is that leases and leasing companies are often taxed differently than loans and lenders. Therefore, even if lease oriented contracts widen the pool of prospective occupants, they may lack the optimal legal and regulatory infrastructure to equal loans in efficiency. Lease to own products have wide and successful implementation in a number of Islamic markets.

The final form of lease based solutions is based on the concept of ground lease where the land is leased providing an option for the lessee to redeem the land. Since the lessor is only leasing the land, the tenant is responsible for making any improvements and maintaining it. One of the challenges is whether or not the improvements have separate recognized ownership The concept of ground lease exists in many GCC countries in the form of

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[80] Op. Cit., White.

[81] The US approval for banks to deliver Islamic products under a bank's mortgaging powers, which will be discussed below. The United Bank of Kuwait, PLC secured the following interpretations to engage in Islamic transactions as banking transactions. Interpretive Letter of October 17, 1997 No. 806 from the Northeastern District of the Comptroller of the Currency Administrator of National Banks governs *Ijārah* and Interpretive Letter of June 1, 1999 No. 867 governs *Murābaḥah*. Both letters respectively are posted at the Comptroller's website http://www.occ.treas.gov/interp/dec97/intdec97.htm and http://www.occ.treas.gov/interp/nov99/int867.pdf.

(*Musataha* – the right to use or build on land owned by others), but may not have redeemable features. In UAE for example, *Musataha* is limited to 50 years and may be renewable. However it does not provide the option to redeem the land.

Co-ownership and shared equity concepts are less common unless delivered in the form of cooperative societies. Compared to leasing models, the buyer may have partial ownership in the house. However these are more complex solutions. The next section will deliberate further how co-ownership has been applied in the cooperative model.

5.2.2. Summary of Conventional Housing Finance Models

Table 5.2 summarizes the various conventional models applied for housing finance, but does not touch on subsidies. The main purpose of this section is to summarize the various models and identify any gap in the current Islamic market. In total, there are 14 models reviewed. A traditional loan secured by a mortgage is the easiest way to do business as almost all jurisdictions have laws and regulations governing loans by banks and non-banks. Commercial banks and building societies are in the same category as both collect deposits from the public and their operations are not limited to providing housing finance, even if that was the original raison d'etre for building societies. There are jurisdictions with weak mortgage laws and many mortgage laws are poorly enforced. Nonetheless, lending is simple and quick to implement as a housing finance solution.

Yet, loans by their contractual nature do not directly link the lender directly to the property. The lender at best receives a mortgage of the property as a form of collateral. Often the loan or mortgage will have restrictive conditions. But, the lender does not wish to interfere in the property management or risk. Indeed, some countries like the United States have laws criminalizing lender interference as "lender liability". Traditional loans are so well entrenched that they make non-loan alternatives difficult to implement.[82] Adjustable interest mortgages present a risk to clients in that the rate may rise above their capacity to pay.

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[82] When the first *Ijārah, Mushārakah Mutanaqisah* and *Murābaḥah* alternatives to traditional mortgage loans were proposed to Fannie Mae and Freddie Mac, they were compared to traditional loans and *Ijārah* was completely rejected. Because the client held some or all of the title, *Mushārakah Mutanaqisah* and *Murābaḥah* were pursued by Freddie Mac. Licensed banks in the US are not allowed to use *Mushārakah Mutanaqisah,* but, may use *Ijārah* and *Murābaḥah* pursuant to specific regulatory approvals. SHAPE™ experience with US banking clients, regulators and GSEs.

Table 5.2: SWOT Analysis of Various Housing Finance Solutions in Conventional Market

Models	Strength	Weakness	Opportunity	Threat	Islamic Applicability	Execution in Islamic Context
1. Commercial Banks & Building Societies						
a. Adjustable interest	Ease of execution, diversified operation	Interest may rise above borrower capacity to pay	Protects lenders	Crowds out alternatives, not focused on low income	Applicable in *Ijārah* and *Mushārakah* models	Commonly applied by Islamic banks
b. Fixed interest	Ease of execution, diversified operation	Interest, may be too low for lender to profit	Protects borrowers	Crowds out alternatives, not focused on low income	Applicable in *Murābaḥah*, *Ijārah* and other models	Commonly applied by Islamic banks
2. Mortgage bank or companies	Focused purpose	Limited access to funds, especially in a crisis	Single purpose, capacity to act quickly	Scalability, durability	Adaptable	Pursued in multiple countries – e.g. Tamweel
3. Cooperative society	Common bond, Various models (rental, limited equity, full market value)	Risk of shortage of funds	MHOS – innovative alternative for intermediate market	Scalability	Adaptable. Requires significant modification if function of coop is to lend	Islamic coop focuses on ownership transfer. Applied when Islamic banks are not present widely
4. Credit union	Common bonds, Wider base than coop, give loan to members	Limited purpose (member needs), shortage of funds	In US credit unions are successful and more common than Coop	Scalability	Requires significant modification if function is to lend	No direct application in Islamic market. Maybe done via coop

Table 5.2 (continued)

Models	Strength	Weakness	Opportunity	Threat	Islamic Applicability	Execution in Islamic Context
5. Contractual savings for housing	Addresses lack of credit history, and shortage of market resources	Liquidity risk (closed), rate of return risk (open)	Suitable alternative to Commercial Banks in emerging market.	Accurate CSH design – loan multiplier, waiting period. Best applied in building society or coop setting	Feasible with multiple products	Only a few banks offers CSH - Social Islamic Bank (Bangladesh) & Gulf African Bank (Kenya)
6. Government lender (SHB)	Focused purpose, government will	Questions of transparency, fairness and sources of funds	Commercially run, low income focus is successful. Thailand – lease followed by mortgage for low income	Crowds out alternatives	Adaptable with multiple products. Not really encouraged by WB	No Islamic SHB in current market
7. Liquidity provider	Supports multiple strategies for home acquisition	Ultimately question of source and limitation of funds	Enhance performance of whole primary market players	Overextends itself, relaxes credit	Feasible with multiple products	Cagamas issues *Ṣukūk*
8. Housing funds (HPF)	Long term self funding	Non clarity on mandate, weak performance	Clear mandate and refocus on low income one banks enter the market	Low income cross subsidize higher income group	Feasible with multiple products	No fully Sharīʿah compliant alternative in current market

Table 5.2 (continued)

Models	Strength	Weakness	Opportunity	Threat	Islamic Applicability	Execution in Islamic Context
9. Self Build (HMF)	Focus on low income, short term material purchase loan	Shortage of funds	Community development program (bulk purchase, quality control, savings)	Higher risk and deeper involvement needed (monitoring etc)	Feasible with multiple products	Some Islamic HMF & construction material finance, but not common
10. Rental Scheme	Simple – using without owning	Least developed in many emerging markets	Low income: Private small-scale investors build additional rooms or floors	Too high building standard	Feasible with multiple products	There are some residential *Waqf*, but not really focused on middle and low income
11. REIT	Tax advantage subject to regulation, liquidity for investors	Depends on investor appetite for funding	Efficient funding for master developers	Needs regulatory clarity for REIT establishment	Feasible with multiple products	Malaysia has Islamic REIT, but may not focus directly on residential
12. REOC	No regulatory and tax restrictions	Depends on investor appetite for funding	Able to pursue multiple strategies at full freedom	Focuses on narrow shareholder interests	Feasible with multiple products	There are master developers (Emaar, ODOC, Sunway etc) but no mandate to be fully Sharīʿah compliant

Table 5.2 (continued)Table 5.2 (continued)

Models	Strength	Weakness	Opportunity	Threat	Islamic Applicability	Execution in Islamic Context
13. Government loans	Subsidized terms	Questions of transparency, fairness and sources of funds	Smart subsidy toward targeted group proves efficient and effective (Jordan etc)	Overextends itself, relaxes credit	Feasible with multiple products	Interest free provided in multiple markets KSA, Kuwait, etc
14. Charitable entity	Easiest terms	Donor restrictions which may reach beyond funding	Able to pursue multiple strategies	Crowded out by other charity demands, misalignment of donor beneficiary goals	Feasible with multiple products	Besides *Waqf* and Bait al-Zakat, no organized arrangements

Fixed interest mortgages present rate risk to banks for which their cost of funds may rise above their contracted mortgage income. The former is beneficial to the bank in mitigating rate risk. The later is beneficial to the client by offering certainty of cost. Islamic banks in many markets offers Islamic house financing based on various underlying Sharīʿah principles.[83] Fixed rate financing can be offered under sale, lease and partnership based solution. However, floating rate solutions will be restricted to lease and partnership based ones to avoid *Gharar* in a sale contract.[84]

Mortgage banks have traditionally been perceived to be lending entities. These are different from commercial banks because they do not collect deposits from public and only offer housing loan. In the United States and the United Arab Emirates, dedicated Islamic mortgage banks have delivered *Ijārah* and *Mushārakah* products. The weakness for mortgage banks is that they are often capital constricted. As a result, whether or not they are Islamic or conventional, they are subject to external events in the banking and capital markets.

Credit unions evolved contemporaneously with co-ops. For most of their existence, credit unions focused on mortgage lending to customers. Co-ops either provide loans to members, or provide occupancy rights to members (rental versus limited equity versus full market value model). The MHOS model suggested by CDS UK provides an affordable ownership option for the intermediate market segment. In countries with both co-op rules and credit union rules, Islamic housing finance has been easier to organize under co-op rules. Nonetheless, the Islamic coop normally focuses on ownership transfers and is applied when Islamic banks are not present in the market. The co-ownership or shared equity models may be analogized to declining balance partnerships ("DBP"). The common bond concept (either by geography, religion, ethnic group, employers) has been popular and helped credit unions and co-ops to succeed. Besides scalability, their biggest limitation has been the problem of securing long term funding to supplement member units.

Contractual savings for housing are among the most interesting cross-over processes/products from the conventional to the Islamic markets. The concept allows certainty of funds and facilitates operation in markets without good consumer data. The name is neutral and one may apply the concept to saving in order to secure a loan or to enter into another

[83] Details are outlined in Chapter 4

[84] Malaysia has come up with an alternative mechanism for sale based solutions using a ceiling rate and rebate or Ibra'.

relationship like a lease or a declining balance partnership. There is a trade-off between liquidity risk (in closed scheme) and rate of return risk (open scheme). This depends on the deposit rate paid to the savers, and whether the financing is based on fixed or floating rate. Only a few Islamic banks have offered CSH - Social Islamic Bank (Bangladesh) & Gulf African Bank (Kenya) for example.

The World Bank recommends that CSH is offered by a building society (Coop or MFI for that matter), side by side with other housing finance product. For example, CSH may be suitable for low income group without established creditworthiness.

A State Housing Bank (SHB) has the advantage of government backing, however many SHBs have failed due to weak corporate governance, lax credit management (don't focus on recovery) and poor risk management practices (especially interest rate risk as they offer fixed rate financing). Government Housing Bank (Thailand) successfully provided financing to low income clients. An innovative approach for low income financing was to first lease the house to the household. Once the household is able to make a consistent lease payment, the property will be sold to it and mortgaged by the bank. There is no dedicated Islamic SHB in the market.

Instead of establishing a primary institution to provide financing, the World Bank recommends the establishment of secondary market institutions that benefit the whole primary market, like Fannie, Freddie and Cagamas for example. Although these institutions provide liquidity to financial institutions, their liquidity depends on third party investor funding. In addition, it is vital to maintain the quality of underwriting by the banks to ensure sustainable, high quality liquidity in the mortgage market. Currently there is no dedicated Islamic mortgage liquidity provider. In Malaysia, Cagamas provides this facility for both conventional and Islamic housing finance providers. Cagamas demonstrates that the concept of a liquidity provider is able to function in any business space or environment.

Housing provident funds (HPF) are long term self-finance that begin when the commercial banking in many markets were weak or non-existent. If there is clear mandate (separation of pension from housing finance), governance and risk management, HPF may provide a focused, smartly subsidized housing finance for low income group. Otherwise, the lower income group ends up subsidizing the higher income group. Once commercial banks are developed in the market, HPF should require the middle income group to obtain market rate funding from the commercial banks and focus on the low income group. Currently there is no Islamic HPF in the market. EPF in Malaysia is an active investor in the *Ṣukūk* market, and members may use their EPF savings for housing finance down payment, or improvement. However, EPF is not mandated to be fully Sharīʿah compliant.

Housing Micro Finance (HMF) is an efficient and effective solution for low income housing finance. A client may take short term loan to buy construction materials for incremental improvement to his or her house. The same solution is also the most effective for stimulating rental scheme for low income housing. To manage the high risk in HMF, the government may establish community development program that buys building materials in bulk, implements quality control, monitoring, and community savings scheme. As HMF cannot collect deposits, they are exposed to funding risk. From the survey in Chapter 4, only one bank offers HMF (Integrated Microfinance Bank in Nigeria) while a few other banks offer *Murābaḥah* for construction material.

Rental Scheme for residential housing is least developed in many emerging markets as the focus has been on home ownership. Nonetheless, the World Bank recommends that the most suitable approach for low income rental housing development is allowing private small-scale investors obtain financing to build additional rooms or floors to be rented. One has to keep in mind that in many cases, lowering the minimum building standard helps increase the supply of rental housing without the need to provide subsidies. In the Islamic market, there are a few residential *Waqf*, however these are not necessarily focused on the low and middle income housing.

REOCs and REITs are another form of neutral vehicle for housing finance. These tools can be applied for land development and master planned communities (ideal for REOCs) and apartments (ideal for REITs). The vehicles are indifferent as to the form of leverage that they apply or whether or not they are leveraged. As a result, REOCs and REITs may be very powerful tools in less well developed markets. Indeed, REITs and REOCs may be able to provide alternatives to mortgage banks in certain environments. The Irvine REIT for example was structured to enable the Irvine REOC to tap liquidity in the capital markets when the banking market dried up. REITs nonetheless are subject to regulatory requirement in order to receive tax benefits. REOCs on the contrary are just real estate companies that have complete freedom of operation including dividend, leverage etc. Rouse did not choose to form a REIT as they wanted to retain the freedom and manage the pace of their development[85].

In the Islamic market, Malaysia offers Islamic REITs, but none that specifically focuses on residential properties. In November 2010, Dubai Islamic Bank and Eiffel Management launched Emirates REIT in an effort to facilitate the restructuring of many troubled real estate development companies in the Emirates. Nonetheless, the properties acquired under the Emirates REIT were geared towards non-residential (office buildings, warehouses, schools, car parks etc.). Retail residential REITs may prove to be profitable rental schemes if planned and implemented correctly. There are many master developers that are REOCs (Emaar, SODIC, Sunway etc.) but these are not mandated to be fully Sharīʿah compliant. Many of these companies have been tapping into the *Ṣukūk* market nonetheless.

Government loans to citizens exist in a few countries. Frequently, these are concessionary sources of housing finance. On the one hand, their operations are subject to political scrutiny and often opaque. On the other hand, these forms of funding can be utilized in conventional, interest free and Islamic modes.

Charitable entities like Habitat for Humanity have defined a unique capacity to deliver housing. But, the model, despite being replicable and convertible, are limited to the unique bond of the universe of charitable donors and subject to interference in funding from non-financial sector events such as natural disasters or changes in donor focus and taste. There is no established charitable entity for this purpose in the Islamic market. The closest alternative may be provided by *Waqf* and Bait al-Zakat.

Before making a final recommendation, the next segment will evaluate the different conventional housing finance models from various angles.

5.3. Evaluation of the Conventional Housing Finance Models

5.3.1. Evaluation Basis

The following section will evaluate the conventional models taking into account the Sharīʿah objectives, efficiency, financial risks, liquidity, return, operational risk, and legal issues. For financial risks, we are evaluating from both the institutions (property, credit and funding risk) and

[85] Curiously, The Rouse Company was acquired by a REIT in 2004.

client perspective. Table 5.3 lists all the factors, their definitions and the meaning of the rankings.

In brief, efficiency relates to the ease of providing the service in large scales with reasonable cost and time. Credit risks refer to the availability of information and protection of financier's interest. Property risks refer to the exposure to market risk, upkeep risk and construction risk if relevant. Funding risk evaluates the diversity of funding options available to the financier (deposit, market funding etc.) and the maturity gap in the asset and liability structure. The financial risks (client) examine the probability of the client losing his previous payments and the property.

Liquidity risk refers to the ability of the institutions to monetize or securitize their assets. This is not from Sharīʿah perspective. It takes into account the common approach to managing liquidity in the different models. The return risk relates to the rate of return risk (i.e. long term fixed asset funded with short term variable rate liability). Operational risks evaluate the complexity of the model while legal risks refer to the legal certainty of the rights of different parties. In light of these factors, the evaluation is made on scales ranging from the 0 to 10 with 10 being the most favourable.

Sharīʿah objectives do not have a stand-alone category. Rather it is embedded in Factor 3 (property risk), and Factor 5 (financial risks to client). There are two guiding Sharīʿah objectives when approaching the challenge of Islamic housing finance. The first and most important is to complete the financing without any trace of *Riba* in the business arrangements. The second Sharīʿah objective is to bring ease to the believers in particular and humanity in general. Without suitable housing, people are less productive,[86] they are insecure in their lives and belongings, and society as a whole is filled with difficulties

The ranking for property risk (market and upkeep risk) and financial risk for the client is based on how the risks and reward are shared. If a model pushes the risk to one party, it receives the least point (0). If a model has a balanced approach to sharing risk and reward, it receives the highest point (10). This approach provides the most practical method of evaluating the Sharīʿah objectives

[86] Islami Bank Bangladesh citation from www.apuhf.info.

Table 5.3: Evaluation Basis of the Housing Finance Model

Factors	Definition	0	10
1. Efficiency	Ease of providing service - fair cost, reasonable time, large number of people	Least efficient -has a lot constraints	Most efficient - least constraints
2. Credit risk	Collateral/asset control, creditworthiness, income verification	Least secured	Most secured
3. Property Risk (take into account Sharīʿah objectives)	Exposure to market and upkeep risks	All risk towards one party	Risks are balanced between the stakeholders
4. Funding risk	How model fund property acquisition/refinance & degree of funding maturity gap	Reliant upon third party funding and(or) have largest funding gaps	Diversified funding with fewer gaps
5. Financial Risk (client - taking into account Sharīʿah objectives)	Client exposure to risk of loss of property and previous payments	Most risk	Balance risk and return between client & financier
6. Liquidity	Ability to monetize/securitize asset (not from Sharīʿah perspective)	Not possible	Highly liquid secondary market
7. Return	Rate of return risk (rate gap)	Long term fixed asset funded with short term and(or) variable rate sources	Matched funding
8. Operational	Ease of implementing model – complexity	Very complex	Simple
9. Legal	Degree of legal certainty supporting the model	High risk of rescission or legal challenge	High confidence of legal rights of parties

5.3.2 Results of Evaluation

The outcome of the analysis demonstrates the historical advantage that modern conventional banking has over almost all other forms of housing finance. This is particularly true given the depth and reach of conventional lending for housing finance in the developed countries.

Conventional Banks and Building Societies generated an average score of 6.89 out of a possible 10 (see Table 5.4). The basic loan and mortgage model is highly efficient, easily understood and delivered in almost every country with traditional conventional banks. But, the model is less efficient than believed in the light of the mortgage crises of the 1980's in the US, early 1990's in the UK, and the recent Global Financial Crisis. In a number of countries, there are also issues relating to the actual registration of mortgages and notarization of loans. Hence, efficiency is scored at 8. From a Sharīʿah perspective, the fact that mortgage loan pushes all property risks to the borrower is a significant weakness: Even in *Murābaḥah*, the bank intermediary must embrace a minimum level of property risk prior to selling an asset.

Mortgage Banks generate a score of 5.67 representing their singular weakness compared to traditional banks, which they often supply. The mortgage bank is notably weak in funding itself since it cannot collect deposits. This impacts the efficiency and liquidity characteristics of the traditional mortgage bank compared to both commercial banks and building societies.

Cooperatives attain a score of 7.22. Although co-ops are subject to legal and regulatory restraints which are greater than banks and mortgage companies, co-ops often achieve the optimal risk of balancing property and return issues between the co-op and the member-client. With a score of 7.11, Credit Unions trail co-ops mainly because credit unions lend against a mortgage and this upsets the balance of property financial risks so well achieved in co-ops.

Table 5.4: Evaluation of Conventional Housing Finance Models

Model	Efficiency	Credit Risks (model)	Property Risk (model)	Funding Risk (model)	Financial Risks (Client)	Liquidity	Return	Operational Risk	Legal	Total
CB & BS	8	9	3	7	0	10*	5	10*	10*	6.89
Mortgage Banking	7	9	3	0	0	8	5	10	9	5.67
Cooperatives	7	9	10	3	10	6	5	7	8	7.22
Credit Union	8	9	3	7	3	9	5	10	10	7.11
CSH:										
Open	8	9	3	9	0	7	6	10	10	6.89
Closed	8	10	3	10	0	5	10	10	10	7.33
SHB	6	5	3	5	3	5	5	7	10	5.44
Liquidity Providers	10	9	2	5	0	10	7	7	8**	6.44

* Assume developed market

**Challenges to Freddie & Fannie securitization emphasis the need to establish clear legal rules for liquidity provider

Table continues on the next page

Table 5.4 (continued)

Model	Efficiency	Credit Risks (model)	Property Risk (model)	Funding Risk (model)	Financial Risks (Client)	Liquidity	Return	Operational Risk	Legal	Total
HPF	6	10	3	5	3	8	9	8	9	6.78
Self Build (HMF)	5	5	3	0	3	5	5	5	5	4.11
Rental Scheme	5	10	10	5	10	7	5	10	10	8.00
REIT	8	7***	10	9	9	9	8	9	10	8.78
REOC	8	8	10	9	9	9	8	10	10	9.00
Government Loan	2	10	3	2	3	5	2	5	10	4.67
Charitable Entity	1	5	3	0	8	0	10	5	7	4.33

***Some REITs are mortgage oriented, some hold mortgage backed securities, and some hold real estate and some sell off-plan in a method that resembles a musawama contract.

Open CSH equals banks at 6.89 whereas Closed CSH scores 7.33. The former is impacted by its capacity to generate external debt to accelerate meeting saver's needs, but the latter is relying on matched funding from members. The latter also balances better the return risks in favour of savers.

SHB scores only 5.44 which reflects the largely poor responsiveness that these institutions show to their constituents and their reliance on politically determined budgets for funding.

The nature of liquidity providers like Cagamas limits their score to 6.44. Moreover, the errors of Freddie and Fannie in the American mortgage crisis also impact these entities and serve as a warning that the legal environment for securitization and covered bonds needs to be carefully developed and implemented.

In evaluating HPF, the global experience includes highly efficient, but complex models and very poorly executed models. This leads to a score of 6.78, even if some funds might do well.

As a general concept Self Build programmes may be very effective in micro environments. But, they can only achieve a score of 4.11 which reflects their funding challenges, and their need for a particular legal scheme.

Renting to use with no expectation of ownership is as basic as a housing program can get. Therefore, Leasing Schemes score 8. This is beneficial to understand as it means that the widespread understanding and acceptance of rental housing by all stakeholders makes it scheme which can be slotted into different approaches to housing finance like DBP, REOCs and REITs.

At 8.78, REITs show the second highest score. This reflects the flexibility of the model and the capacity to adapt it to deliver multiple approaches to housing finance. Only REOCs scored higher at 9. REOCs lack the tax and distribution constraints of REITs which give the owners of REOCs significantly more freedom than the owners of REITs. Nonetheless, both are able to generate both single family homes and finance as well as multi family homes for rent.

Government Loans score only 4.67 which reflect empirical observations of their inefficiencies. Charity Schemes are the second lowest scoring at 4.33. Even well executed models have severe funding limitations, and many have project steps that restrict access. Some have also been known to prove challenging for service organizers to achieve the correct legal status for their operational model.

5.4. Evaluation of Different Islamic Instruments

Since there are multiple Sharīʿah solutions that may be applied to structure different housing finance models, it is worth examining the different Islamic models using similar criteria to the conventional housing finance model evaluation in the previous section. The criteria may be defined as follows:

Efficiency: This relates to ease of implementation and capacity to apply in common credit environments. As a result, constant *Mushārakah* is easy to implement, but never perceived as a credit instrument.

Financial Risks: This is evaluated from two perspectives: the investor and the client. *Murābaḥah* has limited financial risk for the investor compared to *Ijārah* or *Mushārakah*; but *Murābaḥah* conveys the main financial risks to the customer.

Liquidity: *Murābaḥah* is not securitizable, its liquidity capacity in a Sharīʿah context outside of Malaysia is limited. But, *Ijārah* or lease instruments are relatively easy to monetize in numerous environments.

Return: Yield is fixed with only negative adjustment for the investor in *Murābaḥah* and Istiṣnā . But, all other methods allow the investor and client opportunities to manage returns and adjust or fix as mutually agreed.

Operational Risks: Certain transactions or processes have more steps and are harder to implement, some have Sharīʿah implications related to following steps correctly.

Legal: Some transactions are easily adapted to most legal and regulatory systems. Others require extensive adjustment.

In light of these factors, we have scaled the factors from 0 to 10 with 10 being the most favourable. Table 5.5 shows the result.

On the one hand, *Ijārah* and its derivative IMBT rank the highest, followed by DBP. On the other hand, the *Ijārah* and *Mushārakah* methods have limitations as to their channel of delivery.

In terms of risk and legal accommodation, the Islamic construction methods are ranked at the bottom. But, the combined DBP/IMBD/Istiṣnā ranks the highest for construction. The nature of construction products is always risky compared to any other form of loan. Therefore, one should not be surprised about the relative risks. The functional benefit of DBP-IMBD-Istiṣnā is that it creates an environment in which the financier has first instance protection from completion risk (the client is the builder or procurement agent); and, the financier is able, via the *Mushārakah* element to take control of a project going badly.

Simple *Ijārah* ranks at 7.86 on the scale, but is best suited to situations in which the client only requires occupancy. If we take into account a client need for eventual ownership, simple *Ijārah*'s efficiencies cannot fulfill the client's objectives. Despite its establishment, the widespread acceptance of occupancy leases in all jurisdictions, the restrictions in many countries on bank delivery of both simple *Ijārah* and IMBT are problematic. Even if the restrictions can be overcome, the tax issues are often challenging.

Murābaḥah scores poorly even though it has the greatest ease of fitting into the banking environment in most countries. The generally agreed inflexibility of *Murābaḥah* and restrictions on securitizing *Murābaḥah* cannot be overcome. Thus, *Murābaḥah* is necessarily a weaker tool than either *Ijārah* or DBP. *Murābaḥah*, nonetheless, is the one contract that clearly allows the financier to embrace the IMF's call for full recourse to the obligor.

In delivery, we take a distinctive position opposite to the International Monetary Fund's ("IMF") recommendations for housing finance. The IMF recommends full recourse finance.[87] But, *Ijārah*, the highest ranking, and DBP the next are necessarily non-recourse or limited recourse contracts. The second position that we take is that *Ijārah* is a strong tool, but we would like to achieve greater flexibility in structuring a relationship, and we would like to account for greater variability in market conditions wherever we are working. Therefore, we will prefer *Mushārakah* and DBP as the housing finance tool

[87] *Global Financial Stability Report: Getting there from here,* (Washington, D.C.: International Monetary Fund, April 2011), accessed at www.imf.org/external/pubs/ft/gfsr/2011/01/pdf/text.pdf.

Table 5.5: Evaluation of the Islamic Methods

Model	Efficiency & Implementation	Financial Risks (investor)	Financial Risks (Client)	Liquidity	Return	Operational Risk	Legal	Total scale
Ijārah	10	8	10	10	6	1	10	7.86
IMBT	10	10	6	10	6	3	9	7.71
Mushārakah (constant)	10	0	10	8	5	1	10	6.29
DBP	7	7	5	10	6	3	9	6.71
Murābaḥah	8	10	0	0	5	4	10	5.29
Agency *Murābaḥah*	10	10	0	0	5	9	10	6.29
IMBD	5	5	5	7	6	1	7	5.14
MPO	8	8	2	0	5	7	7	5.29
DBP and IMBD and Istiṣnā	6	8	5	8	5	4	5	5.86
IMBD - Istiṣnā	6	7	0	8	6	4	5	5.14
Istiṣnā	6	3	0	2	5	1	8	3.57

DBP allows unique versatility in several ways. The relationships may be completely operational and totally severed. In other words, the *Mushārakah* element does not require either a lease or sale relationship.The lease or sale elements of the relationship may be negotiated independently of the *Mushārakah* deal. And, the *Mushārakah* deal may be renegotiated to reflect changes in the lease or performance in the sale.

DBP has three components; the *Mushārakah*, the lease and the sale. The *Mushārakah* contract is the first and most flexible piece of the DBP relationship. Depending upon business strategy, regulation, or legal infrastructure, the *Mushārakah* may be established in the following ways:

1. Shareholding company: The goals of the shareholding company might extend beyond real estate development, ownership, and management. The goals might embrace another business or social objective that generates returns unrelated to activities connected to real estate. The prospective buyers of the real estate will obtain shares in the company. The model also easily facilitates occupancy leases for multi-family and single family use;
2. REOC: The goals of this type of shareholding company are to develop, own and/or manage real estate and to engage in businesses that enhance the real estate or derive additional value from the real estate. Again, the prospective buyers of the real estate will obtain shares in the company. The model also easily facilitates occupancy leases for multi-family and single family use;
3. REIT: This shareholding company has more limited goals than a REOC as discussed in appendix 5. The REIT will normally seek to distribute income and will not usually undertake development as it ties up cash without generating revenues during the construction period and this would affect negatively how the REIT is compared to peer REIT investments. Again, the prospective buyers of real estate would be unit holders in the REIT. The model also easily facilitates occupancy leases for multi-family and single family use;
4. Cooperative or Mutual Society: This form of member owned entity would have its purpose of owning and operating property to be delivered to members as either rental or let to buy. The prospective buyers and tenants are members buying units according to the membership rules of the society. The

model also easily facilitates occupancy leases by members for multi-family (members sharing a common building or development) and single family use;

5. Single Asset Entity: This entails creation of a limited purpose company or trust with the sole purpose of acquiring a single property for a single customer. The customer is a member of the buying entity and therefore a co-owner. The customer may wish to occupy the property, or the customer and financier may elect to let the property to third parties. The model also easily facilitates occupancy leases for multi-family and single family use; or,
6. Credit Union: Another form of member owned entity. Credit unions are forms of cooperative or mutual societies. Where local law would permit, a credit union could engage in asset acquisition for delivery and its letting out to members via IMBT or sale by *Murābaḥah*.

One of the more advanced approaches to *Mushārakah* methods is to revive *Awqāf*. In this model, a specific *Waqf* contributes the right to use land or buildings under its control to a developer or party in need of housing. The right constitutes the *Waqf's* "equity". The developer or housing client contributes the required elements to support the improvement of the real estate or refurbishment of the buildings to deliver good quality habitable housing. Given the nature of *Awqāf*, the improvements are necessarily reversionary and at the end of an agreed period the partnership will end, and the improvements will revert with the ground to the *Waqf* to do with as it pleases.[88]

The benefit of *Mushārakah* units is that these can stand alone away from the banking institutions. In other words, the ownership of property can be with parties unrelated to banks. This means that banks may enter the process via the occupancy or sale arrangements. The *Mushārakah* units themselves, subject to local regulations governing securities, may be freely traded or subject to restrictions governing membership organizations. The fact that the *Mushārakah* units or shares are, from a Sharīʿah perspective, tradable, means that any housing finance solution involving *Mushārakah* has a natural liquidity element in its base structure. Effectively, the *Mushārakah* may issue *Ṣukūk al Mushārakah*, *Ṣukūk al Muḍārabah*, or *Ṣukūk al Wakālah* depending upon legal restrictions and the *Mushārakah*'s Sharīʿah governance.

[88] This is essentially the approach taken by Zam Zam Tower project in Makka, and similar projects in Makka, Madina, and Karbala.

The second relationship in our DBP transaction is occupancy. Once the ownership of the shares or asset is established, it is a single unique relationship. The property owning entity may now lease the property to anyone. The lease may be a fixed or adjustable occupancy arrangement that allows the tenant undisturbed use of the property for a specific period of time.

The lease now creates a second liquidity feature for the *Mushārakah* approaches. Pursuant to AAOIFI, the property allocated to a particular lease may be sold with the lease for a period of time to an investor who enjoys the risk of the unitized property and the benefit of the operational lease for occupancy. Essentially, the *Mushārakah* may issue *Ṣukūk* al *Ijārah*. Banks, which are often not allowed to engage directly in *Mushārakah* or may not engage in direct leasing, may normally by leasing based securities. As a result, the *Ṣukūk* al *Ijārah* expand the investor universe for *Mushārakah* housing finance.

The third relationship is sale. The DBP approach is generally based upon a member or tenant's promise to buy units periodically. The source of payment is external and may be a direct payment to purchase units on the promise dates, or conversion of the member or co-owning tenant's rent into a capital payment to the *Mushārakah* leading to partial redemption. This is the most common form of *Mushārakah* transfer, but other methods could be imagined.

For instance, the *Mushārakah* could sell an occupied unit spot to a bank, and the bank could then sell the unit on installments to the tenant or a third party. In such a case, the *Mushārakah* could act as manager on behalf of the bank. The *Mushārakah* has now "refinanced" itself, and made it possible to acquire more properties, and the client may have been able to fix the amount of monthly installments for the property and prospectively extend the maturity.

All of these variations in the *Mushārakah* model which lead to customer ownership make it the most flexible tool. The DBP approach has already been taken up by housing liquidity providers like Cagamas and Freddie Mac.

There is no reason that common housing subsidies may be integrated into DBP models. For instance, Freddie Mac purchases DBP units in which the customer enjoys the mortgage interest deduction by analogy. Other forms of subsidy relating to down payments may also be integrated but reflect *Mushārakah* equity share as opposed to a client's equity share.

In the case of customer difficulties or property valuation changes, the DBP may assist the client in the following manners:

1. Rent Adjustment: During a period in which a co-owning or equity sharing customer is facing job loss or reduced income or other financial stress, the *Mushārakah* may reduce the rent or adjust the rent according to a more favourable index until the customer is able to recover;
2. Rent Deferral: Alternatively, during the client's difficult period, rent might be forgiven or deferred until a later period;
3. Unit Adjustment: In lieu of adjusting rent, the number of units or amount to be spent on units by the buying member of the *Mushārakah* may be reduced until the customer recovers. This strategy may be pursued independently or in come with either of the preceding strategies;
4. Unit Purchase Deferral: Instead of reducing the number or price of units, the *Mushārakah* may grant the buying member a deferral, so that the customer is not obliged to make capital payments until his or her economic condition improves. This strategy may be pursued independently or in come with any of the preceding strategies; or,
5. Unit Cram Down: A non-cash solution to a client's problem is to pay the client's rent from equity. This is fundamentally a reduction in the client's ownership and will cause the client to take longer to achieve ownership. Yet, the method allows the investor to stay "current" and the client to avoid loss of the client's share in the property or property owner, and/or tenancy in the same.

Some scholars have also approved that DBP may be structured so that the customer's equity in the *Mushārakah* may be bought back by the investor partner creating something similar to the infamous home equity lines of credit which were part of the problem in the American and British real estate crises of 2008.

In summary, the review of conventional housing finance models indicate that in the Islamic market, housing finance based on bank funding is the most developed model. The MHOS model based on limited equity cooperative model and contractual housing scheme are innovative concepts that can easily cross-over in the Islamic market. REITs may be used as an alternative funding mechanism for master developers program, or may be used to structure a successful rental scheme.

As for the Islamic instrument, the optimal model is *Mushārakah* with the capacity to branch into declining balance partnership. The *Mushārakah* approach may slot into the existing concepts of housing coops, mutual societies, REOCs, REITs, shareholding companies, even credit unions. These forms of *Mushārakah* give investors control over the real estate in environments with weak mortgage laws. The baseline *Mushārakah* concept also gives maximum flexibility to manage client needs and client difficulties. On the pure equity side of *Mushārakah*, capital may prove finite and limiting on how much land or how many resources are applied. But, the capital restriction leads to two opportunities. First, the capital limited *Mushārakah* gives an option for limited focus local service entities. The concept of capital limitation should be understood in the context of The Rouse Company or the Irvine Company, which by themselves were large businesses. Second, the *Mushārakah* is able to build a model of providing funding into the community wither as a co-op or a finance company providing DBP or *Ijārah* financing. The *Mushārakah* base allows for easier monetization compared to other methods, indeed, it creates more tools facilitating securitization or the issuance of covered *Ṣukūk*. Nonetheless, delivering the different *Mushārakah* models including the DBP concept require careful thought about implementation and this issue is covered in Chapter 6.

PART III

THE WAY FORWARD

CHAPTER 6

Suggested Models and Infrastructure Requirements

6.1. Suggested Model for Innovative Islamic Housing Finance

The analysis of conventional housing finance indicates that co-op model is robust and the easiest to apply for low income housing because there is a unique set of bonds that govern it. This bonding minimizes credit risk normally associated with financing low income groups. CSH also shares the same advantage since the savings period reduce the information opacity of low income group and establishes their credit worthiness. For middle income housing, REIT has proven to provide funding for master development projects in the US when bank funding dried up.

What is unique about all three housing finance model is that it is not necessarily confined to a particular group of housing type. In other words, co-op may be used (and has been used) for middle and higher income housing as well. REITs, if coupled with the correct tax credit scheme (like the US Low Income Housing Tax Credit - LIHTC) may be used to fund low income housing as well. In cases where there is no tax credit, REIT may not be an attractive enough investment if it invests in low income housing properties.

To implement the coop, CSH and REITs model in a Sharīʿah compliant manner, one needs a robust tool that may be deconstructed into unique components; adjust to different circumstances, across markets and within the deal itself; and provide multiple liquidity and exit strategies. The Sharīʿah tools analysis in Chapter 5 indicates that *Mushārakah* and its variant *Mushārakah Mutanaqisah* (Declining Balance Partnership – DBP) has this versatility; the relationships may be completely operational and totally severed. In other words, the *Mushārakah* element does not require either a lease or sale relationship. The lease or sale elements of the relationship may be negotiated independently of the *Mushārakah* deal. And, the *Mushārakah* deal may be renegotiated to reflect changes in the lease or performance in the sale.

Constant *Mushārakah* is a useful vehicle for raising capital for large scale projects involving land acquisition and development. This model has been used in a number of markets including the GCC, Egypt, Turkey and Southeast Asia. The constant *Mushārakah* as REOC or REIT allows for a next step application of sub-tools for customer occupancy, operating *Ijārah* or customer acquisition: DBP, IMBT, or even *Murābaḥah*; and build to customer specifications via *Istiṣnā* or IMBD. In addition, DBP as financing tool has also been scaled into a mass market model in Malaysia and the United States where respectively Cagamas and Freddie Mac buy DBP units in their securitization models.

The analysis recommends for the adaptation of *Mushārakah* in three main settings; co-op, REOC and REIT. Each model builds in the essence of CSH as well. Before going into the details on the different models, let's examine how a standalone DBP financing works with an emphasis of the infrastructure requirement to implement it. Following this, the application of *Mushārakah* and DBP in co-op, REOC and REIT models will be explained. The focus in each model will be its qualification issues, legal infrastructure, asset management issues, and capacity for establishing liquidity for the instrument.

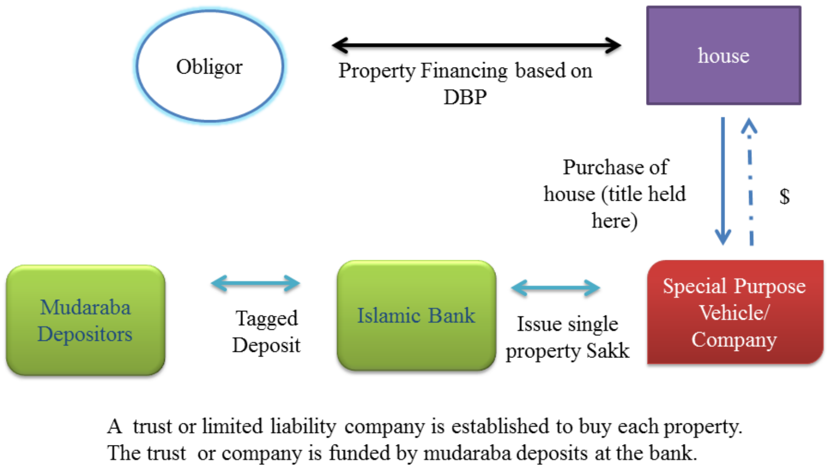
6.1.1. DBP - Financing Instrument

There is a subtle difference between shared equity and co-ownership. The distinction depends upon the law in which the sharing takes place at the business level or the real estate level. Generally, the concept of shared equity is more suited towards the holding vehicle and co-ownership at the property level. As a result, the former is more likely to be an equity equivalent and the latter a form of financing. A REOC, for instance, could be a shared equity tool allowing an individual to build equity towards a house. And, the same REOC could engage in co-ownership DBP financing for a retail customer if allowed.

This proposal starts with the concept of a stand-alone DBP to examine the infrastructure requirement related to the implementation of DBP. The application of DBP in Coop and REITs are discussed separately. This allows any institution that wants to implement DBP but not in a Coop or REIT setting, to benefit from the findings. This standalone DBP is currently provided by finance companies like Guidance Financial in the United States or banks like Arab Banking Corp. in the United Kingdom, Bank Muscat in Oman, and Citibank (Islamic) in Malaysia for example.

There are two ways for the financial institution to invest in the underlying property. The first is for the institution to go directly on the title.[89] The second is to establish a property buying entity, a trust or a limited liability company, and then for the property owning company to issue an instrument to the financier that conveys ownership to the financial institution. Refer to Figure 6.1 for illustration.

Figure 6.1: Implementing DBP via Trust or SPV



Source: SHAPE™ Financial Corp

Once the DBP ownership position is established, the DBP needs to determine how the property is to be used. There are two clear choices: Either the partnership as a single entity leases its property to the client as user; or the financier as a co-owner leases its share of the property to the client, giving the client full enjoyment of the property. The choice between these businesses approaches are normally nuanced by local laws.

The general understanding of banking is that banks do not own non-financial assets. The onset of Basel 2.5 and soon Basel 3 means that the

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[89] Depending upon legal environment, many providers of DBP products do not go on title. Instead, they appoint the co-owning client to be their agent to hold some or all of the property for the benefit of the financier. In these cases, the client typically grants a mortgage to the financier in order to preserve the financier's co-ownership rights. This is a "work-around" and not the optimal solution. It leaves legal doubts and generates risk of future disputes.

regulatory pressure will be strong in the effort to push banks to stick to the general concept. Not only is this going to increase challenges for Islamic banking, but it will impact on what type of business entity may provide DBP. Thus, the concept of the co-ownership entity issuing a certificate that fits the general definition of an asset backed security for housing finance is critical.

The DBP model requires several steps which distinguish it from a traditional loan:

1. Explicit financial regulations that allow one or all of the three following ownership approaches:
   a. Banks are explicitly allowed to own property with limited liability for housing finance purposes;
   b. REOCs and REITs are allowed to offer DBP under specific housing finance guidelines; and/or
   c. Limited liability housing owning entities may issue certificates which qualify as "non-recourse" mortgage holdings for banks under Basel rules.
2. The relevant companies' law is amended to allow the establishment of a single purpose limited capital, limited liability company or trust. The former would issue housing units to the financier and client, the latter would hold the property in trust for the financier and client.
3. The financial regulations and the land laws require amendments that acknowledge fractional changes in ownership according to a contractual schedule representing the client's capital payments to reduce the financier's balance in the property.
4. Land, loan and mortgage tax parity have to be given to the stakeholders in the DBP transaction that they enjoy explicit legal projection of the same "cost of doing business basis" as traditional lenders.
5. The means by which the financier performs its duties relating to the property needs to be captured in the appropriate financial regulation.

The DBP based model requires legal determination of each step in a way that secures the rights of both parties, and results in a clean transfer of property. This is summarized in Figure 6.2. The required legal infrastructure requires implementing neutrality in treatment compared to mortgages. For instance, in certain countries mortgage loans have interest deductions and other countries give a break on capital gains for primary residences when they are sold.

The rental paid for occupancy in the DBP needs peer treatment to interest in tax environments that currently give preferences to consumer mortgage interest, and the consumer's real estate capital gains need equal treatment as well. In the latter case, the co-ownership by the financier should not obscure the client's primary role as "owner-occupant".

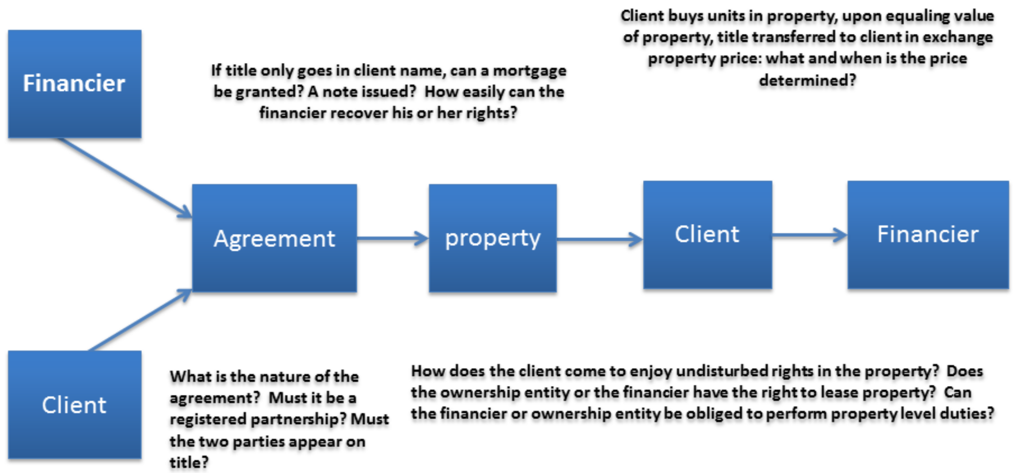
Normally in a *Mushārakah* there is neither collateral nor foreclosure. In some jurisdictions the co-ownership trumps the lack of mortgage laws. In these cases, the investor's position is strong enough to force disposal of the property or repossession and eviction in lieu of foreclosure. This may require the implementation of specialized rules governing the transfer of ownership units, and eventually the property should the client be unable to keep up his or her occupancy payments. In the case of disposal, the client's residual claim on equity proceeds also required contractual and legal protection.

In other jurisdictions, only individual persons who are citizens are allowed to have legal title. If this rule is not adapted to facilitate DBP, then the common work around as in Oman is for the financier to make the client wakeel to own the property. In this case, the financier requires collateral and would normally take a mortgage. Now, if the client fails to fulfill his obligations, then the financier can foreclosure to secure the financier's rights under the *Mushārakah*. But, if the property is disposed of in the foreclosure, the normal process of *Mushārakah* requires that the losses or gains are shared according to the capital contributions.

Secondary markets have been established for DBP instruments in the United States and Malaysia. Freddie Mac and Cagamas respectively provide securitization for DBP instruments. This process has its own requirements:

1. The capital markets regulations require clear definitions of asset backed securitization as is the case in countries like the US, UK, Malaysia, and Egypt. But, such definition is missing in a number of important markets including Saudi Arabia and Indonesia, or has significant gaps as in Turkey.

Figure 6.2: Challenges for DBP



Source: SHAPE™ Financial Corp

a. The definition requires clarity of what is being transferred, is it a *sakk* or certificate representing the DPB ownership units or is it a *sakk al Ijārah*?
b. The conditions of certificate transfer have to be agreed, and whether or not a custodian or trustee may act on behalf of the certificate owners to enforce their rights[90].
c. The definition may helpfully benefit the public by clearly indicating the terms and conditions under which the certificate may be transferred, traded or listed.

2. In many securitization cases, risk and liability management best practices put an SPV or an SPC in between the originator of the underlying transactions and the ultimate buyer of the securities.
   a. In some countries, the legal formulation of trusts needs to make clear that a trust is a pass through vehicle and has no independent will or need for capital beyond the funds subscribing to the securities. This requirement arises because in some countries, a trust is obliged to have a minimum capital in order to prevent frivolous establishment of trusts or their abuse by criminals.
   b. In other countries, the definition of a low capital and limited liability company needs to be delivered so as to make securitization cost effective.
      i. Minimum net worth requirements;
      ii. Definitions of what constitutes tax; and
      iii. Relaxation of tax obligations at the SPC level are necessary.
3. Securitization itself requires investors:
   a. In the Malaysian and American cases, there are government sponsored investors for housing finance securities which are backed by the full faith of the government[91];
   b. But, countries like the United Kingdom and France have active securitization markets which rely on private sector pension funds, insurance investors, and bank investors. In these cases the securitization instrument requires either

[90] This clarity is missing in the current American mortgage litigation over whether or not the Mortgage Electronic Registration System or MERS is permitted to foreclose on notes that it holds for third parties.

[91] Despite claims to the contrary, after the alleged privatization of Fannie Mae and Freddie Mac, the two firms were fully backed by the US government during and after the crisis, even after the banks which received emergency support had been released from TARP.

regulatory approval for certain investor classes, or design characteristics which meet the needs of long term investors. A problem in many emerging markets is that long term institutional investors do not exist and must therefore be created.

c. Agreement about how the underlying properties are qualified; and
d. Agreement about how the underlying obligors, customers are selected.

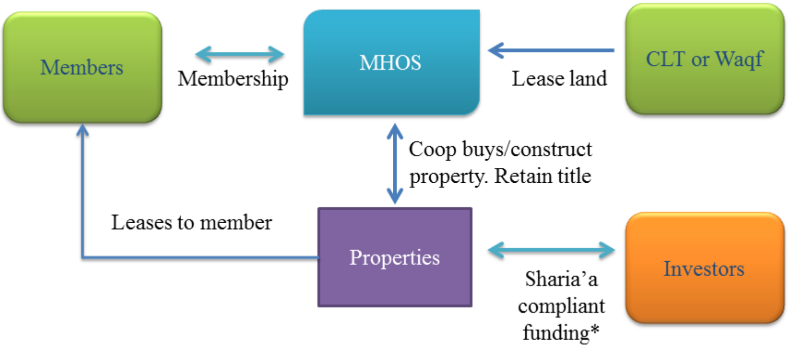
The qualification process for DBP extends to more than just consumer credit. On the one hand, financier must be willing to take a risk in the real estate based on an evaluation of the location and quality of the real estate. This is a unique business proposition as in a mortgage loan, the lender is focused on consumer credit; and, the lender looks to the quality of the real estate solely as collateral. In other words, a traditional lender may accept as collateral poor quality real estate because of a borrower's good credit. But, the investing party in a DBP assumes risks inherent in the quality of the real estate. On the other hand, DBP might only be offered to typical credit worthy consumers as is the case today with most DBP programmes .Alternatively, it might be offered in a context of consumer qualification program whereby the financed party is not easily qualified, but participates in the property ownership and builds credit through rental of the property.

The DBP model is suitable for individual home owners and represents a secure instrument for investors. This form of DBP as a "financing" tool is suitable as a standalone instrument or a tool that may be linked to any other form of *Mushārakah*. For developers of multifamily projects, DBP may also be used to provide project level financing on a corporate level.

6.1.2. Cooperative Society

The co-op model provides two opportunities: single family home acquisition and multi-family. The basic co-op model is based on membership. The first process is membership leading to acquisition of either tenancy or real property. Form the analysis given in appendix 5 and chapter 5, MHOS presents a readily adoptable model in the Islamic market. Depending on the jurisdiction where it is operating, the only tweaking that needs to be done is for the Coop to obtain Sharīʿah compliant funding instead of a conventional corporate loan. This may be done via funding from Islamic banks (either through DBP or other methods), or MHOS may tap into the Islamic capital market. Section 6.2 will examine further the various *Ṣukūk* that the co-op may issue.

Figure 6.3: MHOS with Sharīʿah Compliant Funding



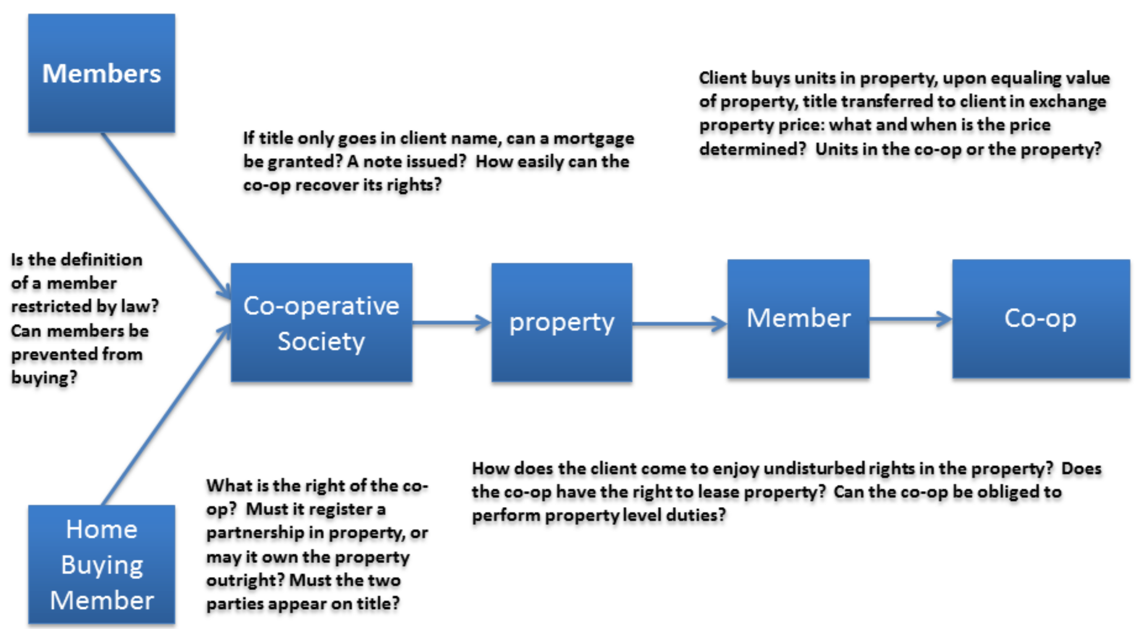
Source: SHAPE™ Financial Corp

Typically, co-ops are governed by specific legislations. So, the primary legal infrastructure is a cooperative societies act. This should have a section governing interest-free co-ops and a section governing conventional if the market is like Nigeria or Malaysia that encompasses a large Muslim and a large non-Muslim population. The cooperative societies act needs to make it clear that the society owns the property until the member requirements are fulfilled.

Enabling a co-op at the most basic level requires the following basic requirements. Refer to Figure 6.4 for summary.

1. There has to be a basic cooperative society act which defines the bonds formed by the members;
   a. The purpose has to focus on housing.
   b. The bonds may be loose: housing; or narrow: a particular location or members of a trade or employees of the same company.
2. The act has to determine if the co-op is funded solely from member funds or may take on debt. In the latter case, what type of debt may the co-op take on?
3. The act needs to define whether the purpose is to accommodate single family houses or multi-family or both.

Figure 6.4: Concerns for Coops



Source: SHAPE™ Financial Corp.

4. The co-op's bylaws need to address the degree to which the co-op is able to accommodate members with the equivalent of a contractual savings for housing or to accommodate poor credit members or members with no standard accommodations.
5. The co-op act has to govern the units, and ultimately the property:
   a. How are units acquired;
   b. Are some units only investments, but not eligible for property purposes;
   c. Are units convertible into homeownership;
   d. Are co-op dividends applicable to cover rent and or unit or property purchases?
6. If the co-op leases property, it requires a clear lease and determinant of how the lease ends under which conditions.

One of the unique features of the MHOS is the use of CLT to obtain and hold the granted land. This requires recognition and clarity of the role and responsibility of the CLT. Section 6.1.4, will discuss further on the concept of trust. Besides using a trust, IDB member countries that recognizes *Waqf*, may also utilize this concept. The function of the CLT is to avoid the sale of the land. This keeps the price affordable on a sustainable basis.

In a co-op, the membership process is the first step in qualification. Unlike a single client process, the co-op does not have to have a standard client evaluation. Instead, a co-op has the capacity to act like a contractual savings program. As the member builds equity, the member builds evidence of being able to meet his or her obligations. The alternative qualification process means that members often have to wait, and a co-op can only accelerate the process if the co-op is adequately funded and perhaps leveraged.

Let's re-examine typical qualifications and see how these might be relaxed in a membership oriented vehicle:

7. Debt to income ratio – generally 45% debt to income is deemed to be the maximum ratio tolerated by lenders. Unlike a subprime lender which raises ratios to accommodate loans for securitization; a co-op may elect to modulate the rental to assist a member in building up his or her qualifications, or may tolerate a higher level for a member whose capacity is expected to change, or has maintained membership

payments (the CSH factor) whilst renting at market elsewhere;

8. Housing ratio – generally between 35 – 40% of income, this ratio captures either rent or mortgage costs on an existing mortgage. Again, this ratio allows for the co-op to assist members in different capacity environments, and to build up member qualifications to in order to acquire housing from the co-op;
9. Transport ratio – This type of conservative ratio is the type which can be ignored by a co-op;
10. Down payment and source of down payment – the size of down payment is often a critically important factor in determining credit risk. For a co-op, the source of a down payment is the membership unit acquisition and the size is determined by the members and the capacity of the co-op to acquire housing;
11. Employment and verification thereof is often a legal obligation for housing loans. To the degree that a co-op is permitted to avoid traditional lending boundaries, maintenance of membership may overcome the conventional requirement to prove employment;
12. Verification of assets: The purpose of a co-op allows for the aspiring housing candidate to avoid accumulating assets. Because a co-op allows the member to build their capacity directly in relation to the housing desired, the accumulation of co-op units fulfils the asset validation obligation. Were a member able to strengthen his or her application for accelerated housing occupancy with other assets, this should be beneficial;
13. Verification of savings and average monthly balances like verification of assets may be replaced by the member's accumulation of assets; and,
14. Cash reserves might also be overcome by the member's building up of co-op units.

The co-op model essentially makes membership a tool for alternative credit assessment. Even old fashioned character references are overcome by the participation in the membership meetings and process of a co-op.

It may be noted that, the coop may offer pure tenancy option, ownership transfer option (like done by many Islamic co-ops) or a hybrid option (MHOS – limited equity). For the low income group, besides providing a pure tenancy option, the co-op may adapt the Government Housing Bank (Thailand) approach – lease followed by mortgage. To make this Sharīʿah compliant, the co-op can first lease the property, once the tenant qualifies the arrangement could then switch to DBP (or gradual transfer of the

Ijārah) or *Murābaḥah* (on credit). Besides this, another common issue with low income group is the highly variable nature of their income makes it challenging for them to commit to a fixed, consistent payment. To manage "missed payment" issue, the co-op may use flexible payment scheme (35% of income for example as applied by MHOS). Otherwise it may also implement the concept of blocked deposit to cover any future missed payment. Building in these features may allow smart government subsidies to be applied in the co-op that focuses on the low income segment.

Since the co-op owns the property, there is no need for separate collateral. In lieu of foreclosure, there is eviction and sale. But, in a co-op, if there is a sale of property to a third party, the tenant is not impacted by the direct sale of property, but by the impact on the value of membership units if the sale is at a profit or a loss.

The nature of a co-op is not to generate an individual customer transaction which can be sold or assigned in the same way as an individual mortgage and note. Therefore, traditional secondary market operations may require the issuance of *Ṣukūk al Mushārakah* or *Ṣukūk al Ijārah* by the co-op representing its pooled transactions or pooled units. As a result, those co-ops which choose to access the debt markets for funding require capital markets infrastructure. Section 6.2 will discuss this further.

6.1.3. Communalized REOC:

The core *Mushārakah* idea facilitates equity collection. Both REOCs and REITs resemble constant *Mushārakah*. Therefore, the need is to implement basic equity capital market rules. A REOC has no unusual rules when contrasted to a conventional equity share. Indeed, REOC is an industry designation as opposed to a specialized type of share. This leads to two distinct choices for the enablement of REOCs:

1. Basic Equity Subscription Rules:
    a. Legal definition of a share;
    b. Allow different classes of shares with distinct prices and different rights;
    c. Legal enablement of share trading, including:
        i. Efficient registration;
        ii. Brokerage and trading rules; and,
        iii. Investor protection rules;
    d. Share custodial rules; and

e. Electronic and telephonic exchanges.

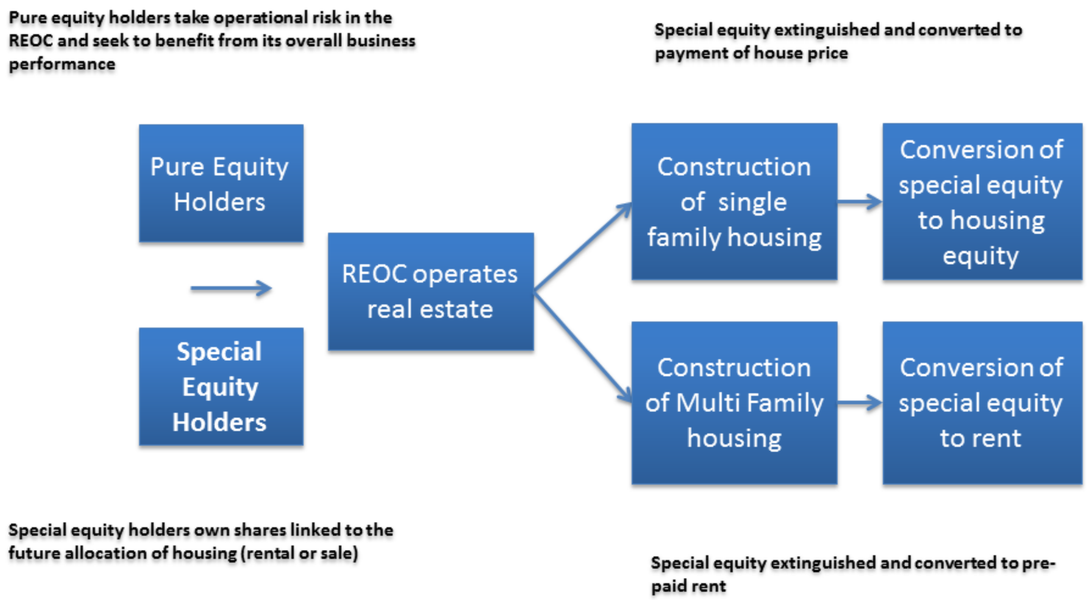
An innovative approach to the concept of REOC is to facilitate contract purchases, a form of dollar cost averaging that is functionally a "contractual savings" for housing program and results in the delivery of a house or apartment as opposed to acting as a simple equity investment. This would drive the second form of enablement:

2. Specialized rules for REOCs:
    a. Establishment of rules for fractional share purchases; and
    b. Explicit categorization of REOCs that removes or reduces the tax and transfer costs for fractional share programmes that result in the delivery of housing ownership or apartment occupancy to specified classes of shares.

Refer to Figure 6.5 for the illustration of the communalized REOC. This is not a co-operative society. Instead it's a real estate company that issues a special equity, which is essentially a convertible share that converts into either ownership of a house or the right to use an apartment. The difference from a co-op is that the pure equity holders determine the business operations, and the special equity holders are prospectively entering into a contract which is akin to CSH. However, the special equity holders face the risk that the REOC cannot deliver the real estate and failure of the REOC will wipe out their shares. This risk is particularly high if the REOC elects to pursue real estate activities which are more expansive than the actual business requirements of the special equity holders.

The Communalized REOC embeds some of the same CSH characteristics as the co-op model. In this variation, the REOC may be operating residential properties rent or it may be developing and selling. The place in the queue for units is based on owning a minimum number of shares in the REOC, and the acquisition of ownership would be based on exchanging shares at market value for a property at its respective market value. Gaps between the number of shares that a buyer has or needs could be made up by seller financing (IMBT or *Murābaḥah*) or third party financing. To do this, it must qualify the client for debt and will need to determine if a long accumulation of shares under a share purchase plan can mitigate missing credit criteria.

Figure 6.5: Communalized REOC



Source: SHAPE™ Financial Corp.

Both REOC and REIT (discussed in the next section) might require a special license for housing finance. This would allow them to deliver financing in the form of DBP, *Ijārah*, *Murābaḥah* or other Sharīʿah compliant manners. This means that a REOC or REIT could be a financing company, or a real estate company with a financing capacity

In terms of basic legal infrastructure for land, the REOC (and the same applies for REIT) requires a clear land registration law. Land and property laws also need to allow for the division of improvements as separate legal property from land. Even within the forms of improvement or above ground rights, clarity has to be established as to whether or not buyers of improvements own common areas, or these are owned separately and may be carved out of the legal rights to allow. If the REOC offers rental properties, tenant landlord regulations, and clarity on eviction procedures is vital. In a develop and sell model, clear land law and mortgage law is crucial.

Subsequent to the Egyptian revolution of 2011, a number of master planned communities have discovered that they face claims from former land owners based on how land was transferred and imperfections in title. Even though Egypt has a long standing mortgage law, not only are foreclosures difficult, but in the case of a poor land registration law, the mortgages may prove to be invalid. Therefore, the lesson is that REOCs and master plan developers need to coordinate closely with local governments to assure that land is properly acquired and title is recorded and transferred properly.

Listed shares have a ready, but not necessarily secondary markets. Therefore capital markets activities might be expanded to create leverage via *Mushārakah*, *Muḍārabah* or *Wakālah Ṣukūk*. Section 6.2 will discuss this further.

Compared to a normal mortgage company, a communal REOC obtains funding via the equity (pure & special class) and the leverage it raises (bank funding or *Ṣukūk* issuance). Instead of governed by a co-op act, the REOC is governed by the securities market ruling (as the special equity class maybe listed).[92] This is more suitable for master development program where the master developer arranges corporate level or property level financing.

[92] Listing facilitates the exit for the investor.

The REOC concept allows for innovative thinking in a more advanced financial market. In less developed markets, the adaptations to law that may be required to implement such an approach. This could allow the market to significantly modernize whilst avoiding problematic intermediate steps that address part, but not all of necessary financial change.

6.1.4. Communalized REIT:

The REIT family of concepts operates functionally in the same way as the REOC with a single difference: tax advantages are given to the REIT and its shareholders. The first tax benefit is to exempt the REIT from tax payments if it pays a specific percentage of its income to investors as dividends. Normally the percentage is between 75% and 90% of net income. The second tax advantage is that REIT unit holders are only taxed at their personal or corporate rate. The apparent benefits of the tax advantages are to encourage more real estate investments and to broaden real estate ownership. The additional requirements for REITs compared to REOCs is the passing of the appropriate tax regulations. As a result, REIT has the same requirements as a REOC, but has the following legal needs:

1. Generally, REITs are trusts holding property on behalf of investors. This requires trust law, which is normally associated with English law countries. In civil law countries, trust law must be imported as it has been in Bahrain and Thailand, or the effect of a trust must be incorporated into the companies' laws. A trust fundamentally divides financial risk (investors) from management and operational risk (the trustee and managers hired by the trustee) for property that is fundamentally belonging to the unit holders as opposed to the corporate holder of title;
2. Tax laws need to be amended to give conditional amnesty to a REIT. This means that as long as the REIT is focused on specific real estate related activities and distributes a minimum amount of income, then the REIT pays no corporate tax, and the unit holders are taxed at their personal rates for dividends paid to them by the REIT.
3. As with the REOC, a special REIT unit needs to be created that allows the unit holder to receive property related benefits

in lieu of a cash dividend. Such benefits might include payments towards acquiring one of the REITs properties or payment of costs including rent if the unit holder is already investing in the REIT.

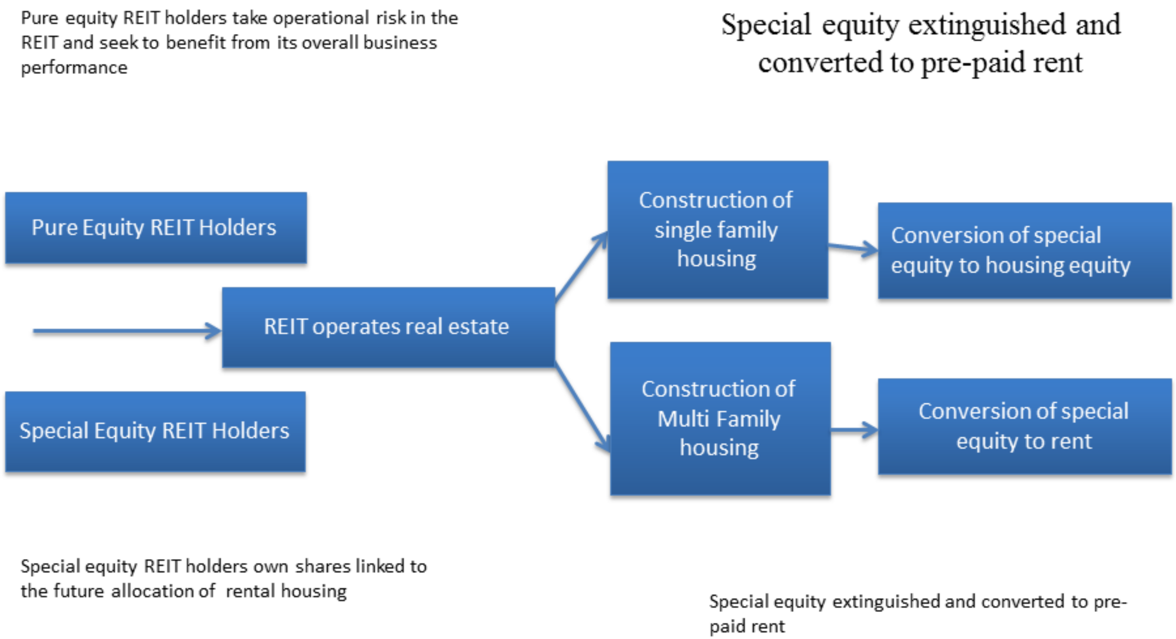
The concept of special equity applied in REOCs (shareholders being able to reserve a unit for rent or acquisition based on holding a minimum number of units) applies to REIT as well. In the United States, there is a class of REITs that focuses on either providing mortgages or buying mortgage debt, the Mortgage REITs. There is also a second class of REIT, the Hybrid REIT, which owns and operates real estate as well as providing mortgages or investing in mortgage debt. Figure 6.6 shows the diagram of the communalized REIT which assumes the classical REIT where it only operates rental properties.[93] All three forms should be contemplated in the Islamic space.

The concept of an Islamic "mortgage" REIT is perhaps easier to contemplate in the sense that the REIT's ownership of property is a natural state. The next step is the extension of credit via IMBT, DBP, *Murābaḥah* or *Musawamah*. Refer to Figure 6.7 for illustration. The mortgage REIT may also invest in *Ṣukūk* issued by a Co-op, REOC or other Islamic housing finance providers. This will allow the Islamic mortgage REIT to provide funding to other financiers and play a role as liquidity provider as well.

In the hybrid Islamic REIT, the REIT pursues a simultaneous strategy of owning and operating housing real estate for its long term benefit, as well as providing credit to individuals which desire to take ownership of the properties held by the REIT. The REIT's credit tools include IMBT, DBP, *Murābaḥah* or *Musawamah*. Refer to Figure 6.8 for illustration. This model exists in a conventional sense in the United States and Turkey (although the current model does offer a special equity class). The hybrid model requires specific approvals by the capital markets and consumer credit regulators, as well as prospectively new laws governing property ownership and transfer

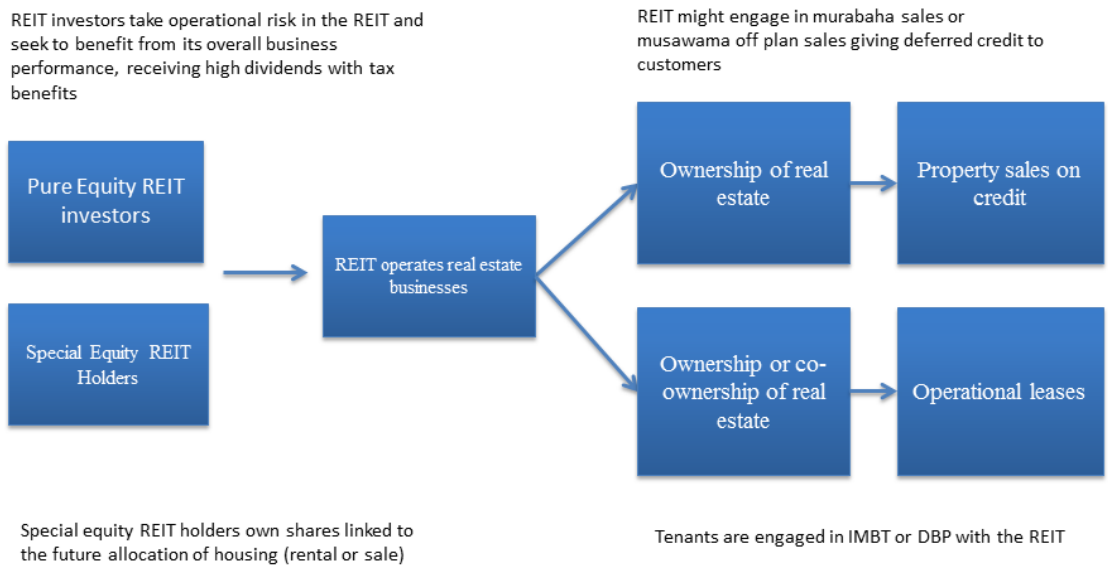
[93] The Irvine REIT was based on the classical REIT where the apartments were only leased and not sold

Figure 6.6: Communalized REIT



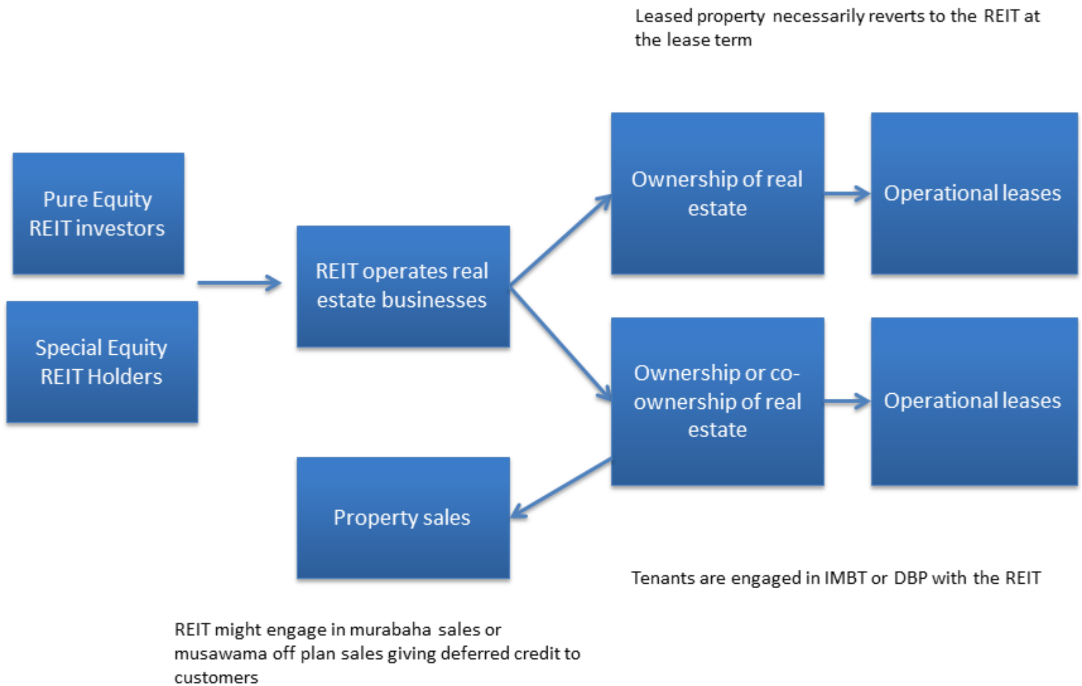
Source: SHAPE™ Financial Corp.

Figure 6.7: Islamic Mortgage REIT



Source: SHAPE™ Financial Corp.

Figure 6.8: Islamic Hybrid REIT



Source: SHAPE™ Financial Corp.

Although the Turkish REIT's exemplified by Emlak Konut REIT[94] are few, they have focused on the housing sector. TOKI is the parent of Emlak Konut and this means that the REIT enjoys good access TOKI's land bank. And, Emlak Konut represents a means for the public to participate in the conversion of excess government lands into housing units which are mostly sold into the middle and moderate income classes. Unlike most REITs, the Emlak Konut model is to acquire raw land and convert it to housing units: the construction and marketing risk is more common for a REOC as opposed to a REIT. Emlak Konut also provides credit to buyers, making Emlak Konut a form of hybrid REIT. The general Emlak Konut model represents a semi-privatization of the government housing finance sector.

Once operational, the REIT might choose to accelerate its business activities by leveraging as a business, most likely issuing *Mushārakah*, *Muḍārabah* or *Wakālah* securities. Or the REIT could leverage itself at the asset level. Section 6.2 will discuss this further.

REITs and REOCs give planners and governments a powerful tool to expand the flow of private and public funds into the housing markets without excessive leverage on the behalf of the government.

6.2. Infrastructure Requirement:

Smith's concept of Law, Environment, Partnership, Subsidy or "LEPS" returns as our fundamental guide in understanding how to manage the new product. The recommended model requires the capacity to divide and sub-divide property in order to deliver different types of housing to consumers. The implementation of DBP means a need for regulated share transfer programmes akin to off plan sales; proper governance for *Mushārakah* programmes and their tools for conveying occupancy or ownership via various *Ijārah* concepts. Expanding housing benefits requires a scalable means for delivering new funds from alternative sources of capital. This capital would most likely come from securitization or *Ṣukūk* programmes. In order to deliver additional funding, capital markets rules as well as core investment entities need to be put into place. All of this requires a return to the core enabling factors for housing markets.

[94] EFG Istanbul Securities, Emlak Konut REIT, Equity Coverage, January 26, 2011.

In appendix 5 the many impediments to housing finance were reviewed. The proposed solutions face many of the same impediments and add new ones. For Islamic housing finance to take off, additional factors have to be considered. As a result, a number of legal and financial rules have to be imported or improved into the legal, housing, and land systems of most emerging markets.

Smith's observation that markets produce a particular quantity of housing for the middle class, but not necessarily enough[95] may be combined with Hoek-Smit's view that getting the right amount of middle income housing requires some form of government intervention.[96]As a result, the enablement of the market requires integrating how the essentially private sector tools recommended above will be more efficient or assist more families with suitable government assistance, whether in terms of law, regulation, liquidity or backstop for the housing finance sector.

6.2.1. General Needs:

The first factor is clear establishment of property rights and their protection. Basic property rights require two fundamental steps in most emerging markets: one is formalization of property rights that have been appropriated by the lower classes and emerging middle classes; and, the establishment of accurate modern land registries.

Modernization of land registration requires two key elements of development. The first is the capacity to register different types of property occupying the same site so that land and improvements may be separated; and, enabling co-ownership which is subjected to periodic contractual changes without creating defects in title.

The title requires a formal discovery process and a means to protect bona fide holders from both usurpation and claims which predate a particular event like conclusion of a civil war, independence or another key event. Whether private or public, this means that a form of title insurance needs to be implemented. Title insurance may be a national project with a

[95] Op. Cit., Smith, Brazil.
[96] Hoek-Smit, Marja C., *Subsidizing Housing Finance for the Poor*, Paper prepared for Development Initiatives Group July 2008

premium or fee paid at each transfer event. Or, it may be a third party independent service hired by one party at closing.

All of these factors are integral to being able to transfer property. In many countries, the rules which govern the transfer of property are convoluted, opaque, and expensive. In some cases, the complexity of transfer rules builds a micro-industry of third party service agents who exist solely to navigate the rules on behalf of a buyer and a seller. In other cases, the opaqueness of the transfer rules creates opportunities for corruption. All of this leads to increases in the cost of transactions.

Therefore a clear property transfer rulebook with simple defined costs is critical to developing an efficient and fair property market. One of the fundamentals is the ability to register a transfer in a short period of time, ideally in minutes, prospectively using valid electronic records.

House price indexes may also useful in the process as these allow for the establishment of market trends, occupancy costs, and fair, comparable valuations. A well-ordered housing index should be based on live data reporting from recent transactions: sales prices, rental contracts, and mortgage rates or *Murābaḥah* profit rates. Transparency in these data elements results in better decision making by housing seekers, providers and financiers. But, the British financial press has reported on the diversity of housing price indexes in the United Kingdom, pointing out the relevant challenges in understanding the benefits of any one index when there are multiple indexes. For instance, the national Land Registry is an accurate view of specific transaction values, but differs from the data provided by the Royal Institute of Chartered Surveyors. Various other indexes express sub-biases of the providers: sell side, bank side based on the bank’s market view, and the components of a particular trend with in the data[97]. As a result, the British experience suggests that the construction of a single composite index may mask specific sub-trends or may be constructed by a data provider who has access to only on data flow. Therefore, as one builds a new market, two problems are present: shortage of data with which to build an index; and determination of the best components to develop indexes in order to achieve the optimal transparency for market development.

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[97] Saunders, Emma, *UK house price puzzle: comparing indices,* Financial Times, October 28, 2010 and Powley, Tanya, *Too much house price information?* Financial Times, February 6, 2012. Both accessed at www.ft.com.

Efficient housing finance is best linked to a well-developed capital markets which allow for the integration of long term funding with more attractive financial costs. Capital markets generally require pensions, *Takāful* life insurance, and state entities to take the long term risk required for housing finance. But, what should the long term investors buy: assignments of mortgage notes; covered bonds, or securitized assets.

The question is critical as matched funding for long term housing assets. Historically, banks have relied on a mismatch of assets to liabilities and interpreted a significant portion of their deposits as "core deposits". Events following the deregulation of interest rates in the 1980's, like bank runs in the 1930's and later in the 2006 – 2008 mortgage crisis in the western countries, resulted in banks being unable to fund their assets and forcing them to seek protection or collapse. This was the case of Northern Rock in 2007 and fundamentally Lehman Brothers in 2008.

Following the collapse of American rescue of Lehman Brothers, many experts have raised the idea that covered bonds are superior to securitized assets. But, covered bonds are loans at interest secured by notes or mortgages issued by underlying investors. In the 2000's a number of issuers in the *Ṣukūk* markets issued the equivalent of covered bonds in the form of *Mushārakah*, *Muḍārabah* or *Wakālah* notes. But, these securities were issued because the basic Islamic concepts were not easily applied in the relevant jurisdictions.

The general preference in AAOIFI is to issue securities based on the sale of an asset and attached to it the risk and reward of the underlier. This is the essence of securitization. Despite the IMF's bias in favour of covered bonds[98], the Sharīʿah bias is to have a proper sale.

The Alrajhi Bank *Ṣukūk* issuance for Villamar, a multi family project with units for sale was structured as secured covered *Ṣukūk*. In the Villamar case, the underlying relationship between investors and originator is *Mushārakah*, but due to complexities under the existing project contracts, the investor rights are secured by a mortgage.

[98] Op. Cit., IMF.

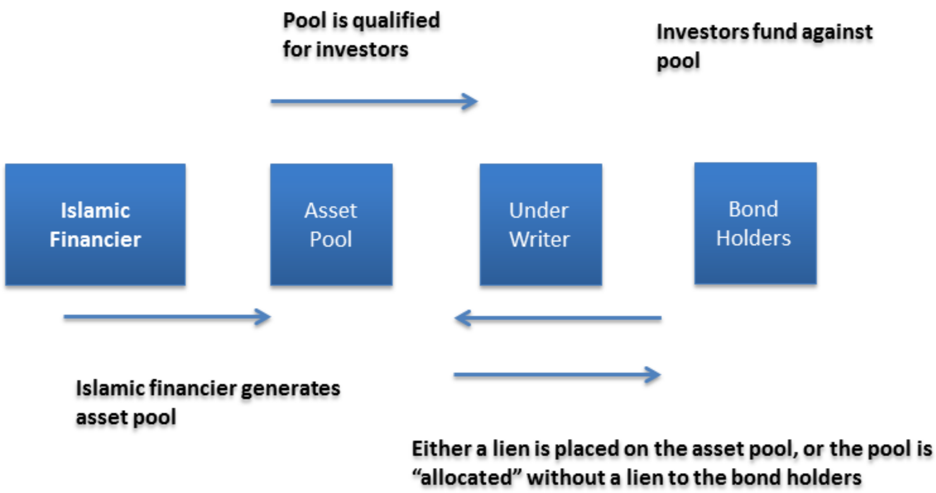
The covered bond process is fundamentally a secured lending process and the bond holders expect that they will lend to the mortgage bank based on sufficient security and security of a specific quality that they are fully insulated from the risk of loss at the mortgage bank. This process is not precisely replicated in the Islamic markets although some efforts have been made on this front. (See Figure 6.9 for the operation of a covered bond).

Refer Figure 6.10 for the illustration of a simple covered *Ṣukūk*. In the case of most *Ṣukūk al-Mushārakah*, *Ṣukūk al-Muḍārabah*, and *Ṣukūk al-Wakālah*, the underlying assets are not pledged to the investors. Instead, they are frequently referenced as the basis for payment to the investors, which makes these securities less secure than traditional covered securities. The reason for the lack of coverage is that the laws governing securities and property transactions in most Islamic countries do not easily facilitate either conventional covered securities or risk sharing *Ṣukūk* with explicit rights on the underlying asset being conveyed to investors. Figure 6.11 illustrates how a co-op may issue *Ṣukūk Mushārakah* covered with the co-op properties.

A co-op, REIT, or REOC may also leverage its asset to raise funding in the *Ṣukūk* market based on a sale and leaseback structure. Figure 6.12 shows the transaction step and structure of *Ṣukūk* Al-*Ijārah* issued by Al-Aqar (an Islamic REIT in Malaysia) to refinance its Islamic bank funding.

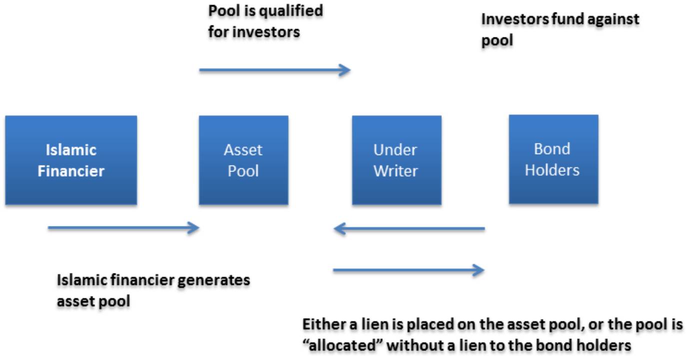
A REOC may replicate the well tried conventional model of raising property level investment or issuing REOC level securities. In the former case, property level transactions result in the release of cash back to the REOC to fund its ongoing business, acquire and improve new properties, or pay dividends. The single property level deals push risk towards the investors and remove corporate recourse, unless the REOC undertakes to buy back the property. Refer to Figure 6.13 for a simple illustration.

Figure6.9: Simple Covered Bond Concept



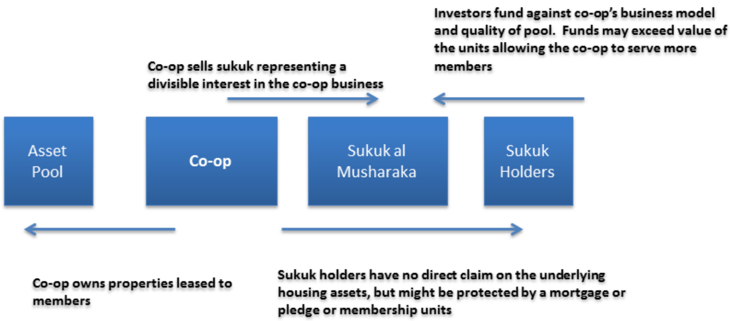
Source: SHAPE™ Financial Corp.

Figure 6.10: Simple Covered *Ṣukūk* Concept



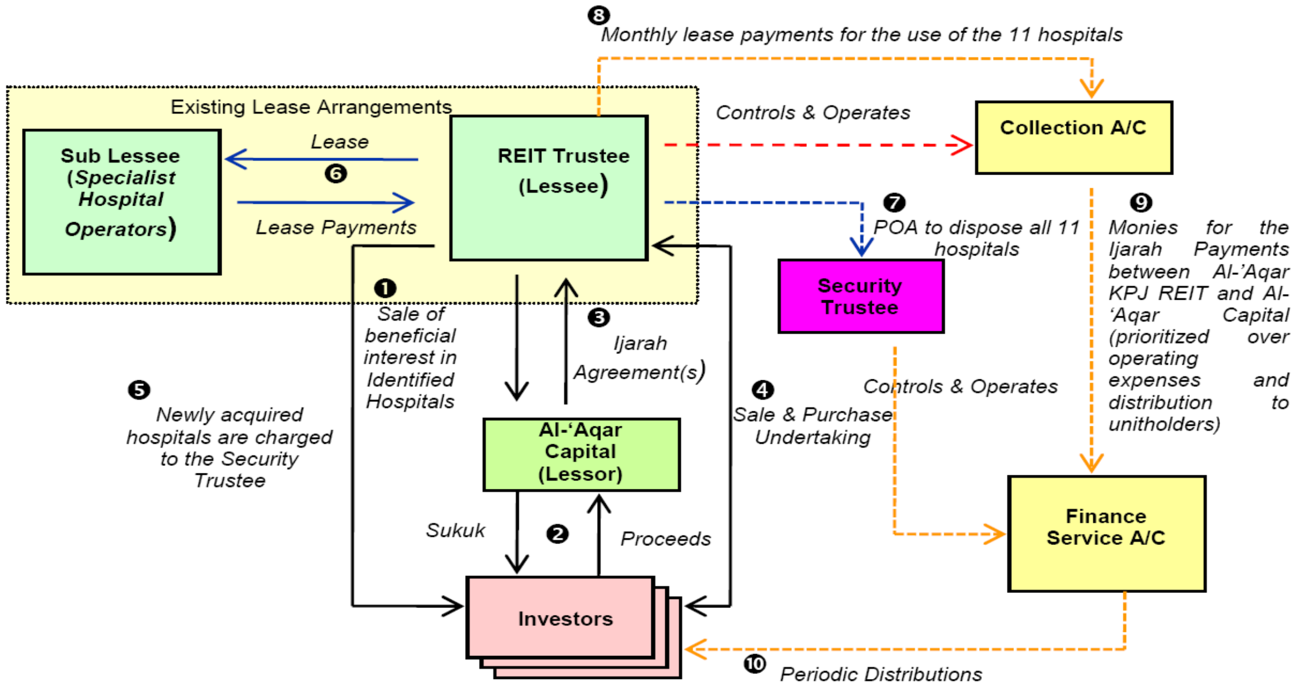
Source: SHAPE™ Financial Corp.

Figure 6.11: (Covered) *Ṣukūk Mushārakah* for Co-Op



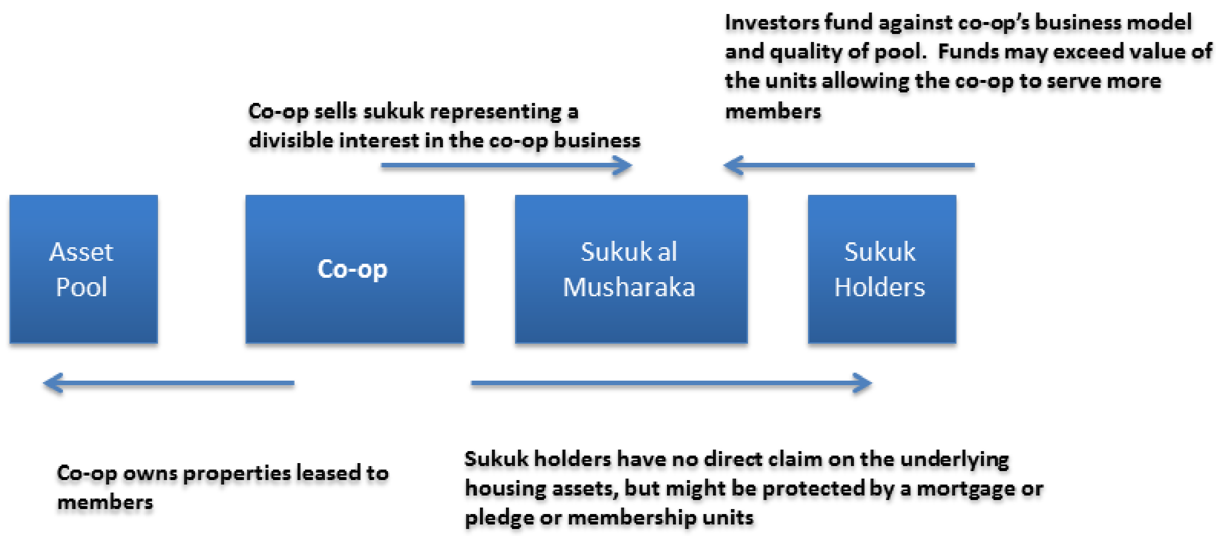
Source: SHAPE™ Financial Corp.

Figure 6.12 : *Ṣukūk Ijārah* by Al-Aqar REIT



Source: (Al-Aqar REIT, 2008), p50

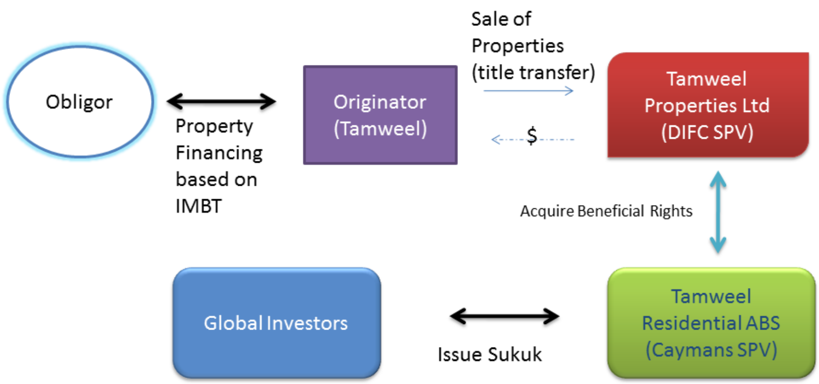
Figure 6.13: Sharīʿah Compliant Leverage for REOC



Source: SHAPE™ Financial Corp.

In contrast to covered bond/*Ṣukūk*, securitization transfers long term risk to long term investors. In the case of Tamweel in the United Arab Emirates, the Islamic mortgage company sold IMBT transactions into a Dubai International Financial Centre ("DIFC") entity in a process that re-titled the assets from Taweel to the DIFC SPV. Then, the DIFC SPV sold securities to a Cayman Islands trust which sold securities to global investors. In this transaction, the investors have recourse only to the property and under the IMBT contract. Tamweel's sole ongoing role is to provide collections to the investors and act against tenants who fail to meet their obligations per the instructions of the trustee representing the investors. This is a successful securitization in which the originator, Tamweel has no credit or property risk remaining and has no credit duties to the investors. Refer to Figure 6.14 for the illustration of Tamweel's asset backed *Ṣukūk Ijārah*.

Figure 6.14: Tamweel *Ṣukūk Ijārah*

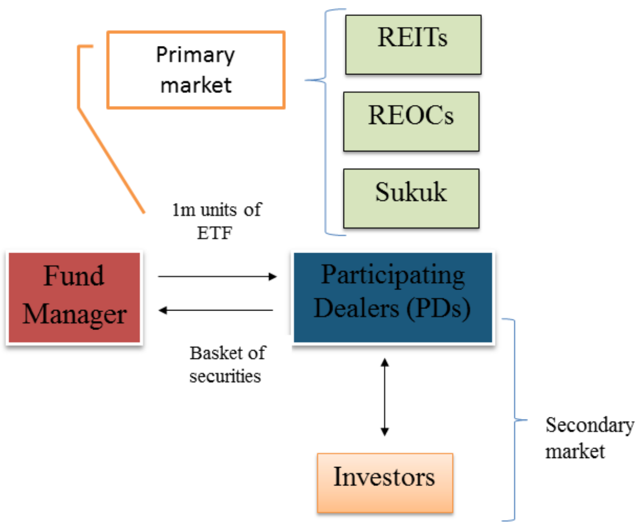


Source: SHAPE™ Financial Corp.

Covered bonds retain a risk on the underlier at the originator. The IMF position is that the originator will continue to have a risk on the relationship with the underlying customer and will closely focus on the quality of the asset and activities in the market. Recent Basel III initiatives include efforts to make securitization more aligned between originator and investor. These ideas are parallel to some of the concepts applied in the German and Egyptian markets in which the originator retains risk in the form of equity in the relevant special purpose company that holds the assets. As a result, the retention of risk in the sold asset both consumes capital at the originator and helps to align the originator's interests with the long term investors.

Besides *Ṣukūk*, exchange traded fund may also provide another liquidity and funding option for the suggested. Since an ETF is fundamentally a buyer of securities which it holds, an ETF might be used as a primary means to co-fund either a housing finance REOC or REIT or to support *Ṣukūk* issuances supporting the housing finance sector. Essentially, an ETF would allow the sector to raise its profile and expand funding resources. Refer to Figure 6.15 for illustration.

Figure 6.15: ETF as Liquidity Provider



Source: SHAPE™ Financial Corp.

The ETF concept could also serve as a partial liquidity backstop for some Islamic property securities by acquiring securities in the primary market. The basic ETF creation is centred on primary securities dealers delivering securities, shown here as REITs, REOCs and housing based *Ṣukūk* to a fund manager in exchange for fund units. The process has no reliance on primary issuances or secondary market deals going into the ETF: hence an ETF at inception or upon expansion could provide the partial liquidity support to the housing market. Once the primary dealer has received the ETF units, it can make market in these for secondary investors. When the

ETF is terminated, the ETF units are redeemed in exchange either for cash from the liquidation of the securities or the securities are exchanged for units with the primary dealers.

In addition to the debt capital markets in which *Ṣukūk*, covered bonds, and securitization, there is a need for robust equity market rules. In our recommendations, REOCs and REITs will be critical. REOCs only require a basic equity securities law. But, REITs require a blend of both tax and securities regulations[99]. The former allow REITs to pass income through to investors without double taxation: the idea is that the REIT is not taxed on its income, and the investor is taxed at the investors corporate rate meaning that yields are enhanced to investors.

REITs either require trust law as is common in English law jurisdictions or a construction of a company's act that causes a company to function in a similar fashion to a trust. This has been done in France, Turkey and several other civil law countries.

User literacy is the next major issue. Most emerging markets have had long periods of low home ownership, and relatively recent migration to cities over the last two generations. Likewise these markets are in need of modernized financing laws. As a result, most users of housing finance, most prospective owners, most investors, and many tenants are in need of education about the system or systems being delivered to the market. Even in seemingly advanced countries like the United States and United Kingdom, the regulators and market players invest in extensive consumer and investor education programmes with the hope that the markets will be more efficient and transparent.

6.2.2. Specific Legal and Regulatory Requirement:

As discussed in appendix 5, most legal systems in emerging markets do not facilitate housing finance, whether for the construction of housing or financing the acquisition of housing. Land registration, land division, and perfection of title are among the most difficult challenges. Imaginative regulation and enablement of financing solutions are normally difficult: precisely because simple secured lending and mortgaging is not always possible. Even if mortgages can be registered, courts are inefficient.

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[99] REITs were invented in 1963 and represent an effort by the United States Congress to distribute real estate holdings to smaller investors. The concept was designed to make the investment easy for small investors and to convince large investors to divest their holdings into public companies.

Egypt has a good capital markets law and allows for securitization. Egypt also has a mortgage refinance entity. Nonetheless, securitization of either conventional mortgages or IMBT (Tamweel has provided IMBT home acquisition processes in Egypt) or *Murābaḥah* (available from some Islamic providers), has not taken place. The reason appears to be that the local market lacks comfort with the procedures to perfect title and mortgage holders find it difficult to foreclose on a defaulted homeowner.

As a result of inadequate legal and regulatory infrastructure, citizens create ad hoc housing solutions. De Soto points out that these problems[100] require only a few basic enabling factors which include:

1. Capacity to value assets;
2. Easy and efficient asset registration;
3. Clear legal rights and duties established around land and its improvements;
4. Easy transfer of assets and their basis derivatives in the form of bonds or *Ṣukūk*;
5. Ease of legal exchange; and,
6. Legal protection for contracts.

The improvement of legal regimes to acquire, demonstrate clear rights over land and improvements; and all that follows with clarity: leasing to third parties; selling; encumbering; and, enjoying the property without disturbance. All of this requires simple and fast registration of land, improvements (if they may be separated from the land), as well as mortgages and liens. Generally, a sound property regime defines and protects the priority of mortgage rights over unsecured positions. This, in turn, means that there are well defined regimes governing lending, leasing, co-operative societies, and equity products as well as their derivatives like DBP and REITs. The final requirement is that each regime has a well-defined universe and regulation of consumer and financier rights and duties.

If underlying instrument is transferred, the instrument and any accompanying mortgage must be easily and legally transferrable to new party. Often a good trust law with clear provisions is required. Despite the common law's character to embrace "habitual practice" and incorporate it into the legal practices, many American trusts are now facing legal challenges to their practices acquiring mortgages and their transfer or

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[100] Op. Cit., De Soto, March 2001.

foreclosure of the same[101]. The clear lesson from the American mortgage crisis is to prescribe a clear national legal regime that supports both true securitization or the means to issue covered securities akin to conventional covered bonds. These rules will define how and under what conditions an instrument is mortgaged, assigned or sold. The rules will also determine when exculpation clauses apply: exculpation is fundamentally a clawback clause based on the failure of the originator in a non-recourse arrangement to properly disclose information, represent and warrant truthfully, act properly, or deliver the correct documents. This raises the question of to what degree is a financing sharing risk; does the transaction deliver the financing with full recourse to the obligor; or are the instruments without recourse to the obligor and the financier is limited solely to the real estate to satisfy its claims and achieve its rights.

This form of clarity is raised as an important factor in order to support securitization or liquidity support for rules and linkage of the same to the basic housing finance tools. Basel 3 will impact securitization by making it more difficult to delink an originator from the end securities, thereby placing a capital limitation on the total volume of assets which might be securitized. Whereas a covered bond is necessarily matching the assets and the debt whilst retaining both on the originator's balance sheet, a securitization process could lead to almost infinite transacting capacity prior to Basel 3.

The complementary set of laws governing pledges on DBP or co-op units, granting of mortgages or other collateral, and, finally seizure and foreclosure rules which are enforced in a reasonable time frame by the courts.

This chapter argues for the application of equity models which are fundamentally non-recourse, occasionally limited recourse. In their report on the housing finance sector's impact on financial stability, the IMF takes a fundamentally opposing view. The IMF argues strongly for a full recourse loan system funded by matching covered bonds and less securitization.

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[101] Morgenson, Gretchen, Fair Game: The Mortgage Machine Backfires, New York Times, September 27, 2009 accessed at http://www.nytimes.com/2009/09/27/business/27gret.html?emc=eta1. Subsequently through 2010, 2011, and 2012, the MERS system has been under increasing legal challenge with many transactions being rolled back as MERS common law transactions are periodically invalidated by courts.

The IMF's view is that servicing by third parties leads to disincentives for fair and efficient housing finance. The IMF worries that servicing fees can become bloated and begin to represent far more costs, and even set servicers against the investors and the financing obligors as the servicer may benefit from foreclosure or delaying the flow of funds in order to benefit from investing the float. But, the IMF view is shaped in the absence of understanding the demand for housing finance without traditional loans, and the IMF does not examine the benefits or risks of housing finance delivered in a profit and loss sharing mode. As a result, the Islamic housing finance sector, cannot derive more than narrow benefits from the IMF's suggestions, such as the application of covered bond technology to *Ṣukūk* in the housing arena.

With respect to state support of housing finance, the IMF worries that the state intervention in the housing finance market leads to market distortions. Nonetheless, the delivery of sufficient retail and ownership units to house any particular society has required state support either in the form of direct lending and credit support programmes. This requires one of three elements to be in place:

1. The state has a functioning tax system and collects sufficient taxes to support housing programmes with both financing, direct and indirect subsidies, and tax incentives;
2. The state has a strong debt raising capacity and can fund its programmes directly or indirectly through the domestic (better) or international (risky) capital markets; and / or,
3. The state is blessed with a disproportionate amount of natural resources to the number of citizens and is able to fund programmes from the sale of or reinvestment of sale proceeds in the natural resources sector.

State financing and subsidies cannot be effective if the actual property market is afflicted with inefficiencies relating to legal certainty of title and its transfer, legal clarity of the right to occupy, and legal certainty of the enforcement of rights. Subsidies must pass the following four tests to be more effective than not:

1. Transparency – Are the rules governing the subsidies clear and easily understood?
2. Access - Are the people targeted by the subsidies able to access the subsidies?
3. Fairness – Are the subsidies actually fair? If they are not "fair" in an individual consumer sense, do they correct an imbalance in the

housing environment that improves access to housing making the "market" more fair?

4. Adjustment – Do the agencies providing the subsidies do so in a "smart manner"? In other words, when there are problems with implementation or imbalances introduced, do the managers adjust the programmes to improve success?

In summary, LEPS is a highly dynamic area in which the stakeholders are frequently testing how to improve market capacity by improving the legal environment, establish the correct incentives for different partners in the housing finance process, and deliver subsidies as and when needed (but not more or less). Subsequent to the 2008 Global Financial Crisis and the fact that many of its roots are derived from the American Subprime Housing Crash, much of the current debate as reflected in the IMF's discussions is geared towards activities that will scale back the government's role and restrict the stakeholder's ability to act in lieu of assuring compliance with law when the law is well thought out.

6.3. Speculation, Real Estate & Housing:

Controlling speculation is notoriously difficult in any asset class. The reality is that speculation has two distinctive faces. The first is when leverage is not required and people with excess cash are able to bid up prices with the hope that the next buyer will pay more. In this case, the best way to control speculation is to interfere with transactions involving second homes or to reserve housing in certain areas to people who have no primary owned residence. In a number of countries, like Korea, transfer taxes and other measures are imposed including tools which delay registration and transfer or make flipping (buying and selling immediately) difficult. For instance, a minimum holding period may be imposed prior to permitting the transfer of a property. Nonetheless, speculators will still use proxies to attempt to benefit from price variation.

In the case of foreign speculators, foreign exchange controls, whether targeted or general can slow down the flow of funds into a speculative bubble and discourage speculators by making profits difficult to repatriate.

Change capital gain or interest tax benefits to become effective only after a minimum holding period of say three years or link them to proven occupancy.

The second speculative impact is when leverage is applied. This is more easily controlled by the central bank and regulators. In these cases, the housing ratios used to qualify customers may be adjusted, minimum down payments increased, and maximum investment to value factors applied. In the recent speculative real estate bubbles that took place in parts of the United States and the United Arab Emirates, the bubbles were partially caused by spill over from the financial sector which made leverage too easy and was benefitting from historically low rates.

For instance, loan to value/investment to value ratios may be reduced from high levels of debt funding, say 80% to much lower levels 50% or 60%, effectively requiring home buyers to come up with down payments which are not easily possible for most customers.

In some cases, the central bank might mandate provisioning of performing transactions, making new funding into the sector undesirable. Likewise, the central bank might elect to raise the risk weighting on mortgage like assets, creating an effective capital surcharge. Or the central bank may mandate a minimum profit per transaction on new transactions. A central bank might also mandate the types of funding, for instance adjusting the amount of core deposits to be applied, or disallowed from funding, requiring the issuance of covered bonds, or securing a specific securitization commitment or freeze securitization or establish originator retention limits in the case of securitization.

If the state has no direct risk, and does not adjust factors to control overheated markets, then does financial stability mean that the state should put its risk into the buy side with an indirect subsidy in the form of "down payment insurance"?[102] But, if this is done for conventional customers, could it be done in Islamic programmes ?

What is the impact of DBP on housing and financial stability? Does the nature of the *Mushārakah* mean that there will be a natural inclination of investors to be biased towards rental housing and to pursue home ownership policies focused on the more secure segments of the emerging middle classes and above? These questions are as yet untested. Nonetheless, the Islamic tools may mean that speculators are uncomfortable entering contracts that impose downside risk on them, and financiers are not willing to gamble with the same downside.

[102] Wilcox, James A., *A way to make people buy homes again*, New York Times, January 25, 2012, accessed at: http://www.nytimes.com/2012/01/25/opinion/down-payment-insurance-for-homebuyers.html?_r=1&nl=todaysheadlines&emc=thab1.

A substantial theme of the IMF's research into housing finance is that the modern markets are afflicted by a misalignment of interests between the different stakeholders. The IMF asserts that a key element in the misalignment is the degree of government interference in housing markets. The IMF takes the view that more government interference results in greater price volatility, which eventually affects systemic risk in the financial system.[103]

In their Global Financial Stability Report, the IMF looks in Chapter 3[104] to the best practices for stable housing finance which include enhanced risk management (better underwriting and supervision), more careful calibration of government participation; and improved incentives for participants using housing finance. Why? Because in six banking crises in advanced countries since 1970, housing declines were closely associated with banking failures[105]. Therefore, the establishment of a good housing provision and finance system is critical to preventing systemic financial risks.

This report builds its recommendations on a concept that necessarily is opposite to the IMF's recommendations. Equity real estate investment may not insulate a financial system from booms or crashes in demand, but it changes the dynamics by leading to a better alignment of interests between the different stakeholders. And, the generic character of DBP when used for financing means that the "financing" is actually non-recourse as opposed to recourse. This means that the extreme risk of a deal is restricted to the stakeholders in that deal: the profit or loss risk is particular and much less likely to be systemic.

The benefits of the equity universe of solutions, whether core equity in the form of a REOC, REIT or co-op, or DBP is that there is greater flexibility in crafting unique solutions according to location, level of economic and legal development, or even the qualifications of users. Moreover, the core equity and DBP methods provide a seamless solution for single family residential and multi-family properties. This later point is critical as the

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[103] Op Cit., IMF. P. 134.
[104] IBID.
[105] Op. Cit., IMF p. 111 and 112, also see table on p. 116. One issue that the IMF does not examine in light of the 2007 – 8 American housing crisis is the degree to which the suspension of 30 year bond issuances by the US treasury led to investors demanding US 30 year AAA housing securities, first from Fannie and Freddie, then from the structured markets helped to cause the housing finance bubble in that country.

post 2008 financing world is restrictive and now funding for single families in the developed countries lags household formation[106].

The fundamental challenge in emerging markets remains LEPS. Even a good concept like DBP cannot help enough people if it is not properly enabled.

[106] Hammond, Ed, Number of UK home renters up by almost 25%, Financial Times, February 9, 2012, accessed at http://www.ft.com/intl/cms/s/0/428a6c1c-5275-11e1-ae2c-00144feabdc0.html?ftcamp=rss&ftcamp=crm/email/201229/nbe/FinancialServices/product#axzz1lfyfEeS5.

CHAPTER 7

Summary of Findings and Suggestions

7.1 Summary of Findings

7.1.1 Importance of Housing

Housing is a blessing from Allah. It is a place of rest and peace of mind. Housing provides physical, economic, and social security to the resident. Housing plays a pivotal role in the development of the economy. This sector is linked with many other sectors and any change in this sector affects the others. Promoting this sector consequently promotes employment, consumption and investment in the economy. Housing represents 15-40 percent of the monthly expenditure of households worldwide and the investment in housing accounts for 15-35 percent of aggregate investment. Housing construction and housing-related sectors constitute about 9 percent of the labour force worldwide.

7.1.2 Estimates for Housing Demand

Although the demand for housing is of tremendous importance for the families, the society and the economy at large, the fact remains that all the developing countries including the IDB member countries have been facing severe shortage of housing. The Demand for new housing is increasing every year. The IDB member countries need around 8.2 million houses per year to accommodate poor and low income urban people. This translates into nearly 22,421 dwellings per day in order to accommodate the expected urban population growth. MENA requires the most housing needs of 3.2 million units per year followed by Asia (2.7 million), Sub-Sahara (1.9 million) and Countries in Transition (CIT) (0.4 million). This projected figure of housing needs is expected to increase (at an average of 2.83 percent annually) along with the increase in the urban population in IDB member countries. However, these figures do not include the housing needs of the rural people which is not much severe in the rural areas of most of the member countries.

7.1.3 Estimates for Financial Requirements

Approximately US$15.5 billion per year will be required to meet the housing needs of the IDB member countries. As expected, Bangladesh, Nigeria, Turkey, Indonesia Iran and Pakistan are required to provide the most financial resources in order to accommodate the rising needs for housing. Regionally, MENA requires the most financial resources (US$6 billion) to meet the housing needs, followed by Asia (US$5.2 billion) and SSA (US$3.7 billion), while CIT requires the least financial resources (US$0.7 billion). However, this challenge is amplified by the high degree of slum formation in major cities of IDB member countries.

7.1.4 Challenges and Issues Constraining the Housing Supply

There are many challenges and issues which ultimately cause shortage of housing supply especially in the urban cities. The non-availability of affordable land for the low-income housing in the big cities is a major problem. The economic growth and fast urbanization have pushed up the land price. Not only the availability of land, but poor quality of infrastructure have also affected the supply of affordable housing. The non-transparent ownership, vague property rights, weak legal and regulatory framework, ineffective foreclosures laws, ineffective land registration system, high transaction costs, and inadequate long term housing finance funds have been the major issues of the housing sector.

The registration and Title transfer of property are cumbersome in some of the member countries. In Brunei, registering a property involves seven procedures and takes 298 days. U.A.E, Saudi Arabia and Oman involve only one and two procedures. Saudi Arabia gets rank one in the world for easy transfer of title with only two procedures, no transfer cost and it takes only 2 days to transfer the title of property. The cost to register a property and transfer its title in some countries, like Kazakhstan (0.1%), Qatar (0.3 %), Azerbaijan (0.2 %) is low compared to other member countries like Syria (27.9%) and Nigeria (20.8) etc.

Foreclosure on property is ineffective in most of the member countries; it takes longer time and involves high cost. However, there are many variations in time involved for foreclosure in IDB member countries. It ranges from 55 days (in Kazakhstan, the lowest in the world) to 446 days (in Tunisia). Similarly, cost associated with foreclosure also varies across the countries. Cost to foreclose in Uzbekistan is the highest (32.35 % of property value), followed by Tunisia (19.22 %), Azerbaijan (15.32 %), Lebanon (14.52 %) and Pakistan (12.33 %). In other countries, it varies from 3.52 % to 7.55 %.

Although most of the member countries have introduced some reforms for credit information through establishing credit bureaus or special departments, however, complete information is not available.

Strong primary mortgage market is needed to finance the ever-increasing demand for housing. To facilitate the primary mortgage providers and solve their liquidity problem, mortgage refinance companies are also needed. However, these are not developed in the member countries and such funding facilities are scarce. Some IDB member countries have recently taken the initiative to establish refinance companies for solving the liquidity problem of the primary mortgage market. In Malaysia, the establishment of Cagamas Berhad (Cagamas) has been very successful in promoting secondary mortgage market and promoting the housing sector in the country. The other IDB member countries can learn the best practices of Cagamas for the promotion of their secondary mortgage market and housing sector.

7.1.5 State of Use of Various Islamic Modes for Housing Finance

A survey of financial institutions offering Islamic finance for housing was conducted. It included 108 institutions from 27 countries covering the GCC, MENA, Sub-Saharan Africa, Central Asia, South Asia, South East Asia, North America, United Kingdom, and Australia. The survey showed that the use of a specific mode or a combination of them for housing finance depends on many factors but principally on whether the property is complete (ready for occupancy) or it is under construction.

Mushārakah Mutanaqisah (39%) is the most widely used Sharīʿah solution offered for financing completed properties. This is followed by *Ijārah* (31%) and *Murābaḥah* (28%). Only one institution used *Wakālah* and Commodity *Murābaḥah* . There were two main variations of *Mushārakah Mutanaqisah* – the first is offered by banks – which include purchase undertaking, sales undertaking and service agency. The second, *Mushārakah Mutanaqisah* is offered by Islamic coop; these do not include purchase undertaking, sales undertaking and service agency. *Ijārah* and *Mushārakah Mutanaqisah* inherit similar flexibility when it comes to restructuring and liquidity management issue as the institutions are the owner of the asset.

For property under construction, *Ijārah* Mawsoofa Bi Dhimma (IMBD) (36%) is the most widely used solution, followed by *Mushārakah Mutanaqisah* (32%) and *Istiṣnā* (16%). To avoid construction risks, a few institutions offer *Murābaḥah* for construction materials. Some banks use *Istiṣnā* to buy the property under construction from the client and lease it back to the client under *Ijārah* Mawsoofa Bi Dhimma. This arrangement manages both the construction risk and refund risk.

7.1.6 The Role of IDB In Housing Finance

IDB has also played some role in developing housing finance in its member countries and for Muslim communities in non-member countries. Housing related projects were financed using various modes from its Ordinary Capital Resources (OCR), Unit Investment Fund (UIF) and *Awqāf* Properties Investment Fund (APIF). Consistent with its human development and infrastructure strategy, IDB has participated in the financing of social housing in Mali. On the side of private sector initiatives in housing finance, the private sector investment arm of the IDB Group, the Islamic Corporation for Development (ICD), has participated by providing equity to developers of housing projects and sponsoring their establishment. ICD is also endeavoring to establish a mortgage finance company in Saudi Arabia. It is also working on establishing a housing development fund to invest in the development of middle-income housing in selected member countries. In future, synergies can be created in this program whereby Islamic Trade and Finance Corporation (ITFC) can finance building materials for housing development projects and project developers while Islamic Corporation for Insurance and Export Credit (ICIEC) can provide insurance and investment protection products for cross-border investors and traders of building materials and products for housing projects.

7.1.7 Survey of World-Wide Housing Finance Models (Conventional Finance Models)[107]

The shortage of affordable housing is a global problem. The affordability rests on the provision of infrastructure for house building, liveability and financing. It also depends on the provision by the government of

[107] For detail see appendix 5.

appropriate Law, Environment, Partnership and Subsidy (LEPS). Within the IDB member countries there is a shortage of public and private funds that are being directed to the housing sector. It is sometimes the legal system's inefficiencies that prevent capital from actively beneficial, the absence of basic infrastructure worsens the legal lacunae, thus the housing finance becomes a massive challenge.

The modes and models for housing finance are based on the available infrastructure and the direction of its development. There are three specific issues in the delivery of housing finance which must be addressed by the models. These are: (i) availability of institutional finance, (ii) fostering of long-term finance, and (iii) a clear funding criteria. What mechanisms have been created to garner long-term savings, mobilize untapped potential in savings, and allocate them in right projects is quite important. Similarly, how and where to direct housing subsidy is an important question. These subsidies can be in the form of direct money transfers, free development of services (Sewerage, Electricity, Water), subsidised land or some other Public-Private-Partnership. Several methods and models have been tried in various countries to cater for the needs of housing finance. For the purpose of this study they can be classified into three broad categories: Lending based products, non-lending based products, and hybrid products.

7.1.7.1 Lending based products

Many products of this category are available in the conventional finance. However, the product innovation in the developed markets is only limited to simple adaptations of basic mortgage loan model. The nature of all these products is to make a secured loan for the purpose of housing. The nature of innovation is to manipulate either the interest rate or the capital payment. The state provides some additional features such as guarantee, liquidity functions and subsidy in these products. Examples of these innovations include:

1. Balloon payments at maturity – typically short term fixed rate with a large payment to be made at maturity;
2. Negative Interest – adjustable rate loans with a constant payment, whether or not the index rate adjusts up or down. At maturity, the client may have to pay an additional amount. Depending upon interest rate movements, the borrower may amortize the loan;
3. Interest Only – This is a form of balloon mortgage in which the borrower will not make any contractual capital payments;

4 Option ARM – at each adjustment date, the borrower may elect either a minimum payment, interest only, or a payment based on a fixed rate index which converts the ARM to fixed;
5 Fixed Period ARMs – the borrower may have a fixed period after which the interest will adjust. The program is structured to have a cap;
6 Two-Step Mortgage- the loan has a fixed rate for a short to medium period, and then adjusts to a new fixed rate for the remainder of the loan;
7 Convertible ARM – A loan product that has specific dates which allow the borrower to convert to a fixed rate. The borrower may retain the ARM status for the life of the loan;
8 Convertible Fixed – A loan product which has an option to reduce the interest rate if a comparable fixed rate index drops;
9 Graduated Payment Mortgages – Monthly payments are low, and increase at predetermined dates. These loans have the risk of negative amortization;
10 Buydown Mortgage – This type of loan has a discounted interest rate which increases at a specific date. The discounted interest rate is actually based on an upfront payment of interest at the loan closing; and
11 Longer terms – in the early 2000's, the American government sponsored mortgage companies increased terms to 40 years in some loan products from the American standard 30 year fixed rate.

However, these innovations are not of direct use by IDB due to use of interest and involvement of various other Sharīʿah violations in their design.

Another aspect of lending based products for housing finance is their use of qualification criteria to make a loan. This requires a set of information infrastructure that can deliver credit, income and other information on the borrowers. In the absence of such detailed information on validation mechanisms other countries rely on contractual saving schemes to ensure bonding and repayment. An interesting gap in the market is that virtually no private or public sector loan programmes exist that are geared to assist expatriate workers to save or borrow in order to buy a home in the worker's country of origin.

7.1.7.2 Non-Lending based products

Many non-lending alternate products for housing finance are available in the conventional finance. However, they form only a marginal portion in size and are used only to fill some gaps in the loan-based financing. Some of these products include: leasing, lease to own, lease with an option to own, co-ownership, shared equity, cooperative societies (such as rental cooperatives, limited equity cooperatives, and full market value cooperatives), credit unions, contractual saving schemes (closed membership and open membership schemes), insurance linked schemes, mortgage banking, and self build programmes (e.g., housing microfinance, financing of building materials). None of these alternative methods to conventional lending have been developed into scalable products and operations. They are used to fill gaps left by the conventional lenders and rarely scale beyond a particular limit. Often the shared equity and cooperative concepts are more complex and require more consumer education and social cooperation.

7.1.7.3 Hybrid products for housing finance

The larger size schemes involving some element of state sponsorship frequently use products that combine lending and non-lending modes. Two such schemes are (i) Housing Provident Fund (HPF) and (ii) Public Private Partnerships (PPP) for housing. HPF is a compulsory housing saving programme in which both employee and employer contribute. The savings can be withdrawn for house building combining loan with other non-loan features from government. The public private partnership can have many variants for example, under PPP the government owned land is developed for multi-family housing complex through a developer for catering to the needs of under-housed citizens. Thus the land is contributed by government and buyers pay for the construction cost in installments.

7.1.7.4 Other models of housing finance

A number of other models of housing finance are also in vogue. These include: (i) State owned specialized financial institutions, (ii) State administered loan programmes, (iii) Private specialized financial institutions (including master planned communities, multi-family finance, large scale housing projects). They all rely on direct or indirect lending along with targeted subsidies or aligned with government policy on

housing. Each of these have their pros and cons and require certain preconditions for their success. Examples abound that a method that succeeded in one country failed in the other due to difference in environment, culture and unmet preconditions.
The outcome of the survey drives three important conclusions:

1. Housing finance for any economic segment is problematic in many countries because the legal and financial rules are not sufficiently deep or modern to facilitate the sector;
2. Markets will generally produce as 'affordable' housing what can be afforded by middle-class households, not for the very low income segment.
3. Since the urban land is costly, even for the middle income segments, delivering housing finance requires some form of direct or indirect government subsidy.[108]

Even in the wealthier parts of the MENA region, there is a challenge putting the Sewerage, Electricity and Water (SEW) into place as it may not have a meaningful economic return compared to other non-social investments. The SEW may have high associated land costs.[109]

Putting in place the property laws and ease of its clear transfer are pre-requisites followed by efforts to increase access to finance for building a robust housing finance system. Reformation in the banking institutions, financial markets and diversification of local investor base are also needed. For supply and demand factors to work well consumer education on financial matters and the housing finance products will also be necessary. Many of the problems of support infrastructure may be addressed with the assistance of multi-lateral development banks, including the IDB. Their core competencies include providing guarantees, funding long term infrastructure, and even providing support to nascent capital markets.

7.1.8 Suggested Models and Infrastructure Requirements

The analysis in this study indicates that: (1) The Co-op model is robust and relatively easy to apply because it creates unique bonding between the individual and the cooperative members. This bonding minimizes the credit risk normally associated with financing, particularly for low income groups where credit information is absent. (2) Compulsory Saving for

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[108] Hoek-Smit, Marja C., *Subsidizing Housing Finance for the Poor*, Paper prepared for Development Initiatives Group July 2008, accessed at
[109] Op. Cit., LaSalle.

Housing (CSH) schemes also shares the same advantage since savings period reduces information opacity of low and middle income groups, reduces moral hazard and establishes credit worthiness. (3) Real Estate Investment Trust (REIT) is another model that is suitable for middle income housing. (4) The Public Private Partnership (PPP) is suitable for all income groups.

The three housing finance models mentioned above are applicable to all income groups and all types of housing. To implement these models in Sharīʿah compliant manner appropriate tool (or product) is needed that allows for adjustment to different circumstances, across markets and within customer needs, and provide multiple liquidity and exit strategies. This study finds that *Mushārakah* and its variant *Mushārakah Mutanaqisah* (Declining Balance Partnership – DBP) has this versatility. *Mushārkah* and Declining Balance Partnership can be applied in the settings of Co-Operatives, Real Estate Operating Companies and REITs combined with Compulsory Savings for Housing schemes.

For the DBP to work efficiently, explicit regulations are needed that: (i) allow banks to own property with limited liability, (ii) provide guidelines for real estate operating cooperating companies on the use of DBP, (iii) allow securitization of housing projects. In some countries amendments in company laws are needed to allow for the creation of trust companies, and changes in land laws are needed that allow fractional changes in ownership as the client gradually buys the property. Similarly, parity in tax treatment and clear definition of duties of financer relating to properties is required. In regard to these requirements the IDB Group can help by suggesting to IFSB to come up with appropriate standards, and highlight to the financial sector regulatory authorities of member countries the importance of allowing and promoting Islamic financial institutions specializing in housing finance. It can provide Technical Assistance to countries in creating trust laws where they are missing. It can also encourage the governments and the financial sector regulatory authorities of member countries to come up with guidelines for issuance of housing based *ṣukūk*. The IDB can not only encourage the establishment of housing finance companies but can invest in them as well. It can also suggest to AAOIFI to come up with appropriate accounting and Sharīʿah standards for them regarding the unique features of their operations and duties.

An important balancing feature of DBP is that, on one hand the financer must be willing to take risk in the real estate based on the evaluation of the location and quality of the property. On the other hand, the DBP may be offered only to typically credit worthy consumers. Combining the DBP with Co-Operatives or Compulsory Housing Saving schemes or REITs enhances the establishment of credit worthiness in a cost effective manner. In order to scale up the combination model of DBP and Islamic housing finance to take off a number of legal and financial rules have to be improved in the legal, housing, and land systems of most emerging markets. All this requires governments' vision, assistance and support. Some of these needs are: (1) Clear establishment of property rights and their protection. (2) Modernization of land registration system. This includes capacity to register different types of property occupying the same site (so that ownership of land and of improvements can be separated) and enabling of co-ownership. (3) Creation of house price indices. (4) Development of capital markets.

Several possible methods of funding the housing finance model have also been proposed in the study. These include: Simple covered sukuk, Sukuk *Mushārakah* for Co-Op, Sharīʿah compliant *ṣukūk* for Real Estate Operating Company, *ṣukūk Ijārah* (REIT), and Exchange Traded Fund as liquidity provider.

The conventional housing finance models emphasize lending as their mainstay with non-lending modes used only as supplements to fill in the gaps left by loan operations. Whereas, the proposed Islamic financing model for housing emphasizes equity sharing and co-ownership, loans are used only to fill in the gaps. The advantage of this approach is that the interests of the investors and the clients remain aligned in all phases of the market and it provides fair deal to both. Moreover, the shocks to the real estate market are absorbed locally first before getting transmitted to other sectors of the economy. This is a significant advantage of this model for the overall financial system.

The experience of the global financial crisis of 2007-2009 tells us that risk transfer products and mechanisms were relied upon but local risk absorption was not strengthened. Moreover, the securitization of loans and their insurance through credit default swaps created a wedge and opaqueness between creditors and the ultimate borrowers. As a result, risk concentration took place at certain node points in the financial network without anyone realizing it. When defaults occurred in the sub-prime mortgage sector it increased uncertainties rather than decreasing it. Renegotiation and restructuring of loans is one mechanism that can potentially dampen the domino effect of defaults and stop a spill-over to other sectors. But due to the nature of products the natural link between original borrowers and the ultimate creditors was severed thus no possibility of recourse and renegotiation. This further amplified the problem. Therefore, to remedy this deficiency the IMF in Global Financial Stability Report has advocated financial products with full recourse. The real problem is not of recourse or non-recourse instruments but of information certainty, clarity of rights, ownership and obligation. In Islamic financial system as the loans cannot be sold other than at par value the uncertainty and non-negotiability cannot arise. Moreover, the non-lending modes emphasize clearly defined rights and obligations of sharing and co-ownership that act as first defence to absorb shocks locally between the contracting parties before transferring it further. Thus the housing finance and the overall financial sector remain stable.

The other benefits of equity based solutions whether through Co-Ops, Real Estate Operating Companies, REITs or DBP is that there is greater flexibility in crafting solutions according to location, level of economic and legal development or even qualifications of users. They can be applied for single family residential and multi-family properties. To properly enable DBP concept the fundamental challenge are Law, Environment, Partnership and Subsidy.

7.2: Suggestions

7.2.1: Suggestions for the IDB Member Countries

In most of the member countries record keeping of property is vague, registration and title transfer are cumbersome and consequently increasing the time involved in transaction of property and the cost of transaction. Records are manually maintained which increases the probability of mistakes and the claim of third party on the property, which leads to corruption, increase the time involved in registering property and title transfer. MCS should make the registration process simple by reducing the number of processes and make the cost of transaction reasonable. The IDB member countries, which still depend on manual system, should change to electronic registration. This will speed up the process, brings efficiency in the system, maintain record with ease and it will be easily accessible at any time.

In some MCs, the involvement of notary is compulsory, which delays the process of registration and also makes it costly. The process can be made simple by allowing the registration department to certify the documents rather than involving notaries. This will also cut the procedure involved in and the cost associated with it.

In most of the MCs foreclosure on property is inefficient. It is not fully implemented. The recovery is not certain. The cost of lending increases with uncertainties. The foreclosure takes too much time and the cost associated with it is high. The MCs may implement the foreclosure laws to the spirit. They may empower their financial institutions to foreclose the mortgage property without recourse to court, which will reduce the foreclosure time and cost.

The non-availability of credit information is another challenge to the financial institutions. For this purpose, some member countries have introduced required reforms while other did not. The MCs may establishe credit bureau or special departments and collect information on the borrowers. Similarly the central banks may present data on housing finance from all the financial institutions in the country concerned.

In general, there is a lack of funds for housing finance in MCs. The mortgage industry is weak. There is a need to develop and strengthen the industry in the MCs. Member countries may promote secondary mortgage market to support the primary mortgage market and enhance the liquidity.

The availability of land and the required infrastructure for development of housing sector is a big challenge. Developing this sector requires some form of direct and indirect subsidy. It is suggested that MCs may adopt the public private partnership model of Morocco and Turkey.

Some housing models, such as Co-op, Compulsory saving for housing (CSH) scheme and public private partnership model are robust and easy to apply to all income groups and all types of housing. MCs are advised to adopt these models for housing development with necessary changes in their existing laws and regulations. Moreover, there is a need for the establishment of clear property. MCs are advised to use *Mushārakah* and its variant DBP, which can easily be applied in the settings of these models. All these require the vision and support of the public sector.

House price indexes show market trend, occupancy cost and fair comparable valuation. This facilitates in decision making by the housing providers, seekers and financiers. Public sector should come up with establishment of house price indexes.

7.2.2: Suggestions for the IDB Group

The provision of affordable housing is becoming a major problem for the IDB member countries. Keeping in view the severity of the problem, IDB has played an important role in house financing in its member countries through utilizing Islamic modes of finance. In the past, IDB has financed several housing projects in IDB member countries, partly under the real estate, education, water, sanitation and urban services and social services sector. The housing related projects for IDB member countries were financed from its Ordinary Capital Resources (OCR), Unit Investment Fund (UIF) and Awqf Properties Investment Fund (APIF).[110] The IDB may continue its existing practices and further strengthen them.

The IDB has also participated in the financing of 1,000 social housing units in Mali for the low income group of urban population in 2011. No doubt the undertaking process is lengthy, which also requires continuous interaction with executing agency especially during the preparation and implementation stage and the political support. The IDB may continue its support to other member countries.

The IDB Group should consider developing schemes or products which would attract other investors or financiers (from private and public sector) into providing housing finance with the IDB in order to augment the IDB's effectiveness, magnify its role and increase the effect of IDB intervention in the sector.

In recent year, ICD has conceptualized the establishment of Sharīʿah compliant real estate fund to invest in the development of middle income housing units within selected member countries. The fund will invest in the real estate sector, with the core investments in projects which develop affordable housing units in member countries, initially targeting 3 to 5 member countries.[111] A Synergy can be created in this program whereby Islamic Trade and Finance Corporation (ITFC) can finance building materials for housing development projects and project developers while Islamic Corporation for Insurance and Export Credit (ICIEC) can provide insurance and investment protection products for cross-border investors and traders of building materials and products for housing projects. If the

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[110] There are few projects related to housing that were financed through the special assistance operation.

[111] The current pipeline projects are in Jordan, Egypt, Saudi Arabia, Mauritania, Niger, Yemen and Indonesia.

experiences of the project form the selected countries is successful, then the same may be replicated in other member countries.

For the Islamic products and especially the DBP to work efficiently, explicit regulations are needed that: (i) allow banks to own property with limited liability, (ii) provide guidelines for real estate operating cooperating companies on the use of DBP, (iii) allow securitization of housing projects. In some countries amendments in company laws are needed to allow for creation of trust companies, and changes in land laws are needed that allow fractional changes in ownership as the client gradually buys the property. Similarly, parity in tax treatment and clear definition of duties of financer relating to properties is required. With regard to these requirements the IDB Group can help by suggesting to IFSB to come up with appropriate standards, and highlight to the regulatory authorities of member countries the importance of allowing and promoting Islamic financial institutions specializing in housing finance. It can provide Technical Assistance to countries in creating trust laws where they are missing. It can also encourage the governments and the authorities of member countries to come up with guidelines for issuance of housing based *ṣukūk*. The IDB not only encourage establishment of housing finance companies but can invest in them as well. It can also suggest to AAOIFI to come up with appropriate accounting and Sharīʿah standards for them regarding unique features of their operations and duties.

Currently Islamic finance for housing is available mainly through Islamic commercial banks. The long-term housing finance maturity and short-term deposits create liquidity risk to the funding institutions. This mismatch could be solved by establishing a mortgage industry that include long term financing institutions and markets. It will improve the liquidity of housing finance; create competition among the institutions, which will keep the cost of financing low and benefiting the home owners. It can issue its own *Ṣukūk* and open up investment opportunities for long-term investors like, institution of provident fund, pensions and insurance companies. Mortgage finance industry is not developed in the member countries and such funding facilities are not available. However, some IDB member countries have recently taken the initiative to establish finance industry for solving the liquidity problem of the primary market lenders and widening the housing finance risk. IDB can help the member countries for establishing and strengthening the secondary mortgage market through securitizing the Sharīʿah compliant mortgages provided by the funding institutions.

There is a lack of real estate developers for the low cost housing. There is also a need for land that is developed for the construction of housing and that is needed to be acquired by the developers. Getting a clean title to the land is a complicated issue in most of the member countries. Consequently, limited funds are available from the financial institutions due to the heavy risk involved. In most of the cases, land is acquired by the developers on equity and since they lack the equity, big projects are not coming forth. Although ICD is supporting developers by providing equity, but it is on small scale. The IDB may help developers through creating a special fund for housing projects in the selected member countries and the successful experience, if obtained, be extended and replicated for housing projects development in other member countries.

The non-availability of credit information is a constraint on the housing finance. To overcome the information problem in long run housing finance, the IDB, may encourage its member countries to gather and computerize information related to different housing events, best practices, reforms and other steps, if any, taken by them and made available to all member countries for the sake of learning and implementation.

It has been observed that the issues related to housing finance, especially in member countries, are complicated. The non-transparent ownership, the vague property rights, the weak legal and regulatory frameworks, the ineffective land registration system, the high transaction costs hade been major issues of the housing sector. The housing sector of the IDB member countries has been facing these challenges with different degrees, which ultimately affect the growth of the sector. Some of the issues are country specific, which can be solved at country level. However, for this purpose, IDB can create a general awareness among the member countries by holding a conference and workshops.

Some Sharīʿah compliant housing mortgage products are being used in the non-Muslim countries, especially in USA, Canada, UK, and Australia. Nevertheless, this use is very limited. In case of the UK, Islamic home finance market accounts about 0.5 percent of the overall mortgage market. In order to expand housing market through Sharīʿah compliant products, a general awareness program is needed. The IDB can provide general guidelines and products information through its web site and encourage the Islamic banks or windows to disseminate the information.

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APPENDICES

Appendix 1. Age Composition in IDB Member Countries

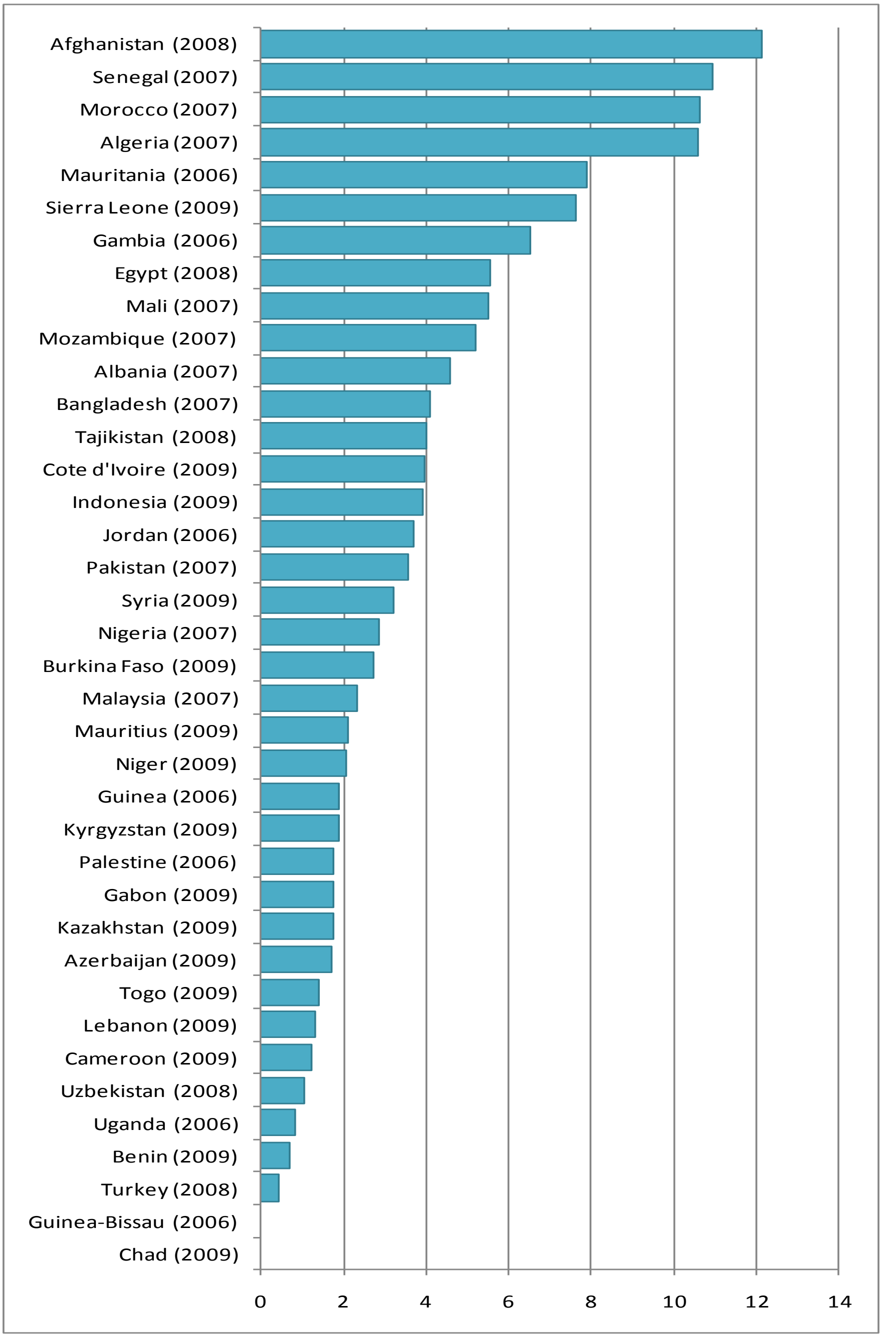
Country	Population Composition (2000)			Population Composition (2010)			Dependency ratio (2000)[1/]			Dependency ratio (2010)		
	0-14 (%)	15-64 (%)	65+ (%)	0-14 (%)	15-64 (%)	65+ (%)	Total	Old	Young	Total	Old	Young
Afghanistan	48	50	2	46	51	2	101	4	97	95	4	91
Albania	30	63	7	23	68	10	60	12	48	48	14	34
Algeria	34	62	4	27	68	5	62	7	56	46	7	40
Azerbaijan	31	63	6	21	73	7	58	9	49	38	9	29
Bahrain	28	69	3	20	78	2	44	4	40	28	3	26
Bangladesh	37	59	4	31	64	5	70	7	64	56	7	49
Benin	46	51	3	44	53	3	95	6	89	88	6	82
Brunei	30	67	3	26	70	4	50	4	45	42	5	37
Burkina Faso	47	51	2	45	52	2	95	4	91	91	4	86
Cameroon	43	54	4	41	56	4	86	7	80	79	6	73
Chad	46	51	3	45	52	3	96	6	90	93	6	88
Comoros	41	56	3	43	55	3	79	5	74	83	5	78
Cote d'Ivoire	42	55	3	41	55	4	82	6	76	81	7	74
Djibouti	41	56	3	36	61	3	79	5	74	64	5	59
Egypt	36	60	4	32	63	5	68	7	61	58	8	50
Gabon	41	54	5	35	60	4	84	9	75	66	7	59
Gambia	46	52	2	44	54	2	92	4	88	86	4	82
Guinea	44	52	3	43	54	3	91	6	84	86	6	80
Guinea-Bissau	43	54	3	41	55	3	87	6	80	81	6	75
Indonesia	31	65	5	27	67	6	55	7	48	48	8	40
Iran	35	61	4	23	72	5	65	7	58	39	7	32

Iraq	43	53	4	43	54	3	90	7	82	87	6	81
Jordan	40	57	3	38	59	4	76	6	70	71	7	64
Kazakhstan	28	66	7	24	69	7	53	10	42	45	10	36
Kuwait	27	70	3	27	71	3	42	4	38	41	4	38
Kyrgyz	35	60	5	30	66	4	68	9	59	53	7	46
Lebanon	30	63	7	25	68	7	59	11	49	47	11	36
Libya	32	64	3	30	65	4	56	5	50	53	7	47
Malaysia	33	63	4	30	65	5	59	6	53	54	7	47
Maldives	40	56	4	27	68	5	79	7	72	47	8	39
Mali	47	50	3	47	51	2	99	5	94	97	4	93
Mauritania	43	55	3	40	57	3	83	5	78	74	5	69
Mauritius	27	68	6	22	71	7	48	8	40	40	10	31
Morocco	34	62	5	28	66	5	62	8	54	50	8	42
Mozambique	44	53	3	44	53	3	89	6	83	90	6	84
Niger	48	49	2	49	49	2	102	4	98	105	4	100
Nigeria	43	54	3	43	54	3	86	6	80	86	6	80
Oman	37	61	2	27	70	3	64	4	60	42	4	39
Pakistan	41	55	4	35	60	4	83	7	76	66	7	59
Qatar	26	72	2	13	85	1	38	2	36	17	1	16
Saudi Arabia	39	58	3	30	67	3	72	6	67	50	4	46
Senegal	45	52	3	44	54	2	92	5	87	86	4	81
Sierra Leone	42	56	2	43	55	2	80	4	76	81	3	78
Somalia	44	53	3	45	52	3	88	5	83	91	5	86
Sudan	42	54	3	40	56	4	84	6	78	77	6	71
Syria	40	56	4	37	59	4	78	7	71	69	7	62

Tajikistan	42	54	4	37	60	3	85	7	78	68	6	62
Togo	43	54	3	40	57	3	86	6	81	76	6	70
Tunisia	30	64	6	23	70	7	57	10	47	44	10	34
Turkey	31	64	5	26	68	6	56	8	48	48	9	39
Turkmenistan	36	59	4	29	67	4	68	7	61	50	6	44
Uganda	49	49	3	48	49	3	106	6	100	104	5	99
UAE	26	73	1	17	83	0	36	1	35	21	1	21
Uzbekistan	37	58	4	29	66	4	71	7	64	51	7	44
Yemen	49	49	3	44	53	3	106	5	100	88	5	83
Suriname	31	64	6	29	65	6	57	9	48	54	10	44
IDB Average	38	58	4	34	62	4	74	6	68	65	6	58

Source: UN Population Division Statistics (2010)

Appendix 2 : Index of Access to Land for IDB Member Countries



Note: High index number indicates high degree of barrier of access to land.
Source: Enterprise Survey, World Bank (2010)

Appendix 3: List of Websites for Institutions Surveyed in Chapter 4

Australia

Australia

1. MCCA: http://www.mcca.com.au/homepage.html
2. Islamic Co-operative Finance Australia Limited: http://www.icfal.com.au/

Bahrain

3. Al-Bakara: http://www.barakaonline.com/default.asp
4. Ithmaar Bank: http://www.ithmaarbank.com/index.asp
5. Kuwait Finance House (Bahrain): http://www.kfh.bh/en/
6. Bahrain Islamic Bank: http://www.bisb.com/default.asp#
7. International Investment Bank: http://www.iib-bahrain.com/index.php
8. Gulf Finance House: http://www.gfh.com/en
9. Arab Banking Corporation: http://www.arabbanking.com/En/Pages/default.aspx
10. ABC Islamic Bank: http://www.arabbanking.com/world/islamicbank/En/Pages/default.aspx
11. Khaleeji Commercial Bank: http://www.khcbonline.com/default.asp#

Bangladesh

12. Standard Chartered: http://www.standardchartered.com/bd/en/
13. Islami Bank Bangladesh Limited: http://www.islamibankbd.com/index.php
14. Shah Jalal Islamic Bank: http://www.shahjalalbank.com.bd/index.php
15. HSBC Amanah Bangladesh: http://www.hsbc.com.bd/1/2/hsbc-amanah
16. Prime Bank Limited: http://www.primebank.com.bd/index.php/home

Canada

17. *Ijārah* Canada: http://www.*Ijārah*canada.com/index.php

18. Ansar Co-operative Housing Corporation: http://www.ansarhousing.com/
19. UM Financial Group: http://www.umgroup.ca/index.php?p=home
20. An-Nur (Ontario) Coop Corp Ltd: http://nurcoop.com/index.php
21. ISNA HOUSING CO-OPERATIVE LTD. (IHC): http://www.isnahousing.ca/
22. Salam Financial: http://www.salamfinancial.com/index.html

Azerbaijan

23. Kauthar Bank: http://www.kautharbank.com/en/banking/

Kazakhstan

24. BTA Bank: http://www.bta.kz/en/
25. Al-Hilal Bank: http://www.alhilalbank.ae/

Egypt

26. Al-Baraka: http://www.barakaonline.com/default.asp

Ethiopia

27. ZamZam International Bank: http://www.zamzambank.com.et/index.html

Indonesia

28. HSBC Amanah: http://www.hsbc.co.id/1/2/amanah_en_US/home
29. Bank Muamalat: http://www.muamalatbank.com/index.php/
30. BNI: http://www.bni.co.id/en-us/home.aspx
31. Mandiri Syariah: http://www.syariahmandiri.co.id/
32. Bank Mega Syaria: http://www.bsmi.co.id/index.php

Jordan

33. Islamic International Arab Bank: http://iiabank.com.jo/Default.aspx?tabid=83

34. Jordan Islamic Bank: http://www.jordanislamicbank.com/en/?

Kenya

35. Gulf African Bank: http://www.gulfafricanbank.com/Home
36. Chase Bank Kenya: http://www.chasebank.co.ke/
37. Real Estate Finance: http://www.firstcommunitybank.co.ke/

Kingdom of Saudi Arabia

38. National Commercial Bank : http://www.alahli.com/EN-US/Pages/NCBHomePage.aspx
39. Riyad Bank: http://www.riyadbank.com/index_en.html
40. Saudi Home Loans: http://www.saudihomeloans.com/phase2/en/Default.aspx
41. Bank Aljazira: http://www.bankaljazira.com.sa/(S(btbb1u553oto0d45wohrg0qz))/index.aspx
42. Al-Rajhi Bank: http://www.alrajhibank.com.sa/en/pages/default.aspx
43. Samba: http://www.samba.com/english/index_01_01_en.html

Kuwait

44. Ahli United Bank: http://www.ahliunited.com.kw/index.html
45. Kuwait International Bank: http://www.kib.com.kw/krebclient/clientpages/Index.aspx?Id=52
46. Anan Real Estate Finance: http://www.anan.com/pages/menu00.php
47. Kuwait Finance House: http://www.kfh.com/en/index.aspx
48. Boubyan Bank: http://www.bankboubyan.com/index.html
49. Warba Bank: http://www.warbabank.com/index_en.html
50. International Investment Group: http://www.iigkw.com/oct/index.htm
51. The International Investor: http://www.tii.com/index_e.htm

52. Kuwait Investment Company: http://www.kic.com.kw/Home/index.asp

Lebanon

53. Blom Bank: http://www.blom.com.lb/English/index.aspx?pageid=8906
54. Al-Bakara: http://www.al-baraka.com/index.php
55. Lebanese Islamic Bank: http://www.lebaneseislamicbank.com.lb/index.asp

Malaysia

56. Standard Chartered: http://www.standardchartered.com.my/en/index_web.html
57. HSBC Amanah: http://www.hsbcamanah.com.my/1/2/amanah/home
58. Kuwait Finance House: http://www.kfh.com.my/kfhmb/ep/home.do;jsessionid=49D3816FD512660A00927B4BA561640A.worker1?tabId=0
59. Maybank Islamic: http://maybankislamic.com.my/index.html
60. Citibank: http://www.citibank.com.my/

Morocco

61. CPI Financial: http://www.cpifinancial.net/
    Dar As-Safaa: http://www.darassafaa.com/

Nigeria

62. Jaiz Bank PLC: http://jaizbankplc.com/
63. IMFB: http://www.imfb-bank.com/index.html

Oman

64. Bank Muscat: http://www.bankmuscat.com/en-us/Pages/default.aspx

Pakistan

65. Meezan Bank: http://www.meezanbank.com/index.aspx
66. Dubai Islamic Bank: http://www.dibpak.com/Default.aspx
67. Bank Al-Falah: http://www.bankalfalah.com/

68. Bank Al-Habib: http://www.bankalhabib.com/index.php
69. Faysal Bank: http://www.faysalbank.com/index.html
70. Standard Chartered: http://www.standardchartered.com/pk/personal/home/en/index.html

Qatar

71. Barwa Bank: http://www.barwabank.com/?sc_lang=en
72. Qatar Islamic Bank: http://www.qib.com.qa/?lang=en
73. Commercial Bank of Qatar: http://www.cbq.com.qa/index.aspx
74. Qatar International Islamic Bank: http://www.qiib.com.qa/qiib/en/default.aspx
75. Masraf Al-Rayan: http://www.alrayan.com/en/Home

South Africa

76. Al-Bakara: http://www.albaraka.co.za/home.aspx
77. ABSA: http://www.absa.co.za/Absacoza/
78. First national Bank: https://www.fnb.co.za/index.html

Senegal

79. BIS Bank: http://www.bis-bank.com/en

Sudan

80. Faisal Islamic bank: http://www.fibsudan.com/en/
81. Al-Baraka: http://www.al-baraka.com/index.php
82. Lebanese Islamic Bank: http://www.lebaneseislamicbank.com.lb/index.asp

Turkey

83. Al-Baraka: http://en.albarakaturk.com.tr/
84. Bank Asya: http://www.bankasya.com.tr/en/index.jsp

Kuviyt Turk Participation Bank: http://www.kuveytturk.com.tr/pages/default-en.aspx

UAE

85. Abu Dhabi Islamic Bank: http://www.adib.ae/
86. HSBC Amanah: https://www.hsbc.ae/1/2/
87. Al-Hilal Bank: http://www.alhilalbank.ae/

88. TAMWEEL: http://www.tamweel.ae/en/Home.aspx
89. Dubai Islamic Bank: http://www.dib.ae/en/index.htm
90. Emirates Islamic Bank: http://www.emiratesislamicbank.ae/eib/en/default.htm
91. Amlak Real Estate: http://www.amlakinvest.com/

UK

92. Islamic Bank of Britain: http://www.islamic-bank.com/
93. HSBC Amanah: http://www.hsbc.co.uk/1/2/pws
94. Ahli United Bank: http://www.iibu.com/home/almhome.aspx
95. ABC International Bank: http://www.islamicmortgages.co.uk/index.php?id=170
96. United National Bank: http://www.unbankltd.com/

United State of America

97. Lariba: https://www.lariba.com/default.htm
98. Devon: http://www.devonbank.com/Islamic/index.html
99. UIFB: http://www.universityislamicfinancial.com/IBDMain.html
100. Guidance: http://www.guidanceresidential.com/
101. Halal Inc: http://halalinc.com/index.shtml

Appendix 4: Survey of Islamic Housing Finance Method

GCC					
Saudi	**Kuwait**	**Bahrain**	**Qatar**	**UAE**	**Oman**
Al-Rajhi - 25 year plan, 20 year plan & UCP. No principles mentioned	Ahli United Bank Kuwait - *Murābaḥah*, *Ijārah* & *Istiṣnā*	Al Baraka -*Ijārah*, MM, IMBD	Barwa Bank - *Ijārah* (no mention of UCP)	ADIB -*Murābaḥah* & IMBT, *Istiṣnā* & IMBD (UCP).	Bank Muscat-MM
Bank alJazira-*Ijārah* (no info on UCP)	Kuwait Finance House - *Ijārah* & *Murābaḥah* (no info on UCP)	Ithmaar Bank (Shamil)- *Ijārah* & *Murābaḥah* (no UCP mentioned)	Qatar Islamic Bank-Musawama & *Istiṣnā*	HSBC Amanah - *Ijārah* Ma'a Wa'd Bi Tamleek & IMBD (with advance rental)	
Saudi home loan-*Ijārah* (no info on UCP)	Boubyan - Construction material finance. No info on concepts	KFH-*Murābaḥah* & *Ijārah* (no UCP mentioned)	CBQ-*Murābaḥah* (conventional)	Hilal - IMBT & IMBD (UCP) - may or may not have advance rental	
Riyadh bank-*Ijārah* & *Murābaḥah* (no info on UCP)	Kuwait International Bank - *Murābaḥah* (no info on UCP)	Bahrain Islamic Bank-IMBT & IMBD	Qatar International Islamic Bank-has HF but no info on underlying	Tamweel-IMBT & IMBD (UCP - no advance rental)	
Alinma - does Islamic home finance but does not mention principles. Only	Warba Bank - not operational yet	AUBB-*Murābaḥah* & *Ijārah*	Masraf al rayan - no home finance, only auto & personal finance (include	Dubai Islamic Bank-IMBT & IMBD (UCP - payment starts upon completion)	

completed properties			renovation)		

GCC					
Saudi	**Kuwait**	**Bahrain**	**Qatar**	**UAE**	**Oman**
Samba Financial Group-*Murābaḥah*, has UCP but no info on underlying	Anan Real Estate Financing Co - subsidiary of Aayan leasing. Cannot offer retail	ABC Islamic - no retail		Emirates Islamic Bank - *Murābaḥah*, *Ijārah*, MM (no UCP)	
Saudi Hollandi - *Murābaḥah* & *Ijārah*. Incomplete Villa purchase uses *Murābaḥah*. No UCP yet.	IIG - no retail offering, only funds & corporate finance advisory	Khaleji Commercial Bank - has HF but no info on underlying principles		ADCB-*Ijārah* wa *Iqtina*, IMBD (UCP - there is advance rental during construction)	
NCB -*Ijārah* (no info on UCP)	TII - focus on NBFI - consumer financial services (auto, white & brown goods)	GFH - investment bank		Amlak - no info on Islamic home finance	
	KIW -funds, treasury & corporate finance				

Other MENA				
Turkey	**Eygpt**	**Morocco**	**Lebanon**	**Jordan**
Kuveyt Turk- *Murābaḥah* but have different payment options - increasing, decreasing, interim etc	Albaraka Bank- have home finance but does not mention specific contract	Dar Assafaa Litamwil- *Murābaḥah*	BLOM Development Bank - Islamic bank (part of BLOM Bank) - but no info on products offered	Islamic International Arab Bank-*Ijārah*, Sakan Kareem. No UCP mentioned - have *Murābaḥah* for construction material.
Albaraka Bank- has home financing but no info on underlying principle - but fixed rate			Al-Baraka Bank - has HF but not info on underlying	Jordan Islamic Bank- part of AlBaraka Group - *Murābaḥah* & *Ijārah* - no info on UCP
Bank Asya-Mortgage-not mention underlying instrument			Lebanese Islamic Bank (LIB) - *Murābaḥah* & *Ijārah* (no info on UCP)	

Sub Saharan Africa					
South Africa	**Kenya**	**Nigeria**	**Senegal**	**Sudan**	**Ethiopia**
Albaraka Bank-*Murābaḥah*	Gulf African Bank-*Mushārakah Mutanaqisah* (no mention of UCP)	Jaiz International Bank -MM (no mention of UCP)	Islamic Bank Of Senegal- only names the Islamic principles (*Murābaḥah*, *Ijārah* etc), but does not mention application for financing	Albaraka Bank- many *Takāful* products - did not mention home finance in specific	Zam Zam International Bank-mentions will provide residential construction loan, others seem commercial orientation (website under construction)
Absa-Barclays subsidiary in Africa. Offers Islamic banking, but no home finance. *Ijārah* is for moveable asset (car etc)	Chase Bank-*Mushārakah Mutanaqisah* (no mention of UCP)	IMFB (Integrated Microfinance Bank)-MM - refer to Islamic banking on *Mushārakah* (micro housing mortgage) - no UCP mentioned		Faisal Islamic Bank of Sudan - no HF	

Sub Saharan Africa					
South Africa	**Kenya**	**Nigeria**	**Senegal**	**Sudan**	**Ethiopia**
First National Bank- *Wakālah* (charge fee for *Wakālah*)	First Community Bank-full fledge Islamic bank -have real estate finance but not mentioned clearly on the underlying structure			Al-Tadamon Islamic Bank - no info on activities	
				al-Shamal Islamic.Bank - no info on activities	
				Al-Salam Bank - no HF	
				Sudanese Eygptian Bank - *Murābaḥah* for personal finance (construction material)	

Central Asia		**South Asia**		**South East Asia**	
Azerbaijan	**Kazakhstan**	**Pakistan**	**Bangladesh**	**Malaysia (main focus on MM)**	**Indonesia**
The Kauthar Bank- mention that MM can be used for home finance but no info whether they offer HF	Al Hilal Bank-started in Kazak in 2010, but no info on products offered	Meezan Bank Ltd- MM (both CP & UCP)	SC Saadiq: MM (also for UCP)	Citibank-MM (no UCP) - first 10 years use capped BFR approach. No *Bay*ʿ al-Ainah	HSBC Amanah- MM (no UCP mentioned)
	BTA bank- *Murābaḥah*, *Ijārah* - but didn't mention this was specific to home finance.	DUBAI ISLAMIC BANK PAKISTAN - MM (CP & only mention renovation)	Islamic Bank Bangladesh - MM (for UCP as well)	Standard chartered-MM (no mention of UCP). No *Bay*ʿ al-Ainah alternative	Bank Muamalat- MM & *Murābaḥah* (no UCP mentioned)
		Bank Alfalah-MM (CP & UCP)	HSBC Amanah - MM (for UCP as well)	Maybank Islamic- MM (both CP & UCP) - have *Bay*ʿ al-Ainah based fixed rate as well	BNI - *Ijārah* (no UCP mentioned)
		Bank Alhabib-MM (no specific info on retail UCP)	ShahJalal Islamic Bank: MM (for UCP as well)	HSBC Amanah- MM - (no mention of UCP)	Mandir Syariah- *Murābaḥah* (no UCP mentioned)

Central Asia		South Asia		South East Asia	
Azerbaijan	**Kazakhstan**	**Pakistan**	**Bangladesh**	**Malaysia (main focus on MM)**	**Indonesia**
		Standard chartered-MM (CP, only mention renovation)	Prime Bank: MM(for UCP as well)	KFH-*Murābaḥah*, *Istiṣnā* (UCP), MM for both completed and UCP - but only selected projects	Bank Mega Syariah-*Murābaḥah* (no UCP mentioned, renovation is mentioned)
		Faysal Bank - MM (no info on UCP)		Al-Rajhi (M) - CM	

North America		United Kingdom	Australia
US	**Canada**	**UK**	**Australia**
Devon Bank-*Murābaḥah*,*Mushārakah*,*Ijārah*. For UCP - either *Murābaḥah* for construction finance or construction *Ijārah*	*Ijārah* Loan- *Ijārah* (no UCP mentioned)	Islamic Bank of Britain-MM (no mention of UCP)	MCCA-*Ijārah* (no UCP mentioned)
LARIBA American Finance House-*Mushārakah Mutanaqisah* (no UCP mentioned) - title in customer name	UM Financial Group-MM (no UCP mentioned)	HSBC Amanah-MM (no mention of UCP)	Islamic Cooperative Finance Australia Ltd - MM (no UCP mentioned)
University Islamic Financial Corp-*Murābaḥah*,*Ijārah* (no UCP)	An-Nur (Ontario) Coop Corp Ltd- MM & *Murābaḥah* (currently no UCP - have plans for property development, have REITs plan for funding mobilization)	Ahli United Bank-*Ijārah* & *Murābaḥah* (No UCP, *Murābaḥah* only for Buy to Let not for residential purposes)	
Halal Inc - MM: no mention of UCP	ISNA HOUSING CO-OPERATIVE LTD. (IHC) – MM	ABC International Bank-MM	
Guidance - MM - no mention of UCP	Salam Financial-*Murābaḥah*	United National Bank - *Ijārah* (no UCP)	
	Ansar Housing Canada - Coop MM		

Method	Mortgage - Depository Institutions			
	Terminating Building Society	**Permanent Building Society**	**Commercial Bank**	**Contractual Savings for Housing (CSH)**
Background & Summary of method	Members contribute regularly until each member was housed (**construction**). **Savers are borrowers**. Once loans are repaid, distribute surplus and terminate the society.	Savers are borrower & non-borrower (permanent society)- this is the beginning of SLI. Funds completed and under construction properties. At the beginning, use CSH. Today use open funding - partly with deposit & partly by issuing securities i.e. there is no link between savings and loan anymore.	Original focus was on commercial funding and not consumer. Regulation also limited mortgage operations and banks were concerned with rate of return risk. After financial liberalization, as central bank introduced deposit insurance, and provides liquidity, bank runs were less. There are also core deposit, so banks entered into the mortgage market. But in many low income countries, banks still refuse to enter into the market.	Originate from mutual building societies. Loan linked savings contract, at below market. Savings - waiting - loan phases. Savings are callable daily, but to get loan, there must be minimum savings period. Two types: • Closed system (savings from potential buyer - Bausparkassen in Austria and Germany - fixed rate) • Open system (use capital market funding if deficit saving - l'Epargne Logement in France - floating rate). German started and remained with closed CSH. France started with closed CSH in 1965 but modified it to open CSH in 1970 due to high inflation.

Method	Mortgage - Depository Institutions			
	Terminating Building Society	**Permanent Building Society**	**Commercial Bank**	**Contractual Savings for Housing (CSH)**
Strength / Advantage	Lower Credit risk because of information sharing among members. Return to savers based on performance. The return to savers evolve from share of profit after termination to periodic dividend, but there was no guarantee.	Scale - wider investor base, risk free form of savings - more funds for housing	Scale & diversification (i.e banks are not focused only on home finance)	**Closed scheme** - Fixed rate on both side (so low interest rate risk) but may have liquidity risk if not enough saver & operate in high inflation environment. Also limited amount of funding – because have to wait for new depositors/amortization. **Open scheme** - manage liquidity risk by accessing capital market funding, but this means cannot offer fixed rate (higher interest rate risk). Open scheme can minimize/eliminate waiting period & may have higher financing. **Alternative: semi open** - fixed rate with inflation indexation (to manage inflation risk).
Weakness / Challenges	Scale: Limited to construction & home buyers	Looser bond between member - credit risk. Fixed interest on savings exposes the institutions to funding risk	Interest rate risk is the biggest challenge - securitization aims to manage this problem	

Method	Mortgage - Depository Institutions		
	Terminating Building Society	**Permanent Building Society**	**Contractual Savings for Housing (CSH)**
Where was it successful? Why?	UK still has mutual building society. Refer permanent building society. Evolved into other forms of funding solution - permanent building society, S&L and commercial banks	UK & US was successful due to regulatory advantage (in UK, banks had high reserve requirements on housing loans. In US, SLIs had funding and tax advantages). In UK, mutual, specialized housing finance societies still exist - they compete on benefit provided to members - lower mortgage rate & higher savings rate (in lieu of dividend). In Mexico SOFOL is successful. In US, SLI failed due to interest rate risk	France and Germany – CSH provides supplementary credit (second mortgages); In Austria it provides primary mortgages. Slovenia – 1999: introduced CSH - semi open, multiplier of 2, transferable right to receive a loan from the bank, only moderately subsidized. **Where were most challenges faced?** • Czech Republic and Hungary – a lot savings aided by savings subsidies (i.e. cover the difference between CSH rate & market rate), but produced comparatively few and small housing loans (mostly for renovation purposes). After 12 years, only 30% loan. • Tunisia – excess liquidity in 70s due to regulation of deposit rate (elsewhere in the system) and restrictive loan policy (4 year minimum savings, loan multiplier of 2). Liberalization of rate in 1983 caused run on the institution. Then became semi open CSH - rate is fixed spread over financial market index, loan multiplier double to 4. • Unsubsidized contract savings programmes have been introduced in India (unsuccessfully) and more recently in China, with limited success. • In Iran, high loan to saving ratio caused the national bank of housing, Bank Muscan, to run into liquidity problems p229.

Method	Mortgage - Depository Institutions		
	Building Society	**Commercial Banks**	**Contractual Savings for Housing (CSH)**
Summary policy recommendation	Mutual organizations have informational advantages to manage credit risk. Suitable in countries where commercial banks are not yet fully developed, weak or government run commercial banking. Don't introduce regulation that gives short term advantages to these institutions, or delay the entry of commercial banks into the market like what happened in UK & US.	For long run, improve the infrastructure and environment for mortgage lending. In many low income countries, banks refuse to enter the market because of: • weak legal foundations for collateralized lending, • relatively high cost of making smaller loans, • political risk - increase rates & enforce liens	CSH's is suitable alternative to banking system for EM since there is high credit risk (income uncertainty, high credit-information opacity). Savings - builds up equity, the willingness and ability to pay. However have to be mindful of at least two things: • Loan multiplier (if too high will have deficit – actuarial based loan to savings multiplier range between 1.2 and 1.5) • Subsidy of deposit rate (crowd out other deposits). Mobilization of savings should be done through deregulation and not subsidy Semi open scheme seems to be more suitable & successful in transition countries. Refer Slovania as example • **Recommendation for EM- it's best to have building society setting that offers CSH with other home finance solution. eg. S-Bausparkasse in Austria**

Method	State Housing Bank	Housing Provident Fund
Background & Summary of method	Collect deposit and give out long term fixed rate mortgage. There are three variations: 1. Collect deposits (like in Chile, Iran, Thailand etc); or 2. Issue bond because limited deposits (Argentina, France, Morocco); or 3. Depend on public finance sources such as mandatory savings or wage taxes, central bank facilities, or government grants and loans (rarest of three - done in Cameroon, Pakistan & Bangladesh). Has been applied in many markets - Latin America (Brazil has a hybrid of development bank & commercial bank - Caixa Economica), Carribean, Central America, Central & Eastern Europe, sub-Saharan Africa (commercial banking is small), some combine retail housing loan & property development (Thailand, Indonesia, Algeria, Egypt, Rwanda, Pakistan). This is emerging a lot in African countries. **In reality many of SHBs have failed.**	Long-term saving schemes that operate through mandatory contributions by employee & sometime employer. HPF collect mandatory saving (% of employee salary) - manage this -return below market - allow member to withdraw for down payment of housing investment, get long term mortgage at preferential rate (either from HPF or other financial institution), and sometimes function as retirement savings. Created in many emerging economies, including Mexico, Nigeria, Brazil, Jamaica, the Philippines, and China. There are two variants: HPF is a direct lender (as in Mexico and China) or not (as in Brazil or Singapore).
Strength / Advantage	Seen as political will from government	Created where private lenders were not active in long-term housing lending, as a self-funded housing finance system

Method	State Housing Bank	Housing Provident Fund
Weakness / Challenges	Difficult to balance social and commercial goal	End up helping those in preferential credit position and not the lower income group: • low-income savers cross-subsidize a smaller number of better-off borrowers; • the accrued savings are not sufficiently remunerated for retirement needs; • administration costs of HPF are high and the lending performance is poor; • their presence may hinder the expansion of other private lenders

Method	State Housing Bank	Housing Provident Fund
Where was it successful? Why?	1. **Government Housing Bank (Thailand)** - operate on commercial basis & don't depend on state subsidy - successful on low income HF, provide lower than market loan but because its bond & MBS issuance enjoy a low cost, has lower capital requirement, support infrastructure development (retail credit bureau, a real estate information centre, and a mortgage insurance scheme). 2. **Bancoestado (Chile)** - created from merger of four state owned S&L to become third largest commercial bank, strategic focus on low and middle income (25% market share in terms of value, 70% in terms of number of loan), run on commercial basis, subject to same banking regulation, low NPL, pay higher corporate tax (40%), pay 75% of profit as dividend, prohibited to lend to other state owned entity. 3. **Korea** - commercial basis from the beginning, weathered AFC. **Summary success factor**: Good governance, autonomy of funding, aligns corporate interest with market development agenda.	1. **Singapore** - separate house lending (HDB) from provident fund operation (CPF). CPF focus on efficient investment of the funds. People can borrow from CPF for down payment required by HDB (20%) and mortgage payment, but this must be repaid to CPF. "In the past, HDB provided both market rate and subsidized loans. Th e Ministry of Finance lends to HDB at the government borrowing rate and the HDB provides interest rate subsidies to households according to need. As of 2003, HDB no longer provides market rate loans (i.e. Must get from commercial bank). Borrowers obtaining market-rate credit from a bank can also use their CPF savings for their required down payment."

Where were most challenges faced? Why?	Since the middle of the 20th century there is high frequency of bailouts and rescue operations of SHB. Examples in Algeria (CNEP, 1997), Argentina (Banco Hipotecario Nacional, 1990–3), Brazil (Banco Nacional de Habitaçao, 1996, and Caxia Federal in 2001), Cameroon (Credit Foncier duCameroun), Colombia (Banco Central Hipotecario, 1998), France (Credit Foncier de France, 1996–9), Indonesia (Bank Tabungan Negara, 1997), Ivory Coast (BHCI recapitalized twice), Pakistan (HBFC, 2001), Rwanda (Caisse Hypothécaire du Rwanda, 2003), Tanzania (1995), and Uruguay (Banco Hipotecario del Uruguay [BHU], 2002). Failures are linked to weak corporate governance, lax credit management (don't focus on recovery) and risk mgmt (especially interest rate risk as they offer fixed rate financing).	1. China benefit upper income and not lower income. The lower end receives limited - reduced-yield savings. So help cross subsidize the loans to upper-income HPF participants. 2. Mexico – two HPFs; private sector (INFONAVIT) & public sector (FOVISSTE). Public sector HPF gives preferential lending rate. Private Sector loan linked to an index of wage inflation plus spread. Suffered from political influence - to provide subsidized lending - had high (30-40%) NPL. Private HPF underwent reform accounting, procedure and governance. 3. Brazil – lower rate on deposit even compared to savings scheme. HPF (FGTS) implement housing loan through Federal Housing Bank; CEF. High NPL. FGTS re-focused on the lower income groups (with upfront subsidies). In 2005, stopped new lending to higher income groups (10 times the minimum income). 4. Philippines – multiple mandate - housing (funding developer & retail), retirement, substantial financial reporting, weak ALM etc - hampered the growth of private mortgage 5. Nigeria – very little disbursement. Fail to provide any sizeable funding to develop a critical mass in the housing finance system.

Summary policy recommendation	Besides SHB, there are other alternatives: 1. **Contractual Credit Orientation/priority lending** - ineffective if underlying (funding & credit risk mgmt e.g. Nigeria & India) is weak. 2. **Focus on developing second tier institutions** instead of primary - ex Fannie, Freddie, Cagamas etc - this is more efficient than subsidy because the whole primary market benefits. Require developed primary & bond market. 3. **PPP** - strategic investment (with pvt) in housing finance companies - example HDFC in India government only have 5% capital but guaranteed HDFC's debt. Same model not successful in Bangladesh & Ghana 4. **Social & commercial private lender** - use microfinance institution/coop rather than creating SHB - have network & diversification Exit strategies for SHB i. **Commercialize/corporatize** - Pakistan & Algeria for example use profit KPI, central bank regulation, professional manager etc. ii. **Privatize** - bring in private partner - profit motive, risk based management - Argentina ii. **State support to private sector** - second tier institution (Jordan successful, Nigeria - fail), improve infrastructure (Pakistan),	1. Review subsidies - better to separate house finance from pension like Singapore. For middle income - encourage taking commercial loan, use CPF as down payment rather than giving them subsidized lending. China - started HPF when no commercial bank provided mortgage. When commercial banks have entered the market, HPF should revise focus - low income & not middle income. Should be regulated by financial regulator not other ministries. 2. Governance - need clarity on mandate & governance (independence, accountability, strategic focus) 3. Once private lender enters the market, HPF needs to encourage private lending for middle-income households rather than competing against them. Need to develop co-financing, let other lenders use the savings as down payment or guarantees, improve lending efficiency, narrow the interest rate gap with market rate conditions, and target the subsidy element only for the underserved groups. Such reforms have been initiated in Brazil by the Fundo de Garantia do Tempo de Serviço (FGTS) and in Mexico by INFONAVIT.

Method	Residential Renting Scheme	Housing Microfinance	Housing Subsidies
Background & Summary of method	Since 70s, public rental housing steadily declined. Ownership enjoys favourable tax regimes and subsidies. Rental housing - underdeveloped and underfinanced Financing Model for Rental Housing: 1. **All Equity** – Morocco – add floor and rent out – easy to control water, electricity etc. Alternative – Saudi RE Co invest in multifamily apt & tap alternative funding. 2. **REIT** – tax exemption, liquidity, economy of scale. • North America, Australia, Japan, Singapore, Hong Kong, New Zealand, and South Korea have REITs. • Belgium, France, Greece, and the Netherlands- have clear tax-efficient REIT structures. • Germany and UK	Lending remains limited to upper- and middle-income households with steady and verify able incomes. HMF is for low income - unbank able population. HMF typically comprises small loans (usually from \$500 to \$5,000) of limited maturity (from six months to three years) generally without collateral. Use micro-enterprise loans to improve their housing conditions (improved roof, a cement floor, or connections to municipal services etc - **incremental construction of home**). Rates are higher than traditional mortgage loan because perceived as riskier. The short maturity and relatively small size helps to	**Supply side subsidy:** *A. Investors subsidy* 1. Debt finance related – interest rate subsidies or credit guarantee –lots of hidden problem 2. Equity finance related - The U.S. Low-Income Housing Tax Credit (LIHTC) is good example. *B. Production subsidy* 1. Upfront land/cash grant – but developer might not translate into lower rent 2. Tax subsidies for landlord – Not suitable for EM because informal lease. Tax subs benefit the higher income **Demand side– Rental Vouchers –** but administrative challenges and abuse. **Subsidies to Household**: **A. Lower Middle Income Subsidies**: 1. **Home ownership** – upfront grant for loan downpayment) 2. **Access to mortgage** – depends on

	introduced tax-transparent Reits in 2007. • Russia and Turkey, also have REIT structures. Social housing REIT – not high return. Need tax exemptions to make it attractive. Example Community Development Trust in New York – private investors, 5% p.a., invest in 20 states 3. **Bank supplied credit** – residential viewed as more risky than commercial, 4. **Capital market** – RMBS (i.e. Securitize bank mortgage provided to fund such – US, Sweden, Finland, Belgium) or project finance like funding for such projects (UK), or municipal bond issuance	control credit risk -the borrower has an incentive to repay the loan to receive another one. HMF is oft en delivered with technical assistance to ensure the durability of the resulting construction A variety of institution types offer HMF loans, including: MFIs, non-microenterprise lending NGOs with a housing focus (such as Fundación Habitat y Vivienda, A.C. in Mexico), financial cooperatives (such as those affiliated with the Guatemalan Federal Credit Union), commercial banks involved with microfinance (for example, BancoSol in Bolivia, and specialized microfinance banks such as Tameer Bank in Pakistan), or traditional commercial banks (such as Crédit Libanais and Jammal Trust Bank in Lebanon).	constraint • Savings constraint – direct payment or (open) savings scheme • Variable income – Bank: flexible payment scheme, blocked deposit/savings, higher downpayment. Subsidy – contribute to blocked deposit. Consumer education • High collateral risk: collateral value decrease – besides insurance, maintenance education & fund **<u>Low Income</u>** First - Improve land registration, subdivisions, permitting procedures **Subsidies**: 1. Serviced Land grant – to household or developer. 2. Home improvement grant –direct grant if don't qualify for loan or MF. • Encourage MF – reduce transaction cost (pay fixed amt per household), finance **missed payments**. • **Community based support program** (buy materials in bulk, quality control, community savings etc)

Method	Residential Renting Scheme	Housing Microfinance	Housing Subsidies
Weakness / Challenges	The rental sector has received, at best, limited attention in many developed countries and emerging economies, in comparison to homeownership	Low income is considered high risk - no constant verifiable income, so high rate (40% - 20%). Scale is a challenge – because HMF cannot collect deposit, no cheap funding	**Misaligned** - most subsidies are linked to mortgage finance and are not accessible for low-income households. The cause of Housing Problems relates to fundamental questions such as property rights, public regulations, and structural problems in the housing finance sector.
Where was it successful? Why?	1. The Low-Income Housing Tax Credit (LIHTC) in the **United States** – use tax credit and transparent criteria for successful affordable rental housing program	**Peru** has relatively large scale of HMF- because a) the historical pattern of urbanization by low-income households; b) the presence of a well-developed enterprise microfinance industry; and c) the promotion of HMF by a market leader, MiBanco. In general, microfinance in Peru is better performing than banking sector	In Thailand development and building standards for rental and ownership housing were lowered in the 1980s (for example, unit size of 20 square meters) to allow an increase in affordable housing supply without additional subsidies. Latvia, South Africa, and Thailand have done an in-depth survey of housing problems and subsidies to come up with medium-term strategic plan for the sector. Several countries have recently engaged in such processes, for example, Brazil, Mexico, Peru, Colombia, Korea, Indonesia, Vietnam, and Morocco.

Method	Residential Renting Scheme	Housing Microfinance	Housing Subsidies
Where were most challenges faced? Why?	1. Minimal housing standard - too high. Low income cannot afford this high standard 2. Rental environment (landlord tenant relationship, rent control, tax). Country Experiences: 1. **Brazil**: the Residential Leasing Program (PAR) – good legal framework, but economic conditions (high subsidies – 70%) prevented successful take off of private rental. 2. **Poland** – unfavourable tax and legal environment – KFM (National Housing Program – public rental program) does not target low income tenants, income declaration is responsibility of TBS (non-profit landlord organization). Rental program have been abounded in Latin America.	**Guatemala - challenge to scale**, **not failure:** HMF lenders (MFIs, cooperatives, NGOs) work successful in the lower-income housing market, at commercial terms and with low defaults (less than 3 percent). Loan interest rates stand between 20 and 25 percent, loan maturities between one and three years, and the average loan amount is between $600 and $700 - but cannot scale up because there is no regulatory support, difficult to raise funding (depend on bank loan). Guatemala gov wants to create fund that guarantee bank loan to HMF.	1. What is needed in many countries is an in-depth, broad-scaled inquiry into the nature, breadth, and causes of their housing problems and a similar wide-ranging review of existing subsidy programmes , their depth, and current beneficiary groups and their performance. 2. More important to **remove regulatory constraints before thinking about subsidy**. Look at unnecessarily strict building, planning, and subdivision standards, poor property rights and registration systems, excessive government involvement in the urban land or housing finance sectors, rent control, and other policy or regulatory bottlenecks may frustrate the efforts of the market to serve all portions of the population.

Method	Residential Renting Scheme	Housing Microfinance	Housing Subsidies
Summary policy recommendation	Those who cannot buy house, requires subsidies. Two conflicting goals: enable the supply of affordable rental housing without discourage investment in rental housing. . Smart subsidies: (from subsidies section) • US experience of tax credit was successful for supply side. • Best delivery of low income housing - private small-scale investors who build additional rooms or floors. Formal sector required too much unclear subsidy. • Community support program - buy materials in bulk, community savings	1. HMF not suitable to give housing subsidy because HMF goal is to encourage financial sustainability 2. Can link commercial bank & HMF - Peru shows that commercial bank can choose to offer HMF. But it's better to offer MFI, and have HMF portfolio. This however requires banks to invest in developing resources and expertise in offering MF - product development, specialized human resource acquisition and training, and adjustment to traditional delivery channels. Success is exception rather than norm.	Best policy is comprehensive housing-market deregulation. If necessary, introduce selective production or investor subsidies to stimulate the flow of new housing to the market. **Low income** • Best policy - improve infrastructure - so life quality of low income improves. • MFI – allow landlord improve low income rental housing & sanitation. **Middle and Lower Middle Income** Review regulatory & double tax problems for investors. Keep in mind building standard.

Appendix 5

Survey of World-Wide Housing Finance Models[112]

A5.1. Introduction

Globally, there is a shortage of housing. The problem is often associated with high land values and access to affordable land. Yet, it is deeper. The housing shortage is characterized by issues surrounding affordability, which ultimately hinge on a very broad concept of "infrastructure". The housing finance environment also has potential inputs on financial stability. David Smith summarizes this as the challenge of Law, Environment, Partnership and Subsidy ("LEPS").[113] This chapter examines the broad landscape of housing finance in developed countries and emerging markets with a focus on the latter. The key themes of the chapter include LEPS and funding.

A5.2. Core Infrastructure

The primary issue in most countries is often quite simple, the legal system does not accommodate the rate of population and income growth that fuel housing demand. The primary legal deficiencies relate to land registration and perfection of title; efficiency of courts; banking and capital markets regulation; and the formalization of ad hoc housing solutions created by citizens in the absence of appropriate laws. As Lasalle notes, there is a significant a need for a broad range of policy initiatives which integrate finance, community involvement, and design.[114]

Legal inefficiencies prevent capital from being actively beneficial

[112] Appreciation to Tim white of PNC Real Estate for sharing insights on post crisis developments in the United States multi-family housing market.
[113] Smith, David A., *Housing the World's Poor The Four Essential Roles of Government,* Harvard International Review, June 2006, accessed at http://www.affordablehousinginstitute.org/ .
[114] Op Cit., Jones Lang LaSalle.

according to Hernando De Soto. He lists six corrections for insufficient and defective legal systems[115]:

7. Who owns an asset and the value of the asset should be easily determined;
8. The legal system must register uniformly the existing (not yet formalized) capital;
9. The legal system must make people accountable for their use, non-use, and application of capital;
10. The legal system must facilitate making assets fungible;
11. The legal system must allow people to network and exchange their capital; and,
12. The legal system must protect transactions and enforce the sanctity of contracts.

If these formalization and legal issues can be properly addressed, De Soto argues that "dead" capital may be converted into useful capital. Beyond de Soto's purely financial analysis, these factors lead to a more stable society with better living standards for all.

Basic infrastructure issues worsen the legal lacunae. On the one hand, simple and basic needs like sewer, electricity and water ("SEW"); schools; public safety/fire and police services; proper roads; and, public transit are often missing or deficient from the areas in which housing is required. On the other hand, data about the market is limited or non-existent. As a result, financiers cannot make informed decisions about how to fund projects and individuals.

In the absence of the core infrastructure, financing becomes a massive challenge. Nonetheless, we will observe that, in important countries including Brazil, Morocco, the Philippines, and Bangladesh among others, different tools have been applied to help overcome these impediments to housing finance. Some of these solutions and others will be examined below.

A5.3. Funding

Before beginning the survey of funding, let's analyze the discrete problems with the delivery of both private and public sector funding to the markets

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[115] De Soto, Hernando, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), Chapter 3. Accessed online at http://www.imf.org/external/pubs/ft/fandd/2001/03/desoto.htm in *Finance & Development*, March 2001, Volume 38, Number 1.

in need. When considering funding, there are three unique blocks to consider: institutional finance, term, and funding criteria.

Institutional finance is typically limited from two perspectives. The simple and most common issue is that not enough institutional funds exist in a particular market. If the funds exist, they are often in the wrong place.[116] Institutional funding requires a number of key factors including access to banking for secure savings, the development of life and pension investors,[117] and government funding.

Term is a massive problem. Foremost, housing is long term in character and most easily afforded by users, tenants and buyers, when financing is long term. But, banks are typically funded through short term deposits. If one combines the short term funding of most banks with the absence of suitable banking services, then bank funding for housing finance is normally insufficient by itself to address the problem of delivering housing. In order to allow banks to become front line financiers of housing, a deep infrastructure needs to be implemented which might include guarantees (Jordan) or private mortgage insurance (USA); mortgage refinance or liquidity entities; securitization; and, central bank support.

A secondary issue relating to term that it impacts the size of commitment a customer can handle. The longer the term, the more manageable the monthly payment (even if the actual cost of financing actually goes up). Inflation is another factor which can affect the willingness of the private sector to provide either fixed rate or long term housing finance.[118]

[116] (De Soto, 2000), excerpt accessed at http://www.nytimes.com/books/first/d/desoto-capital.html. De Soto points out that the capital is often locked up in "illegal" real estate or assets which are not formalized in the local legal or financial environment or which lack data validation. For instance, capital is tied up in "… houses built on land whose ownership rights are not adequately recorded, unincorporated businesses with undefined liability, industries located where financiers and investors cannot see them. Because the rights to these possessions are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside of narrow local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against an investment."

[117] Some state managed pensions including Singapore (Central Provident Fund) and Malaysia (Employees Provident Fund) have imposed high levels of forced savings in order to develop ideal balances between long term savings and the capacity to support long term housing finance.

[118] Smith, David, Best Practices in Slum Improvement: The Case of Sao Paulo, Brazil for the Development Innovations Group, August 2008, accessed at: www.affordablehousinginstitute.org/.../DS_saopaulo_best_practices.

Conversely, either the threat of deflation or realized deflation will also deter lenders as they fear that the value of their collateral will decline relative to loan size. Prior to the global horizon until the 2008 Global Financial Crisis, asset inflation was the concern for home buyers and often led to over leveraging by equity release products. Subsequently, the threat of asset deflation is now raised as often as the specter of monetary inflation. Imagine the worst of all combinations: housing construction input, energy, and food based inflation coinciding with a decline in real estate values, the latter of which is often the main store of wealth for many households.

Middle income housing typically requires "mortgage" financing whereas low and moderate income housing finance normally requires a subsidy.[119] Funding criteria relate to either individual or corporate solutions to housing delivery. These break down further into the housing situation: multi-family housing (apartments, condominiums, row houses, one-by-four houses, and duplexes) or single-family houses; developer built housing or self-build. Once the client and object are understood, the customer's debt to income, housing cost to income ratios and other factors have to be taken into account. But, in countries with inefficient data collection or high levels of tax avoidance, such ratios may not be easy to calculate.

Another factor in the housing finance matrix is whether or not one is buying, upgrading/improving/formalizing, or building. Is there a third party builder or guarantor?

An area that is not fully developed is the degree to which housing saving schemes can be expanded to incorporate expatriate works that support their families.

The next issue is how a subsidy is to take place. Since all countries subsidize housing finance, what is the best approach?[120] Subsidies may enable multiple strategies to address different levels of housing problems. For instance, a government may find that the apartment sector is an efficient solution to short term housing bottlenecks; another government may seek to address a national sentiment that occupant owner homes is

[119] Even Middle Income finance could require subsidies in overheated or space constricted housing environments.
[120] (Hoek-Smit, 2008), *Subsidizing Housing Finance for the Poor*, draft paper prepared for Development Initiatives Group July 2008 accessed at http://www.housingfinanceforthepoor.com/data/images/dig%20subsidy%20paper%2020-08_edited%20rw_changes%20accepted%20to%20post.pdf

more important. But, the means of the subsidies is a major issue: should these be direct monetary transfers, free SEW, free land, some form of private-public-partnership ("PPP") investment?

Common subsidies in developed and emerging markets include:

1. Down payment grants to help first time buyers;
2. Government managed savings schemes including provident funds
3. Preferential fees
4. Loan guarantees
5. Reduced rates or fees to target communities (defined by income, location or ethnicity)
6. Tax deductible interest
7. Tax fee capital gains
8. State backed mortgage entity (lender, guarantor or securitization body)

Subsidies may in the form of tax credits: this is a long favoured policy in the US. Beyond subsidies, there is the direction of credit into the market. As South Korea has shown, the management of regulatory reserves, debt to income ratios and loan to value ratios results in freeing or stifling credit to the housing sector. But, the Korean approach only works in a well-developed banking market.

Subsidies may be complemented by lessons learned from the microfinance field. In two cases below, we will examine concepts that entail either collective ownership as in the Philippines or corporatized ownership as proposed in the US. Subsidies may also be privatized in the case of a market with high non-performing loans ("NPL") as in the US. The nature of privatization is best linked to the conversion of loan contracts into leases with the banking regulator making allowances for both capital adequacy and loan to value ratios.

The important reality of subsidies is that effective subsidy programmes turn on legal certainty of title and its transfer, and legal clarity of the right to occupy. With respect to subsidies, there are important issues which may impact either the public perception of effectiveness or actual success of a subsidy program. These include:

5. Transparency – Are the rules governing the subsidies clear and easily understood?

6. Access - Are the people targeted by the subsidies able to access the subsidies?
7. Fairness – Are the subsidies actually fair? If they are not "fair" in an individual consumer sense, do they correct an imbalance in the housing environment that improves access to housing making the "market" more fair?

8. Adjustment – Do the agencies providing the subsidies do so in a "smart manner"? In other words, when there are problems with implementation or imbalances introduced, do the managers adjust the programmes to improve success?

What is the measure of subsidy success? Is a subsidy successful because there is an increase in home ownership, an improvement in housing quality, a reduction in substandard housing? Often the success of a subsidy is an intangible and the statistical measure may prove misleading. For instance, home ownership increased in the first part of the 2000's in the United States, but most of the incremental homeowners were marginal and many of these owners were foreclosed out of their home during the credit crisis. Section 5.6 will deliberate further on different type of subsidies and lessons that can be learnt from different markets.

The need for subsidies, the availability of proper infrastructure all led to a single question: who can be financed? The concept of the middle class is widely variable in the emerging markets and the concept of the "middle" is relative with the middle class sometimes earning seemingly substance income between US$4 – 20/day and others earning amounts that are closer to middle incomes in developed countries.[121] In the former case, the middle is either building their own-home or living in a slum. Morocco and Brazil has taken aggressive strategies to upgrade slums to become proper middle-income housing. In all cases, the levels, distribution, stability and sources of income are unreliable. As Hoek-Smit discusses:

> "In many developing countries, incomes are extremely low relative to the cost of basic housing packages. At the same time, informal employment is high (e.g., over 70 percent in Indonesia; over 40

[121] (Hoek Smit, 2009) defines Middle and Lower Middle Income as upward from the 40th or 50th percentile of the income distribution. This group has creditworthiness but lack access to financing. She defines Lower Income as below the 40th percentile of the income distribution. This group is often perceived as high risk group and is not creditworthy. For this category, micro finance, credit coop or mutual credit union are the relevant solutions. Refer p422 for more details.

percent in Mexico), limiting access to formal sector housing."[122]

This reality is worsened by the fact that finance and the ability to qualify for it is a key determinant of housing affordability. Finance and qualifying are also closely linked to the availability of savings options. In many key emerging markets, savings are often not secure or easily accessible.

Hoek-Smit further enumerates the constraints on housing and mortgage finance, especially long-term finance:

1. Collateral – access to collateral is impeded to problems with the owner actually holding registered title, whether properties are registered, and the quality of mortgage laws; and,
2. Quality of Neighborhoods – many neighborhoods lack proper SEW, roads, transit, and public safety facilities. In the absence of this public infrastructure, long-term finance is unlikely.

In light of these problems, Hoek-Smit observes that "No more than 25 percent of households in most developing countries would potentially qualify for a mortgage loan."[123]

As noted in many of the studies of the housing finance markets, successful strategies depend upon savings, finance, and subsidies (see Warnholz, 2008).

Efficient financial market laws can only support real estate and housing markets if the broader infrastructure is in place. If all parts of the legal and regulatory puzzles are in place, then scale is possible. The real estate rules include a system that supports efficient title discovery[124] allowing ease of title transfer and registration.

Once one knows who truly owns property, one can begin discussing how to use the financing infrastructure. The problem here is that the encouragement of institutions to provide funds is best when it results in

[122] Op. Cit., Hoek-Smit 2008.
[123] Op. Cit., Hoek-Smit. In her research in Mexico, she created a matrix that compared whether or not a household was in the formal or informal economy to income to access to types of finance and subsidy.
[124] In a number of countries *title insurance* is used to provide third party validation of how a property is registered and to insure the rights of the current "owner" against third party claims.

diversity and scale. The next sections will discuss products which have achieved some degree of scale in the developed and emerging markets.

A5.4. Lending based Products

The global markets have a diverse universe of simple loan products.[125] Each one is based on a payment of money today to a customer to be used for the purchase of a house. An underlying *chicken and egg* question relating to housing finance is whether or not housing shortages mean that building housing related data resources is beneficial until the stocks and financings are more widely available. In exchange for a payment later, the customer pays interest, and typically grants a mortgage so that the lender will have collateral. Simple mortgage products are based on either fixed interest, which are based on an index which defines the rate for the life of the loan; or adjustable ("variable") interest, which are typically based on an index which changes on a regular basis. In markets with well-developed mortgage infrastructures like the major OECD countries, lenders and borrowers have high levels of confidence that their rights are secure: de Soto's qualifying concerns are overcome.

Product innovation in the developed markets is also limited to simple adaptations of the basic mortgage loan model. In order to make loan payments easier to manage, products have been delivered which entail:[126]

1. Balloon payments at maturity – typically short term fixed rate with a large payment to be made at maturity;
2. Negative Interest – adjustable rate loans with a constant payment, whether or not the index rate adjusts up or down. At maturity, the client may have to pay an additional amount. Depending upon interest rate movements, the borrower may amortize the loan;
3. Interest Only – This is a form of balloon mortgage in which the borrower will not make any contractual capital payments;

[125] Op. Cit., IMF. The IMF takes the view that product diversity makes it easier for investors and lenders to hedge their risks. Page 115.

[126] A useful resource on mortgage products in the US market is: http://mortgage-x.com/library/loans.htm which has informed the list in this section. Additionally, there are variations which may be based on equated monthly payments, step down installments, step up installments, bi-weekly payments, and more as discussed by Shukla, Sanjay, *New Mortgage Products to gain an edge*, presented at Asia Pacific Housing Union forum, June 2010 accessed at www.apuhf.info.

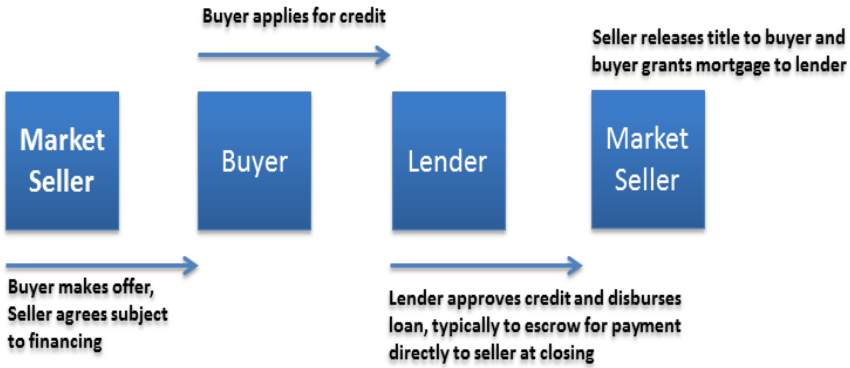
4. Option ARM – at each adjustment date, the borrower may elect either a minimum payment, interest only, or a payment based on a fixed rate index which converts the ARM to fixed;
5. Fixed Period ARMs – the borrower may have a fixed period after which the interest will adjust. The program is structured to have a cap;
6. Two-Step Mortgage- the loan has a fixed rate for a short to medium period, and then adjusts to a new fixed rate for the remainder of the loan;
7. Convertible ARM – A loan product that has specific dates which allow the borrower to convert to a fixed rate. The borrower may retain the ARM status for the life of the loan;
8. Convertible Fixed – A loan product which has an option to reduce the interest rate if a comparable fixed rate index drops;
9. Graduated Payment Mortgages – Monthly payments are low, and increase at predetermined dates. These loans have the risk of negative amortization;
10. Buydown Mortgage – This type of loan has a discounted interest rate which increases at a specific date. The discounted interest rate is actually based on an upfront payment of interest at the loan closing; and

11. Longer terms – in the early 2000's, the American government sponsored mortgage companies increased terms to 40 years in some loan products from the American standard 30 year fixed rate.

Danish balance principle mortgage is a conventional product that is originated by a mortgage bank. The lender retains the underlying credit risk, but funds the product by issuing covered bonds[127] started in Denmark in 2007. Loan stays at mortgage bank, which takes credit risk permanently. The bonds are callable based on the underlying payment dynamics of the mortgage loans. The system only tolerates a maximum LTV of 80%. No loans are made without matching a covered bond issuance. By transferring market and rate risk to investors and keeping the credit risk at the originator, the IMF believes that this creates an optimal alignment of investor/originator interests and provides for a sound housing finance system. As will be discussed later, this process may not be optimal for the Islamic markets.

[127] Op. Cit., IMF, pp. 118 – 9. Originally, the bonds were bullet bonds with maturities shorter than the life of the mortgages. Since 2007, the funding source has been covered bonds.

Figure A5.1: Common Mortgage Loan Process



Source: SHAPE™ Financial Corp.

In addition to these mortgage concepts, the mortgage industry has developed products to manage interest rate risk for the customer and/or the lender. These include cap products, which limit the maximum amount of interest payable without negative amortization; floor products, which are adjustable rate products, which stipulate a minimum rate of interest; and collar products, which combine a cap and a floor. Most mortgages have five year terms, but more advanced markets with diverse long term investors have mortgages with tenors of 20, 30 and 40 years.

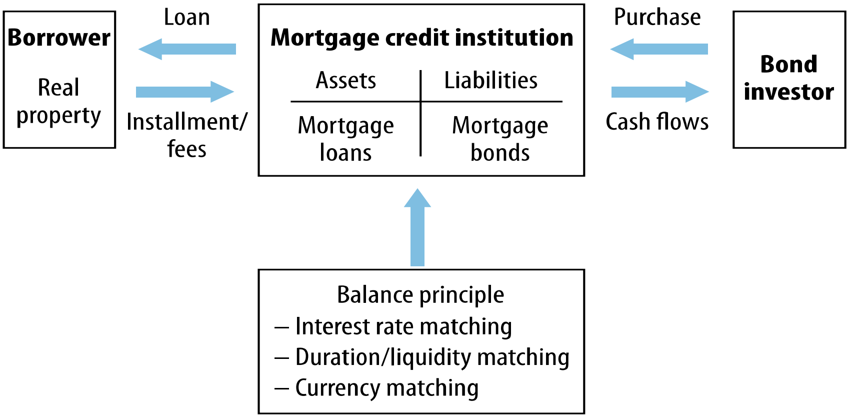
The nature of all of these products is to make a secured loan for the purpose of housing, whether new or re-sale, construction (self or third party), home improvement, or even to cash "equity" out of a home.[128] The nature of innovation is to manipulate either the interest rate or the capital payment. In the OECD countries, the state or state sponsored entities provide additional features, usually in the form or guarantees, liquidity functions, or subsidies.

In the developed markets, lenders operate with defined customer qualification criteria. The qualifications are usually standardized and supported by robust information services that provide generally accurate

[128] So called "home equity" loans or second mortgages or even unsecured lines of credit based on the value of a home.

information about the credit quality of the customers; and which provide useful information about real estate prices and quality.

Figure A5.2: The Balance Principle



Source: IMF[129]

The typical qualifications in developed markets often start with credit scores,[130] which provide simple means to eliminate or pre-qualify financing applicants. The other methods include:

1. Debt to income ratio – generally 45% debt to income is deemed to be the maximum ratio tolerated by lenders. Subprime lenders allowed higher ratios and conservative lenders often require lower ratios;
2. Housing ratio – generally between 35 – 40% of income, this ratio captures either rent or mortgage costs on an existing mortgage. Again, subprime lenders often allowed this ratio to go above 40% of income and conservative lenders may zero in at 30 – 35% of income;

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[129] IBID., p. 118.

[130] Credit scores like the FICO score are calculated from a lot of different credit data in your credit report. This data can be grouped into five categories as outlined below. The percentages in the chart reflect how important each of the categories is in determining your FICO score: Payment history: 35%, Amounts owed: 30%, Length of credit history: 15%, New credit: 10%, Types of credit used: 10%. These percentages are based on the importance of the five categories for the general population. For particular groups - for example, people who have not been using credit long - the importance of these categories may be somewhat different. http://www.myfico.com/crediteducation/creditscores.aspx.

3. Transport ratio – only used by conservative financiers, this ratio measures the amount spent on all costs relating to transportation to help define the prospective obligors default risk;
4. Down payment and source of down payment – the size of down payment is often a critically important factor in determining credit risk. In some countries, a down payments of 20% or more correlate to low risk of default. In others, a 20% down payment may not correlate to a low risk of default at all[131];
5. Employment and verification thereof;
6. Verification of assets;
7. Verification of savings and average monthly balances; and,
8. Cash reserves – a number of financiers emphasize.

The broad assumption in developed markets is of greater income equality. But, in the case of emerging markets,[132] qualifying borrowers is more difficult. This may relate to wide disparities of income inequality as well as poor data on prospective borrowers. Usually, in emerging markets, credit verification is not possible using bureaus, standardized means, or mean based algorithms. As a result, in programmes serving the rural poor in Morocco,[133] the credit validation process includes:

1. Character references by loan officers – This old fashioned method has fundamentally been replaced by credit scoring in the rich countries;
2. Validate customer income level – This is typically done on an anecdotal level as there may not be any form of pay receipts or sales receipts for the customer;
3. Validate customer residency – This requires verifying customer residency documentation and comparing to actual residence by visit;
4. Prepare application:
    a. Stating existing customer debts and payments as validated in customer interviews;

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[131] In a number of countries, either credit insurance in the form of an agency guaranty or "private mortgage insurance" provided by monoline insurers, whose sole purpose is to insure credit risk.

[132] Organizations like Fannie Mae and Freddie Mac in the US refer to "underserved" market segments like low income, moderate income in high price markets, ethnic markets which have suffered historical housing discrimination, and groups needed specialized products as "emerging markets".

[133] Martin, Richard J. and Ashna S. Mathema, Housing Finance for the Poor in Morocco: Programmes , Policies and Institutions, microREPORT #96, Prepared by: accessed at www.abhatoo.net.ma/index.php/fre/content/download/.../wf3.pdf.

b. Stating the ID and residency certificate;
c. Tax status (for the poor – show non-tax paying certificate);
d. Copy of reservation of the property to be occupied; and,
e. Agreement of sale from the developer.

A number of countries have developed statistical analyses of their citizens according to income cohorts like A – B – C – D – E. For instance, Brazil produces these statistics in perspective to the minimum wage.[134] Class A and B citizens are often in the worst of economies able to access financing for their homes or have sufficient case to purchase or construct their homes for cash. Class C citizens of then can afford a reasonable payment, but may not be accommodated by the banking system. Class D citizens can normally afford an occupancy payment. But, Class E citizens will struggle with occupancy payments and may only be able to afford basic utilities or maintenance.[135] The Class D and Class E citizens often require subsidies and grants to obtain housing. In many countries, from Class C to Class E, citizens may lack the capacity to demonstrate their ability to qualify for a loan (hence the Moroccan alternative credit qualification approach).

But, not every market has easily validated data, or wages are not earned in the formal sector. In the absence of data, contractual savings for housing ("CSH") plans are used as we will discuss elsewhere in this chapter.

An interesting gap in the market is that virtually no public or private loan programmes are geared to assist the expatriate worker save or borrow to support his or her family's new home in the worker's country of origin.

The basic lending products are most successful in well-structured legal environments. As demonstrated in the case of Morocco, *work-around* and alternative strategies are feasible in the absence of data. Nonetheless, the existing approach to housing finance using loans and patches raises separate questions for the Islamic market. On the one hand, interest bearing loans are in direct contravention of established Sharīʿah as well as the mandates of the Islamic Development Bank ("IDB"). On the other hand, the patches may introduce unexpected risks. As was the case in the American credit crunch, the first unexpected risk is fraud. The second is that the alternative credit qualification strategies are not sufficiently robust and enough underlying credits fail to introduce systemic risk. A further issue is customer performance, and in many emerging markets non-

[134] Op. Cit., Smith, Brazil.
[135] Op. Cit., Smith, Brazil.

performing loans ("NPL") are often over 10% of risk assets (will above the NPLs in developed markets, even during recessionary times. The next section will examine non-loan based products which divide into two sectors: loan alternatives and community programmes .

A5.5. Non-Lending based Products

This section will briefly review a few of the loan alternatives discussed in Chapter 4 and why these have been applied. Then, the community based concepts that are meant to deliver housing finance in a way that is not centred on a single individual are examined.

A5.5.1. Loan alternatives

Loan alternatives may include conventional products which have stunning similarities to Sharīʿah compliant products as well as non-lending products that are meant to generate more housing finance. Akin to *Ijārah muntahia bi tamleek*, processes like lease with an option to purchase and a long term redeemable ground lease are present in many countries. In a proposal which has now gone to the Federal Reserve in the United States, Daniel Alpert has recommended a conversion of defaulted mortgages into five year redeemable leases. Likewise, shared equity and co-ownership products are used which bear a resemblance to concepts like *Mushārakah Mutanaqisah*. The significant appeal that shared equity can generate for both individual and community housing programmes are discussed in greater detail later. A related concept to the shared equity process is the co-ownership process used by many cooperative societies. The process is used when the society's articles and regulator permit it to co-own and lease residential real estate. During the real estate crisis in the United States, the Center for Economic and Social Justice has proposed a solution of corporatized co-ownership as a solution to the real estate foreclosure problems in the United States.

These concepts as processes as they are not widely used and have not developed into scalable products. In other cases, these are not products as much as public programmes , and are indeed substantially scaled to serve large numbers of people in the areas of delivery. In addition to products and processes, there are state sponsored programmes and self-help groups like cooperative societies or rotating savings and credit associations.

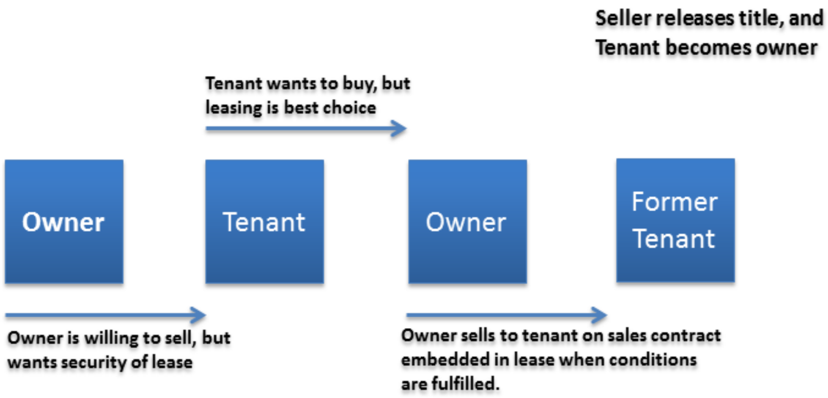
A5.5.2. Leasing

The basic lease to own, and lease with an option, structures are similar. Historically, these structures appear in one of two business environments. The first is the case of a property owner who wishes to sell, but the market is not liquid. Either there are limited lenders or few buyers able to obtain credit. The owner is able to wait to enter a sale, and therefore the lease to own or lease with an option is a suitable compromise to an outright sale. The second case is almost identical, the difference is that the owner is a builder or developer who cannot move property into the market and a lease product generates occupancy until credit markets turn favourable.

Following the credit crisis, Daniel Alpert proposed converting mortgages into leases with the existing tenants:

> "… banks to accept the voluntary surrender of deeds and then lease the homes back to their former owners. The former homeowners should then retain a right to purchase their homes back at fair market value, after, say, five years, during which time they would need to get their financial affairs in order."[136]

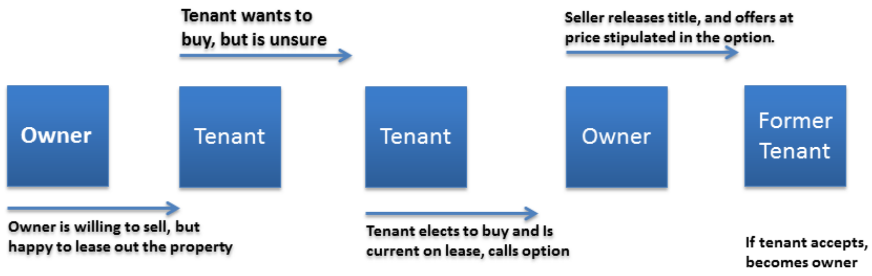
Figure A5.3: Lease to Own



Source: SHAPE™ Financial Corp.

[136] Alpert, Daniel, *Why Own When You Can Lease?* New York Times, August 1, 2009, Accessed at www.nytimes.com/2009/08/01/opinion/01alpert.html.

Figure A5.4: Lease with Option



Source: SHAPE™ Financial Corp.

Alpert's proposal is focused on keeping people in their homes, stabilizing care for the housing stock whilst deferring crystallization of bank write-downs until the markets have stabilized at the five year period. Alpert's ideas are practical: Prior to his article, a small community bank in New York, Bank of Cattaraugus,[137] applied a sale and leaseback approach to avoid foreclosure for its client amidst the financial crisis in the US.[138]

In a document produced with Robert Hockett and Nouriel Roubini, Alpert proposes a "rent to start-over" program which would direct people in need of housing, the former sub-prime borrowers, to lease foreclosed homes with an option to purchase in the home in the future.[139] In these proposals, Alpert et al propose that the former lenders provide traditional landlord services.

Gwinner and Lea (2009) highlighted that the Government Housing Bank of Thailand applied hire purchase prior to mortgage as an innovative underwriting methodology for low income group. In this scheme, the house buyers are required to enter into three to five years prior to obtaining

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[137] With total asset of US$12million, this is considered a micro bank. A small bank is defined as US$10 billion total asset.
[138] Refer (Feuer, 2011) for details.
[139] Alpert, Daniel, Robert Hockett, and Nouriel Roubini, *The Way Forward Moving From the Post-Bubble, Post-Bust Economy to Renewed Growth and Competitiveness*, October 2011, The New America Foundation, accessed at http://www.newamerica.net/publications/policy/the_way_forward. The option to purchase would be a "right of first refusal". The approach is not uniformly popular and resistance has emerged following the Federal Reserve's willingness to embrace the concept. See Whitney, Mike, *The Foreclosure-to-Rental Screwjob,* CounterPunch, January 14, 2012 accessed at http://readersupportednews.org/opinion2/279-82/9439-the-foreclosure-to-rental-screwjob.

a mortgage. The lease establishes the creditworthiness of the low income group which normally does not qualify for financing. The Islamic market may either use IMBT or even *Ijārah* combined with *Murābaḥah* to provide financing to lower income groups.

Another concept is the redeemable ground lease. The origin of many redeemable ground leases starts with large estates which were willing to contemplate eventual break up with lessees converting their status from tenants to owners. In the ground rent, the tenant is responsible for determining the best use of property and choosing to make or maintain any improvements. The lessor is solely delivering ground which will either revert with any improvements to the lessor, continue to be leased, or be redeemed by the lessee and converted into *fee simple* property. In the 1950's developers in the American State of Maryland used existing ground rent rules to attract tenants to their properties during a soft period for sales. Later, in 1963, conditions were agreed to allow the rent paid on such leases to be treated as mortgage interest.[140]

A5.5.2. Co-ownership and Shared Equity

There is a subtle difference between co-ownership and shared equity which turns on local law where one is doing business. The concepts have been used to deliver loan and risk sharing products. For instance, co-owners will make an equity payment to buy a property and borrow jointly based upon their equity in the property. They are co-owners of the property and co-obligors/mortgagors for the loan.

Shared equity may turn with the financier jointly acquiring the property with the obligor and then determining the next relationship: is the property leased to a third party, is it leased to the "obligor", does the "obligor" buy the property from the "partnership" or the financier's share of the property? Each variation is nuanced according to local law where the property is located.

In his presentation on mortgage developments in India, Sanjay Shukla summarized the benefits and difficulties of shared equity "financing":[141]

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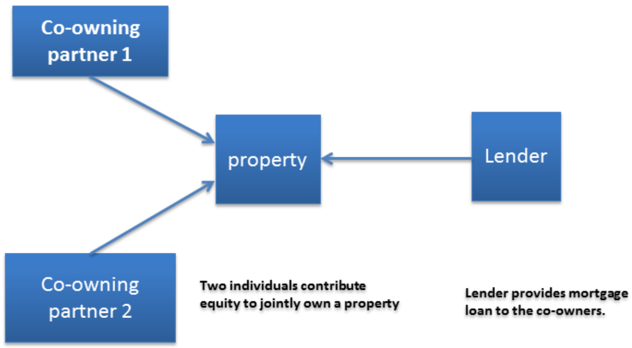
[140] *Redeemable Ground Rents*, H.R. 1597 — Public Law 88-9, approved April 10, 1963 summarized at http://www.jfklibrary.org/Research/Ready-Reference/Legislative-Summary-Main-Page/Legislative-Summary/Taxes.aspx. Based on this law, *Ijārah muntahia bi tamleek* was approved as a mortgaging instrument in the United States.

[141] Op. Cit., Shukla.

1. Benefits:
    a. The concept helps low and middle income earners to make a purchase;
    b. It is an effective means to own property when mortgage finance is not widespread and mortgage payments may be high; and
    c. It may be an effective tool to manage rental costs when market rents are rising.
2. Difficulties:
    a. In India, the concept only applies to new construction and not purchases of existing property;
    b. The home-buyer has to generate more cash to buy out the financier; and,
    c. The financier may have to deal with more parties than the home-buyer, especially in the case of delinquencies.

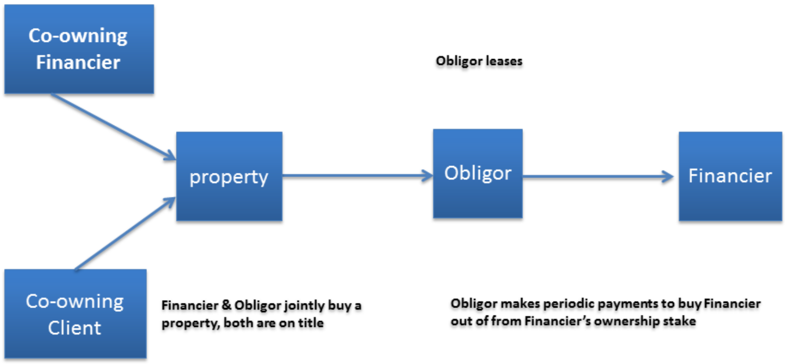
Figure A5.5: Conventional Shared Equity 1



Source: SHAPE™ Financial Corp.

In conventional shared equity, the co-owners often secure a loan from a traditional lender. Their joint equity is sufficient to qualify for the loan.

Figure A5.6: Conventional Shared Equity 2



Source: SHAPE™ Financial Corp.

Another version of shared equity has the financier co-owning the property with the obligor. This model is strongly similar to the declining balance partnership concept.

In the midst of the Global Financial Crisis of 2008, the Center for Economic and Social Justice ("CESJ") in Washington, D.C. raised the question of whether or not the proposed methods for saving the banks were truly equitable.[142] CESJ's approach is to corporatize the private equity model by creating the Homeowners' Equity Corporation ("HEC") as a for-profit stock company. In their concept, the HEC buys "foreclosed properties and then enter lease-to-equity arrangements allowing the homeowner to remain in the home, pay the true market cost of the residence, and build equity as shareholders of HEC."

The plan stabilizes the housing market, protects the need of the financial troubled mortgage debtor for shelter, and prevents abuse of the "equity" in the house from being used as a credit card. The simple mechanism allows the tenant to acquire shares in HEC until the value of the shares equal the value of the house at market prices. The program would allow a tenant to sell his or her shares in the HEC; HEC to re-let the house; or HEC to sell if the tenant does not wish to buy the property.

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[142] *A Plan for Saving Homes and Building Resident Equity*, Center for Economic and Social Justice, Washington, D.C. 2008 accessed at: http://www.cesj.org/homestead/strategies/national/homeequitycorp.htm.

Although CESJ intended the HEC model to be applied in addressing the foreclosure fallout from the subprime crisis in America, the model could easily be adapted to serve the need for new housing, either in planned communities or as a form of cooperative to build equity towards a particular house that one would rent from the corporation. The HEC model is designed to achieve scale through leverage.

A5.5.3. Cooperative Societies

The first modern cooperative housing society was documented in 1720 when a fire destroyed large number homes in Rennes, France. The local community pooled resources to develop a multi-family home.[143] Subsequently, the concept evolved in Europe, North America and Australia to address periodic shortages of housing in local communities. The core concept is to pool community resources in order to provide housing for members. Typically, cooperatives address affordable housing issues. A typical motto for a cooperative housing society is that the society "puts people before profits".[144]

Modern cooperative societies often remain local, but achieve scale by engaging management firms to provide customer service, property management, and collect payments. In addition, may modern housing cooperatives attain scale by leveraging. In the United States, the National Cooperative Bank, Fannie Mae and Freddie Mac provide debt to assist cooperative societies to attain scale and serve more customers with more or better housing. In most cooperative housing societies, the members acquire ownership of their home, and therefore are sometimes called terminating building societies[145].

The historical means was periodic monthly contributions by members into a common pool until each member was qualified to obtain loan or a home. More modern cooperatives have been established to facilitate home acquisition, especially in the low to moderate segment of the population when banks decline to lend, or when sub-segments of society feel

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143 Siegler, Richard and Herbert J. Levy, *A Brief History of Cooperative Housing*, Washington, D.C., National Association of Housing Cooperatives, undated, accessed at www.coophousing.org/.../NAHC.../nahc%20history%20Siegler.PDF.

144 http://www.breez.com.au/index.php/about-housing-cooporatives.

145 http://www.breez.com.au/index.php/about-housing-cooporatives. These were first established in England in 1780. Refer to Appendix 2 for a review of how the terminating building societies evolved into permanent building societies and savings & loans institutions (SLI).

excluded. As a result, cooperative societies tend to have a common bond: same workplace, same ethnic or religious community.

There are three types cooperative housing system:[146]

i. Rental Coop – where the Coop owns house and land. The member pays rental but have no involvement in the asset value.
ii. Limited Equity Coop – where there is some equity contribution by the members (through savings or personal loan) and the remaining is funded by the coop (through corporate mortgage). The members buy occupancy right in the property (not at full MV). When members are leaving, they sell their equity shares at certain agreed formula, which allows some capital gain, but not at full market value. This model is applied in Sweden for example.
iii. Full Market Value Coop – similar to limited equity coop but members buys the occupancy right at full market value and when they leave the coop their shares are sold at full market value. This is applied in the US (New York), Portugal and Spain for example.

In Australia where cooperatives are regulated by law:

> "The societies had a fixed life, usually between twenty-six and thirty-one years, and a limited membership - usually between thirty and one hundred. Most members would join at the beginning of the society's life; however provision was made for late entry. Members when joining a cooperative applied for a number of shares, each share entitling the member for a loan. Monthly subscriptions were paid on each share at a rate determined by the nominal life of the society and notional interest rate on which it is based. After taking the loan the member paid an additional sum each month which represented interest. As subscriptions were received the indebtedness of the society was reduced and when the loans were completely repaid the society was wound up."

Cooperative housing societies are member owned mutual financial institutions or real estate companies. Unlike credit unions, which are also member owned common bond organizations, cooperative housing societies are not licensed to take deposits. This means that the housing societies are dependent on member contracts and wholesale funding from banks and the

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[146] With special thanks to David Rodgers, the President of International Cooperative Alliance Housing (ICA) and Executive Director at Cooperative Development Society (CDS) Ltd UK

financial markets. On the one hand the ownership structure means that the cooperatives are better able to manage member problems. On the other hand, they are subject to constraints caused by restrictions in the lending markets.

India has a well-developed cooperative society system which is exemplified by in the Tamil Nadu Cooperative Societies Act, 1983 and Rules 1988.[147] Through a specific Cooperative Housing Department, the operations of housing cooperatives are closely regulated down to the loan type, purpose, amount, interest rate, and penalties for late payment. The goal is to develop a diverse universe of societies that address areas not reached by commercial banks. The societies are meant to encourage savings and self-help. Cooperative loans may be used by members to build homes, acquire land and develop master planned communities for members, or to maintain properties. The means of service may include leases. The Tamil Nadu scheme has been biased towards rural areas, and has resulted in the delivery more than one million homes to members of the various unions.

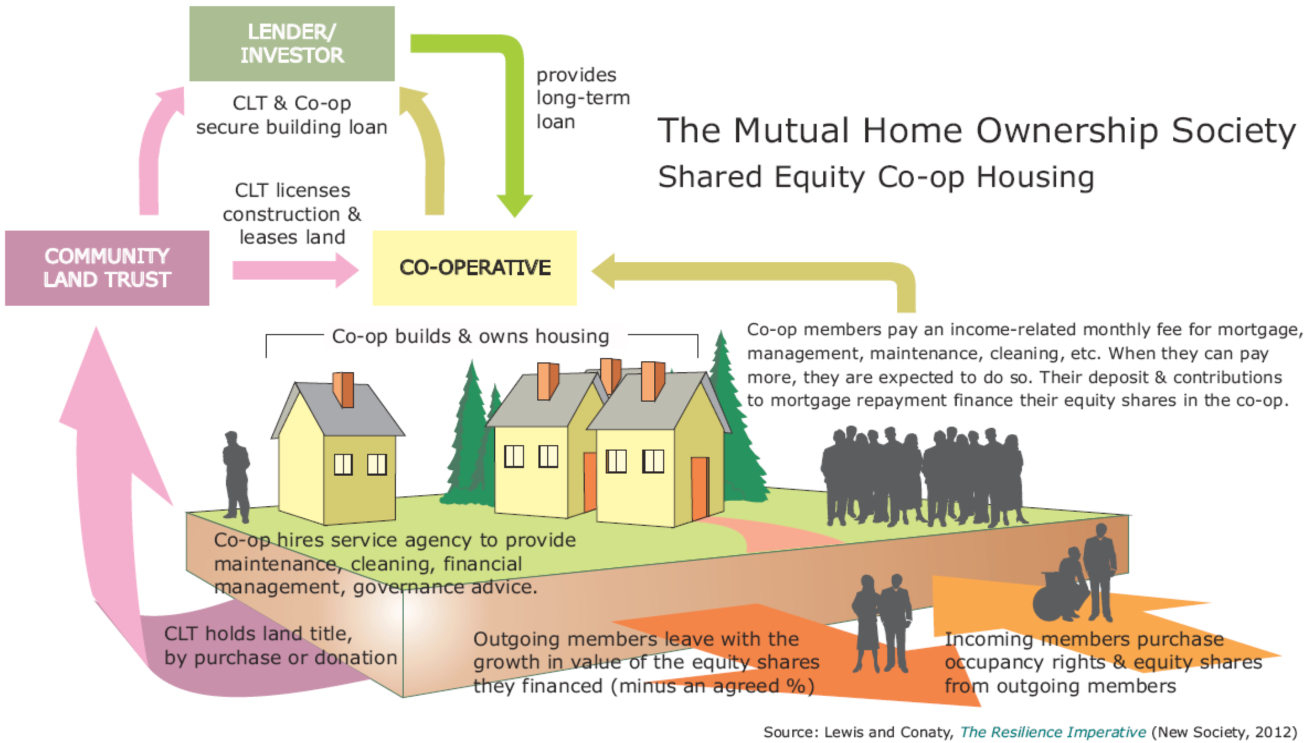
CDS UK has proposed a mutual home ownership model based on limited equity cooperative.[148] The model aims to provide housing for the intermediate market segment i.e. those who do not qualify for subsidized rented house (i.e. low income) but cannot afford to get a house in open market. Thus it targets to increase home ownership and not merely rental housing.

The model relies on separation of the land cost form the building cost to provide affordable housing. Government or local authorities will provide land as grant, subsidy, or offered at below market value. To avoid windfall gain (speculative increase in land value), the land will be held by a Community Land Trust (CLT). The CLT will lease the land to a Cooperative which will take a corporate loan to fund the construction. Members of the coop will have also have limited equity in the Coop. Refer to Figure A5.7 for illustration of the model.

During construction, the coop will take a short term corporate loan.[149] This will be rolled over into a longer term loan upon completion. The interest during the construction will be capitalized into the long term loan. Once

[147] www.tn.gov.in/rti/proactive/hud/handbook_rcs_housing.pdf.
[148] The information about this model is based on interview with David Rodgers, (Lewis & Conaty, 2011), (Rodgers, 2009) (CDS Coop, Third Draft)
[149] This manages issues of the individual members that may not qualify for retail mortgage.

Figure A5.7: The Mutual Home Ownership Housing Model



Source: (Lewis & Conaty, 2011)

the houses are completed, members will pay rent to the Coop. The occupancy charges are based on income of the members (35% of net income after all deduction). However all of the members pay the same revenue cost (maintenance, management and service cost)

The more a member pays monthly, the more shares they earn in the coop. The value of building financed by the loan is divided into equity shares with a base value of £1,000 each. For example, if a member finances 60% of a house that costs $1,000,000, he or she will have 60 shares. For a more detailed illustration of the different payment that will be made by members and the shares they will earn, refer to Table A5.1.

When a member is leaving the coop, he or she may sell his share to other members according to certain formula. Recall that this is limited equity coop model. Thus, the selling price of the share will not be at full market value. This is to provide an affordable option for the intermediate market segment and to prevent property bubbles. Besides bank funding, the Coop may also obtain funding from pensions and life insurances companies that are looking for long term stable investment. Since the coop owns the asset, the funding will be secured with the assets.

One pre-requisite to apply this model in emerging countries is the availability of suitable legal and financial framework. It is vital that the role and responsibilities of the Coop and the CLT[150] are properly defined and regulated. A coop in Leeds (LILAC) has applied the model, although the land was purchased by the founders instead of obtaining it via a grant. Low Impact Living Affordable Community (LILAC) aims to create communities that live in affordable and sustainable housing with low environmental damages. [151]

[150] In many Islamic countries these could be structured with waqf properties as the owners of the ground, and the improvements being owned by the cooperative.
[151] Refer to www.lilac.coop for more information

Table A5.1: Monthly Rental and Equity Shares in the MHOS model

1	Total Net Household Income	£14,406	£16,688	£18,845	£23,108	£26,318	£32,738
2	35% of net household income for housing costs	5,077	5,841	6,596	8,088	9,211	11,548
3	Less revenue costs payable for all members						
	i) Management	33	33	33	33	33	33
	ii) Maintenance	53	53	53	53	53	53
	iii) Service Costs	18	18	18	18	18	18
4	Net monthly payment for corporate mortgage loan repayment	319	382	445	570	663	850
5	Capital value of corporate loan serviced	64,336	77,190	89,892	114,997	133,900	171,707
6	Number of equity shares funded by monthly payment	64	77	90	115	134	172
7	Add equity shares paid as 5% deposit	7	9	10	13	15	19
8	Total equity shares owned	71	86	100	128	149	191
9	Monthly cost of each additional equity share	4.95	4.95	4.95	4.95	4.95	4.95

Source: (Lewis & Conaty, 2011)

The early housing cooperatives and their evolutionary elements are not meant to be full financial institutions. In Germany, the alternative to the basic housing cooperative developed in the form of the modern credit union.

A5.5.4. Credit Unions

The first credit unions were established in Germany in 1852. The concept expanded quickly to Italy, the United States, and Canada. The base concept is to assist people of a common bond with a need to save for a particular purpose. The evolution in the United States is state-by-state and evolved from so called unauthorized "people's banks" serving groups of factory workers. A 1908 conference led to the formalization of the Massachusetts credit union act, which then became the model for the United States.[152]
The credit union movement was originally based on common bonds, and common bonds have included labour unions, ethnic groups, and church bodies. The original goal of secured savings was cycled to housing, and now to auto and consumer goods finance. Generally, the limited scope of credit unions has meant that they are easier to establish and subject to lighter regulation. The breadth and depth of common bond bodies continues to be strong in developed countries and has inspired more than one Islamic finance experiment starting with the Mit Ghamr Savings Society in 1963.

Evolving at the same time as credit unions were building societies, savings and loan associations, and thrift societies. In the non-credit union models, the common bond is not an obligation, but geography was typically the binding element between savers and the society. Although not precisely special purpose, especially over the years, the simple operating procedure was that depositors fund mortgages. Prior to interest rate deregulation, the concept of borrowing at a fixed cost and lending at a fixed cost was not as problematic as interest rate risk was effectively controlled by regulation. This left the savings institution with the risk of matching funds, since deposits are necessarily short term and mortgagees are normally long term. The concept of core deposits allowed a bank to treat a specific portion of its short term deposits as if they were long term. In the event of liquidity events, countries like the United States developed liquidity refinance vehicles which are discussed below.

[152] http://www.ccul.org/01consumers/cuhistory.cfm.

A5.5.5. Contractual Savings for Housing (CSH)

CSH originates from mutual building societies. The housing loan will be linked to savings contract, at below market. Savings are callable daily, but to get loan, there must be minimum savings period. There are two types of CSH:

- Closed system (savings from potential buyer - Bausparkassen in Austria and Germany). This scheme offers fixed rate on both side. So there is low interest rate risk, but may have liquidity risk if there are not enough savers.
- Open system (use capital market funding if deficit in savings - l'Epargne Logement in France). This scheme manages liquidity risk by accessing capital market funding, but this means it faces higher interest rate risk since it cannot offer fixed rate.

German started and remained with closed CSH. France started with closed CSH in 1965 but modified it to open CSH in 1970 due to high inflation. Alternatively, Austria has implemented a semi open scheme - fixed rate with inflation indexation to manage inflation risk.

The World Bank worries that CSH essentially shift the risks of housing finance to depositors.[153] This risk transfer is based on the nature of CSH. A depositor must contract to save a specific amount each month, and build the total savings to a particular amount in order to receive a loan to purchase a particular house. If the depositor fails to build up savings or misses payments, then either loan eligibility or timing will be affected. There may also be issues about the gap financing. In Morocco housing reform included government sponsored CSH establishment of contractual savings schemes for housing.[154] Refer to Appendix 4 for the challenges faced by CSH in different countries; Czech Republic, Hungary, Tunisia and Iran for example. The challenges related to either excess liquidity (due to subsidy rate or deposit rate control elsewhere) or deficit (due to too high loan multiplier).

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[153] Nenova, Tatiana, *Expanding Housing Finance to the Underserved in South Asia Market Review and Forward Agenda South Asia Regional Housing Finance Conference January 27-29 2010, New Delhi, India* as presented to Asia Pacific Union for Housing Finance (APUHF) accessed at http://www.apuhf.info/.

[154] Portman, Christiaan; Ahlers, Theodore; Razav L., Hedi; Bigio, Anthony (2005) "International Bank for Reconstruction and Development Program Document for a proposed Housing Sector Development Policy Loan to the Kingdom of Morocco", June, World Bank Report, cited in Hoek-Smit.

An important benefit of CSH means that the normal loan qualification standards can be relaxed as the customer must adhere to the savings contract. This helps minimize credit risk and information opacity as the borrower is building up equity, and establishing the willingness and ability to pay. Dubel (2009) views CSH as a suitable alternative to banking system in the emerging market as it manages credit risk. However, it recommends that CSH is best offered by building societies, in addition to other house financing options offered by the building society. This means, CHS is suitable for certain segment of the market, but is not the only solution offered by the building society. Dubel (2009) also reminds that it is crucial to properly design the CSH (semi open scheme with proper loan multiplier) and avoid subsidizing the deposit rate as this will crowd out other types of deposit.

A5.5.6. Insurance Linked Products

Either endowment products structured to pay off a mortgage or a plan similar to the CSH concept. The former concept is common in wealthy countries and is often cross-sold as a bancassurance product. Endowment products are an alternative credit protection product.
The CSH approach is based on a life insurance loan, which is used to fund a home purchase. In some countries, like Hungary, the loans may be in local currency or foreign currency. The loan is secured and the customer makes periodic payments as part of his or her scheduled premium payment.[155]

A5.5.7. Mortgage Banking

This form of business is fundamentally a non-deposit taking finance company in which the mortgage provider is reliant on third party funds. A typical mortgage lender either sources mortgages for closing and funding by a third party (a brokerage function) or applies its own capital and borrowed funds to close mortgages. In the second case, the mortgage bank "warehouses" mortgages to be sold to investors, either deposit taking banks or as packaged securities.

The model poses significant liquidity risks if the mortgage bank finds no buyers or originates the "wrong" type of transaction. This is essentially the Northern Rock problem, once there were no buyers for warehoused mortgages, the bank's financiers withdrew. In the case of Northern Rock, it

[155] http://www.ergo.hu/index.php?id=331.

was a deposit taker. But, in the United States, mortgage banks have suffered failures with each housing crash.

A5.5.8. Self-Build Programmes

Self-build programmes have existed in many markets and have even been structured to serve expatriate workers.[156] Many countries operate microcredit programmes to facilitate low income families buying construction materials to build small family homes. This is known as Housing Micro Finance (HMF). This program was successful in Peru where microfinance performed better than banking in general and there was leading MFI that promoted the industry. In Guatemala, the HMF providers have been successfully funding the low income group with low default rate. However, since there is no regulatory framework, the HMF had difficulty scaling up since they cannot raise deposits. The government is in the midst of setting up a fund guarantees bank loans to HMF.

Another main challenge for such programmes is that families are not necessarily trained in building a house properly. Worse, the debtor in these programmes may not be able to complete the home faster than natural elements cause deterioration to the property. Success in self-build finance turns on house size and affordability of the materials. Smith warns that a risk with self-building projects is that the client is unable to finish the project, and the farther down the income chain one moves, the greater the need for monitoring in order to be able to account for all funds.[157]

Related to the building standards, Fathy (1976)[158] highlighted that to truly enable a self-sustainable building method, the building materials used for the poor must be based on local, costless material[159] that does not require skilled labour to handle (beyond what the poor can afford – village mason or carpenter). This will not only stimulate local craft, but with also revive initiative in building that will be infinitely more powerful than any ready-made government building programmes can offer.

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[156] Warnock, Veronica Cacdac Francis E. Warnock, Markets and Housing Finance, October 24, 2007 accessed at http://ihfp.wharton.upenn.edu/. The Warnocks document Cemex's tapping into expatriate remittances to deliver cement in lieu of cash in a program that involves global retails. (Warnock & Warnock, 2008)

[157] Op. Cit., Smith, Brazil.

[158] Although he was discussing in the context of building for the peasant, the recommendation regarding building material is beneficial and relevant at least to the low income group.

[159] Fathy recommends using mud bricks in Eygpt for example

As simple as credit for self-building seems to be, some countries like Namibia had to introduce a “Flexible Land Tenure Act” in order to address the changes in how property is used in a self-building environment.[160]

One of the areas that could benefit from further support is the development “planned communities” for self-builders. Such a community is based on a master plan that lays out public spaces and infrastructure including SEW, roads, transit, shopping and places of worship.

The World Bank recommends that rather than using HMF to provide subsidy (which contradicts with its objective of creating financial sustainability), it is better to link commercial banking with HMF. Nonetheless, it’s better if commercial banks offer micro finance portfolio that includes HMF to have better risk diversification.

This section reviewed diverse group of products which are not traditional loans. Some of these have concepts have embraced loans as part of a solution that includes a financier’s equity participation or communal participation or corporate ownership of property leading to later individual ownership. Such strategies are typically pursued to assist in the filling of gaps left by conventional lenders, and rarely scale beyond a particular level. Often the shared equity and cooperative concepts are more complex than traditional loans and require more consumer education.

> “Cooperatives and credit unions can also provide credit to their members, including, in some cases, small loans for housing purposes, particularly if a potential borrower has access to land. Generally these loans are only marginally larger than the other loans on offer as the lenders have to manage quite carefully the relationship between their short-term and longer-term funds.”[161]

A5.6. Government Intervention

Often the concern is that the market will not address housing finance unless the lending environment is perfect, i.e. de Soto’s conditions are in place. As a result, a number of governments intervene in different ways including different forms of subsidies and market support financial organizations.

[160] Op. Cit., FinMark Trust, Yearbook, p75
[161] Tomlinson, Mary R., A Literature Review on Housing Finance Development in Sub-Saharan Africa, Commissioned by FinMark Trust, May 2007.

A5.6.1. Types of Subsidies

Hoek Smit (2009) highlights that although subsidies are often perceived as giving or receiving for free, it is more accurate to define subsidies as incentives to change behaviour either of consumers or lenders and producers of housing. She discussed three main groups of housing finance subsidies:[162]

- Supply side: includes investor (debt & equity finance subsidies), and production subsidy (grant and tax subsidies).
- Demand side: rental vouchers provided to low income group
- Subsidies to households: different solutions provided to households because subsidies to developers were misused or inefficient.

Hoek Smit (2009) reminds that although interest rate and tax subsidies are the most popular types of subsidies, they are not transparent and not effective. These subsides tend to benefit the higher income group more as they take higher loans (thus gets higher interest rate subsidies) and the low income group may not even fall under the taxable groups (thus not benefit from the tax subsidies).

Hoek Smit's (2009) main recommendation was, in order to be effective, a subsidy should be based on actual problems or constraints that the different groups of household face. For example, the lower middle income groups are more bankable than the low income group. Therefore, this group may qualify for a (market based) mortgage if the subsidies provided correctly tackle the constraints that prevent them from obtaining mortgage. If they have problem saving enough for the down payment while also currently renting, it's better to provide direct payment (cash grant) or use a savings scheme (based on market rate) to enable them to make the down payment.

Another constraint that this group faces is high variability in their income. This means they might have problem with a fixed monthly payment. To manage this, the banks themselves may use a flexible payment scheme or blocked deposits to cover any missed payments. The most effective subsidy in this scenario is contribution to the blocked deposit. Last but not least, this group also faces high collateral risk (i.e. the decrease in the value of the properties) because of the neighbourhood they are in. To effectively

[162] Refer to Appendix 2 for details on the different types of subsidies.

manage this risk, besides having insurance, the most effective solution is to have a maintenance fund and educate the consumer on the importance of maintenance.

For the low income group, they are usually not bankable. So rather than focusing enabling mortgage financing for this group, it's better to focus on land ownership and home improvement grants. However, before considering the most suitable subsidy, she suggests that the government should improve land registration, subdivisions, permitting procedures so there is clarity on at least land ownership. One of the most suitable subsidy to this group is a grant of serviced land; either to the household or the developer. Once they have the land, the household can build on the land. This is where the microfinance for home construction or home improvements plays a role. If they don't qualify for the HMF, then the government may choose to provide direct grant for home improvement.

As a long term solution, the government should focus on developing the HMF industry. An effective way to do this is by reducing the transaction costs that HMF institution faces (in disbursing and monitoring many small loans). This can be done by paying the HMF a fixed amount per household. In addition, the government may also contribute to a blocked deposit to manage the problem of "missed payments" to the HMF. Finally, Hoek Smit's (2009) also recommends that the government should focus on developing a community based support program that buys materials in bulk, instills quality control on the material purchase and construction, and develop a community savings program which will provide this group the financial sustainability.

A5.6.2. Selected Countries Experiences

This section will examine two broad groups of country experiences related to subsidy implementation and other community programmes . In Jordan, the government has applied numerous programmes to support housing development. After 2000, the government changed its strategy and introduced an interest rate buy down subsidy.[163] On the one hand, this was

[163] In interest rate buy down, the government pays the private lender certain amount of the full market interest rate. For example if the lender charges 15%, and the government chooses to pay 5%, the borrower only has to pay 10% interest. In the normal interest rate subsidy, the lenders are encouraged to charge below market rate interest on the housing loan. Interest rate buy down is more transparent than the traditional interest rate subsidy because the government may estimate the total cost and is not subject to unknown future costs.

viewed as more transparent than prior programmes . On the other hand, the subsidy is designed to complement private sector involvement in housing finance. The subsidy is in place for the life of the loan which is usually 20 years. The subsidy is paid out of a special fund, and is meant to be self-sustaining based on loan payments. The beneficiaries of the subsidy are targeted and the applications include home or apartment purchases, improvements or plot acquisition for self-construction.[164]

In contrast to the Jordanian interest rate buy down, the Chilean subsidy is made up front. The subsidy is directed to first time homebuyers to use for down payments when borrowing from private lenders. As with Jordan, the subsidy targets a specific market segment and favours lower priced properties purchased by lower income households. The subsidy is allocated by a point system and only about 20% of the relevant applicants are approved. The program is adjusted for types of housing and beneficiary needs from time to time. Historically, the program has struggled to benefit the lower income ranges.[165]

From 2001 to 2003, Indonesia ran the Co-BILD (Community-Based Initiatives for Housing and Local Development) in conjunction with the UNCHS and funding by the Dutch government direct through the UNDP. Mumtaz Babar summarized the objective:

> "Co-BILD aimed to lower the costs of housing provision through incrementally built, sequentially financed housing and community-based initiatives (collective acquisition and development of land and infrastructure)."[166]

Co-BILD program delivered revolving loans to community groups in twelve Indonesian cities. The community groups then disbursed funding to neighbourhood bodies which used the funds for local projects ranging from housing construction, land acquisition, or property improvements. The loans were made at market interest rates. Although the reach was meaningful, the international funding ended and the project was not integrated into any other financial infrastructure.[167]

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[164] *Source: Diamond et.al, 1999* cited in Hoek-Smit.
[165] *Source: Ruprah and Marcano, 2007;Hoek-Smit and Diamond, 2008; Pardo 2001; Rojas, 1999 cited in Hoek-Smit.*
[166] Mumtaz, Babar (2001) *"Non-Conventional Housing Finance for Indonesia*", Habitat Debate, Vol.7 No.2, www.unhabitat.org/hd/hdv7n2/supp_community_based_housing, cited in Hoek-Smit.
[167] IBID.

When the Kingdom of Morocco initiated its 2004 Cities without Slums program ((*Villes sans Bidonvilles* (VSB)), the Kingdom learned that the effort to eradicate slums was not possible because most of the target beneficiaries were unable to pay for either new housing or serviced lots. Therefore, the Kingdom has reformed the program by adding:

1. A mortgage guarantee ("FOGARIM") – This is administered by the Caisse Centrale de Garantie and is funded by the Housing Solidarity Fund of the Ministry of Finance and Privatization from a tax on cement. The guarantees cover 70% of loan principal and are directed towards borrowers with irregular sources of income;
2. Micro-finance for housing; and
3. Contractual savings schemes for housing.[168]

The FOGARIM guarantee has also impacted the market by allowing banks to reduce interest rates and stretch tenors (now out to 25 years from seven). Concerns about the FOGARIM program include the fact that monthly payments are low and the high degree of coverage seems to disincentivize banks from performing sufficient underwriting of borrowers. The program has also drifted towards plots compared to ready to live in housing.[169]

In the Philippines, the government administers the "Community Mortgage Program" which focuses on the bottom 30% of society by providing financial assistance in the form of a low interest loan for 25 years to help people to buy the land that they currently occupy. Beneficiaries of the program must have already participated in a microfinance program, thereby validating their capacity to perform. The loans are "community" in the same sense as traditional microfinance as groups of applicants are responsible for monitoring each other's performance. The community mortgage program has struggled building a good repayment record and has improved collections from 75% to over 85%.[170] The model, however, can be scaled and applied in higher income cohorts.

Where the Philippines uses the community mortgage program to formalize what is effectively slum occupancy by transferring ownership to the

[168] Op. Cit., Portman from Hoek-Smit.
[169] Op. Cit., Hoek-Smit.
[170] Carandang, Jr., Florencio R., *Low-Income Housing Finance in the Philippines: Community Mortgage Program*, *Social Housing Finance Corporation*, Asia Pacific Union for Housing Finance (APUHF) Workshop on Housing Finance, 26-29 June 2011, Ulaanbaatar, Mongolia accessed at http://www.apuhf.info/.

households, Mozambique has focused on acquiring serviced lots to deliver to future occupants. Through the Housing Promotion Fund (Fundo de Fomento de Habitação or FFH) Mozambique acquires land, provides SEW, road connections, and title. The fully serviced sites are sold to individuals to construct basic housing, which is typical incremental self building. The project faces difficulties as demand for serviced plots exceeds supply and banks will not use the plots for collateral.[171]

Latvia, South Africa, and Thailand have done in-depth surveys of housing problems and subsidies to come up with medium-term strategic plan for the sector. Several countries have recently engaged in such processes, for example, Brazil, Mexico, Peru, Colombia, Korea, Indonesia, Vietnam, and Morocco. In Thailand, development and building standards for rental and ownership housing were lowered in the 1980s (for example, unit size of 20 square meters) to allow an increase in affordable housing supply without additional subsidies.

Up until now, our focus has been on single family housing finance. But, multifamily is another means to address housing issues. A common tool to manage the direction of investment to multi-family housing for low and moderate income families is the use of tax credits. These may be used to incentivize developers and owners to focus on market sub-segments or geographic locations or to improve quality. In the United States, the federal government funds the program through the Department of the Treasury which issues tax credits. The credits require that the housing funded under the program remain “affordable” for 30 years. The maximum federal funding is $2.30/resident of each state with the state making the determination of how to use the money. Subject to the state’s allocation criteria, developers are funded. The state funds help to reduce market debt and allow the projects to operate with lower debt, thereby allowing lower rents. Typically, the projects serve families with income that is 60% or less of the local area median income and tenants pay rent that is up to 30% of their income. Investors can buy a connected ten year tax credit.[172]

In summary, Subsidized programmes have proven effective band aids to address a number of general real estate risks. Yet, these programmes often create a situation in which the customer’s main issues are not addressed, whether these are real estate or job related. Hoek Snit (2009) recommends

[171] Op. Cit., Housing Finance in Africa FinMark Trust P.70. FFH also provides low interest loans terms of 5 to 20 years. In other countries, the form of subsidy is a grant in the form of serviced lots which can be used as collateral.

[172]Accessed at: http://www.enterprisecommunity.com/financing-and-development/low-income-housing-tax-credits/how-low-income-housing-tax-credits-work.

that the best approach in implementing subsidies is to first do a comprehensive survey of housing problems in a country. This should be followed by a thorough removal of regulatory constraints; unnecessarily strict building, planning, and subdivision standards, poor property rights etc. Only after these steps are taken, the most effective subsidy should be considered. Although interest rate and tax subsidies are the most popular subsidy, these are the least effective subsidy as it is not transparent and tend to be regressive (benefit the higher income group).

A5.7. Hybrid Products & Services

This section reviews two broad group of solutions; housing provident funds (HPF) and public private partnerships (PPP). Successful solutions commonly involve a number of well thought out and complex hybrids have been developed that combine government enforced savings, government standardized multi-family residences, and urban renewal as a combined package.

A5.7.1. Housing Provident Fund (HPF)

Housing provident funds (HPF) are long-term saving schemes that operate through mandatory contributions by employee and sometime employer. HPF collects mandatory saving, manages this, pay below market return and allow member to withdraw for down payment of housing investment, or get a long term mortgage at preferential rate (either from HPF or other financial institution). Some HPF also functions as retirement savings. HPFs were created when private lenders were not active in long-term housing lending, as a self-funded housing finance system.

HPFs were created in many emerging economies, including Mexico, Nigeria, Brazil, Jamaica, the Philippines, and China. There are two variants in application; HPF is a direct lender (as in Mexico and China) or HPF is not the direct lender (as in Brazil or Singapore). The lessons from different markets show different results. The HPF in Singapore was successful, while the HPFs in many other countries faced many challenges and required restructuring.

Established in early 1960, the Housing Development Board of Singapore (HDB) sought to address chronic formalized housing problems in the country. At the time, as much as ten percent of the population resided in "unhygienic slums and crowded squatter settlements".[173] The HDB began a program of land assembly and multi-family housing development that resulted in the percentage of Singaporeans living government sponsored flats increasing from 9% to 84%. The HDB attributes its success to be based on it being the only government body responsible for public housing strategy and implementation. This allowed HDB to achieve scale in accessing materials and negotiating construction contracts.[174]

The HDB originally enjoyed bi-directional funding from another government agency, the Central Provident Fund ("CPF"). Today, HBD is fundamentally funded by the government through Government Grants and Loans. CPF has subsequently become a funding source by purchases of HDB bonds issued.[175]

Until the 1990's, CPF deductions from payroll earnings were 40% and used to fund HDB land acquisition, construction, and project management. As the national housing needs have been largely built out, the CPF has redirected its investment focus to government securities. In other words, the house lending function (HDB) was separated from the provident fund operation (CPF). CPF focuses on efficient investment of the funds. People can borrow from CPF for down payment required by HDB (20%) and mortgage payment, but this must be repaid to CPF.

In the past, HDB provided both market rate and subsidized loans. However, since 2003, HDB no longer provides market rate loans. Those who qualify for a market rate loan must get from commercial bank. These borrowers can use their CPF savings for their required down payment.

The Singaporean model has been adopted in the People's Republic of China ("PRC") as it seeks to consolidate and improve its various housing finance approaches. The PRC had to change its vision of housing from a social welfare model with an undersupplied and non-market rent based housing product. During the transition to a more market oriented economy, the existing housing product deteriorated rapidly. The PRC's experiment with a CPF/HDB style model began in 1991 in Shanghai with the Housing Provident Fund ("HPF"). Like the CPF, the HPF "is a compulsory housing saving program in which both employers and employees contribute a certain percentage of the employees' salaries, initially set at 5 percent, to

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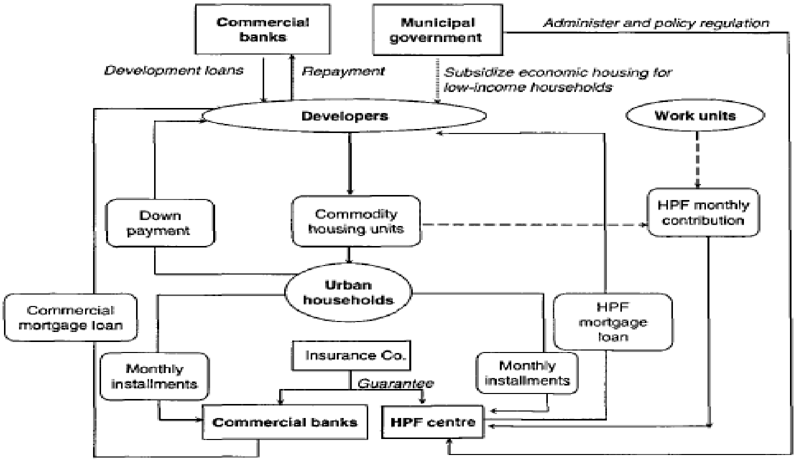
[173]Accessed at:
http://www.hdb.gov.sg/fi10/fi10320p.nsf/w/AboutUsHDBHistory?OpenDocument.
[174] IBID.
[175] For more information, see: http://www10.hdb.gov.sg/ebook/ar2011/financial.html.

HPF accounts administered by the China Construction Bank."[176] The system now integrates commercial lenders and mortgage guarantees. The overall structure of China's current mortgage market is illustrated in Figure A5.88[177]

Figure A5.8: The Framework of the Housing Finance System in China



Source: Deng and Fei (2008)

Singapore and China share a substantial population of formal wage earners unlike many IDB member states which continue to have substantial informal labour markets. As a result the forced savings model has limitations based upon how housing applicants earn their income. In addition, one of the main challenges for HPF is that it ends up helping those in preferential credit position and not the lower income group. In other words, the low income savers actually cross subsidize the higher income group (who gets higher loan at preferential rate), while their savings are remunerated below market rate. This is among the classical challenge faced in China. This was also Brazil's experience. The HPF in Brazil pays a lower rate on their deposit even compared to savings scheme. To have a fairer scheme, and restructure the high NPL it suffered, it focused on the lower income groups (with upfront subsidies) and stopped

[176] Housing Policy and Finance in China: A Literature Review, Prepared for U.S. Department of Housing and Urban Development, Prepared by Lan Deng Qingyun Shen Lin Wang, November, 2009.

[177] Deng, Yongheng, and Peng Fei. 2008. The Emerging Mortgage Markets in China. In D. Ben- Shaher, C. K. Y. Leung & S. E. Ong (Eds.), *Mortgage Market Worldwide* (pp. 1-33): Blackwell Publishing.

lending to higher income groups (10 times the minimum income) since 2005.

Mexico has two HPFs; private sector (INFONAVIT) & public sector (FOVISSTE). These HPFs suffered from political influence to provide subsidized lending. As a result it had high (30-40%) NPLs. The private HPF reformed accounting, procedure (origination, collection, tracking etc) and governance (risk mgmt committee) to restructure itself. The HPF in Philippines has multiple mandates (housing, retirement etc) and suffers from substantial financial reporting and weak asset liability management.

Chiquier (2009) recommended the following policy lessons to implement a successful HPF:

1. There needs to be clarity on mandate and governance. There should be separation of housing finance from pension investment (like HBD and CPF). HPFs should be regulated by financial regulator not other ministries.

2. When commercial banks have entered the market, HPF should revise their focus on low income and not middle income. HPFs need to develop co-financing, let other lenders use the savings as down payment or guarantees, and target the subsidy element only for the underserved groups. For middle income groups, it is better to encourage them taking commercial loan rather than giving them subsidized lending. Such reforms have been initiated in Brazil by the Fundo de Garantia do Tempo de Serviço (FGTS) and in Mexico by INFONAVIT.

A5.7.2. Public Private Partnership (PPP)

Turkey has taken a slightly different approach in which it works in a public private sector partnership ("PPP") led by the Housing Development Administration of Turkey ("TOKI"). The goal is to develop government land for multi-family housing catering to the large mass of under-housed citizens. The process involves public tenders for private developers to submit plans to develop housing on government land. The housing may be rental or sale housing. Under the program, the developers do not have to buy the land and receive title upon completion of the units to TOKI's specifications. The method has delivered over 500,000 units since its inception 25 years ago.[178] In recent years, the Turkish Capital Markets Board has authorized real estate investment trusts ("REITs") and the first Turkish REITs have specialized in the TOKI housing development program.

In India, the government through the state owned development Bank (ICICI) invested 5% capital together with private capital to form the Housing Development Finance Corporation (HDFC) as the first specialized housing lender in India in 1977. The government guaranteed HDFC's debt and directed insurance companies to fund HDFC, declared that loan to specialized housing finance companies qualified for priority lending quota. HDFC proved that housing finance is possible even when the legal infrastructure (foreclosure and repossession) is not fully developed. . It launched retail deposit and a bank subsidiary in 1991 and 1995 respectively. In 2005, it held 28% of the mortgage market share in India.

Although the same model (HDFC) was tried in Bangladesh and Ghana, it was not successful because of unfavourable context. There was lack of efficient external funding and negative impact of a State Housing Bank (SHB) in one case, and, macroeconomic instability in the other. This shows that an institutional model in itself is not enough. It's vital to have a conducive structural and environment conditions for housing finance to thrive.

A5.8. Models of State owned Specialized Financing Institutions

This section will summarize two approaches in state owned specialized financing institutions. First, institutions that are involved in providing finance in the primary market. Although this is a popular approach as it's a clear sign of government will, this approach has resulted in more failure than success. Then, the section will review institutions that play an active role in the secondary market and have experienced a much higher success rate.

A5.8.1. State Housing Bank (SHB)

Many financial historians understand the Prussian Pfandbrief to have been the first modern effort of the state to intervene in support of housing finance. The first "landschaft" or mortgage bank was created by decree of

[178] Op. Cit. Jones Lang LaSalle.

Frederick the Great following the Seven Years War in Europe. The idea was to allow the landed gentry to mortgage their properties to secure funds. The concept was followed closely in France and elsewhere in Germany leading to the first specialized hypothecation or mortgage institutions. In 1903, the Frankfurter Hypothekenbank issued bonds with mortgages as collateral, creating essentially the first mortgage covered bonds[179]. The model has been sustained and fine-tuned until now in Europe. The pfandbrief model required government intervention to start, but was quickly absorbed into the private sector. Yet, in the United States, the public sector had to intervene in the market to preserve the market.

Besides a specialized mortgage bank, many countries have established State Housing Banks (SHB) which collect deposits and give out long term fixed rate mortgage. Hassler & Renaud (2009) highlighted three variations of SHBs:

4. Collect deposits (like in Chile, Iran, Thailand etc); or
5. Issue bond because there is limited deposits (Argentina, France, Morocco); or
6. Depend on public finance sources such as mandatory savings or wage taxes, central bank facilities, or government grants and loans (rarest of three - done in Cameroon, Pakistan & Bangladesh).

SHB has been applied in many markets - Latin America, Carribean, Central America, Central & Eastern Europe, sub-Saharan Africa, Thailand, Indonesia, Algeria, Egypt, Rwanda, and Pakistan. This is an emerging trend in a lot in African countries.

Thailand and Chile have implemented a successful SHB models. In Thailand, the Government Housing Bank operates on commercial basis and doesn't depend on state subsidy. It provides lower than market loan because its bond and MBS issuance enjoy a low cost and has a lower capital requirement. It also supported infrastructure development (retail credit bureau, a real estate information centre, and a mortgage insurance scheme). In Chile, Bancoestado was created from merger of four state owned SLI to become third largest commercial bank. Its strategic focus is on low and middle income (25% market share in terms of value, 70% in terms of number of loan). It runs on commercial basis, is subject to the

[179] Manfred-Pohl, Sabine, *Handbook on the history of European banks,* (London: Edward Elgar Publishing,1994), pp. 403 – 404. Also see Op. Cit., IMF p. 115. The IMF also interprets the modern Danish mortgaging system to the recovery after the great fire of Copenhagen in 1795.

same banking regulation, has low NPL, pays higher corporate tax (40%), pays 75% of profit as dividend, and is prohibited to lend to other state owned entity.

However, success is an exception rather than norm. Since the middle of the 20th century there is high frequency of bailouts and rescue operations of SHB. Examples are in Algeria (CNEP, 1997), Argentina (Banco Hipotecario Nacional, 1990–3), Brazil (Banco Nacional de Habitaçao, 1996, and Caxia Federal in 2001), Cameroon (Credit Foncier duCameroun), Colombia (Banco Central Hipotecario, 1998), France (Credit Foncier de France, 1996–9), Indonesia (Bank Tabungan Negara, 1997), Ivory Coast (BHCI recapitalized twice), Pakistan (HBFC, 2001), Rwanda (Caisse Hypothécaire du Rwanda, 2003), Tanzania (1995), and Uruguay (Banco Hipotecario del Uruguay [BHU], 2002).

The SHBs that were successful had good governance, autonomy of funding, and aligned corporate interest with market development agenda. On the contrary, the SHBs that fails are linked to weak corporate governance, lax credit management (don't focus on recovery) and weak risk mgmt. (especially interest rate risk as they offer fixed rate financing).

Hassler & Renaud (2009) notes that "Providing long-term fixed-rate loans may be a reason to establish an SHB, but such an institutional move does not provide a remedy to the underlying issue: creating an institution does not create a source for long-term resources. This confusion often ends up transferring a significant amount of financial risks to the taxpayer."
For this reason, Hassler & Renaud (2009) recommended that it's better for countries to focus on developing second tier institutions. They view this approach to be more efficient than subsidy because the whole primary market will benefit from the creation of such institutions. They suggested commercialization or privatization as the most effective exit strategies for SHB. Refer Appendix 4 for more details.

A5.8.2. Secondary Market Institutions

During the Great Depression of the 1930's, the United States federal government formed first (1932) the Federal Home Loan Bank system ("FHLB"), and then (1938) Federal National Mortgage Association ("Fannie Mae") During the Great Depression to stabilize the housing market. As banks faced runs on deposits and were short of cash, they aggressively called mortgages for the smallest of reasons. The FHLB made advances, as it still does, to banks against collateral of existing mortgages.

Fannie Mae was established to buy mortgages from banks. Both approaches allow the banks have cash to generate new business. Whereas the FHLB provides cash, Fannie Mae provides capital relief by removing the asset completely from the bank's balance sheet. In the FHLB model, the bank retains the obligation to manage the mortgage relationships solely for its own account. In contrast, Fannie Mae could choose to manage the performance risk of the underlying deals and be more lenient than the banks. The original Fannie Mae portfolio was US$1 billion.[180]

Fannie Mae was "privatized" in 1968 and went public in 1989. The business has always operated under a congressional charter and has been obliged to report to the Congress and the Department of Housing and Urban Development. Its mirror Federal Home Loan Mortgage Corp. ("Freddie Mac") as created in 1970 as a competitor to Fannie Mae.

Fannie and Freddie issue securities to buy mortgages. The securities range from straight debt to mortgage backed securities passing the full risk of the underlying mortgages on to third party investors. The model is distinct from pfandbrief in the sense that the straight securities are direct obligations of Fannie and Freddie whereas the MBS are different than covered bonds as the underlying mortgages are not used as collateral for Fannie or Freddie debt, but are sold on to investors directly.

But, even the Fannie Freddie model can be affected by changes in credit criteria and investor appetites. Following the 2008 Financial Crisis, Fannie and Freddie remained active in multi-family lending, but substantially reduced their single family loan purchase programmes reflecting more stringent investor criteria and a reduction in the number of investors due to turmoil in the American retail sector as well as the expected long term role of Fannie and Freddie. Multi-family lending, however, remained robust reflecting economic reality as home ownership rates in the US dropped from 69% to 63% of the population, but household formation remained robust.[181]

Cagamas Berhad (the National Mortgage Corporation of Malaysia or "Cagamas") was established in 1986 to support wider homeownership through the creation of a secondary mortgage market. The Cagamas model

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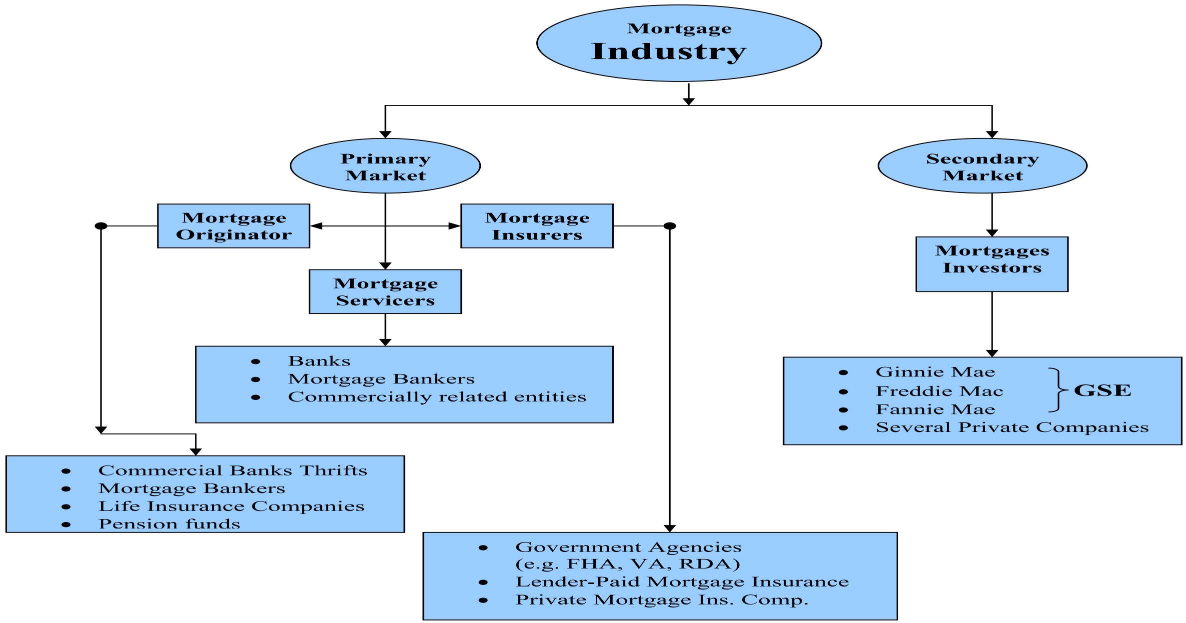
[180] For a summary of the history of Fannie Mae, see: http://www.time.com/time/business/article/0,8599,1822766,00.html.

[181] Private correspondence with Tim L. White, Executive Vice President & Chief Operating Officer of PNC Real Estate, January 9, 2012.

Figure A5.9: Mortgage Industry



Source: Osman Acheampong[182]

[182] Acheampong, Osman, Pricing *Mortgage-Backed Securities using Prepayment Functions and Pathwise Monte Carlo Simulation*, A Professional Masters Project Submitted to the Faculty Of WORCESTER POLYTECHNIC INSTITUTE, May 2003, accessed at: www.wpi.edu/Pubs/ETD/.../etd.../Acheampong.pdf.

is similar to the Fannie Freddie model as Cagamas issues direct obligation debt securities to purchase of housing loans from financial institutions and non-financial institutions.[183] Cagamas is also a substantial issuer of MBS and securities which are similar to covered bonds.

SHBs should aim to correct the fundamental deficiencies if they would like to have a successful operation. In addition, they should focus on the emergence of "market makers" that will provide a catalytic effect on market development.

Most countries which operate secondary mortgage market entities have both a well-developed primary banking market and a sizable and growing middle class. Secondary mortgage activities are rarely able to take off in poorer or small markets in the absence of the two factors. Even then, the Korean model has shown that secondary markets take time to develop. This is because consistent supply, consistent quality, standard documents, and collateral acceptance among investors all take time to become established.[184] As Korea built its economy, the original tools to manage hot or cold housing markets were indirect policy tools involving:[185]

1. Price intervention as policy tool in hot markets;
2. Income and capital gains tax adaptation to prevent flipping;
3. Restriction on number of houses a single customer could have under mortgage;
4. Adjusting the loan to value and debt to income ratios applied in the loan approval process in order to stimulate or restrict market activity;
5. Imposition of mandatory provisioning or relaxation of provisions; and,
6. Manipulation of property registration taxes depending upon heat of market.

Each of these policy approaches implies a developed banking system, a tax system which is honoured, and a properly functioning legal system. As a result, the next step to developing a mortgage purchasing institution and then mortgage securitization is logical and easier to execute. A benefit of

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[183] For more, see http://www.cagamas.com.my and www.adb.org/documents/books/mortgage_backed.../5_malaysia.pdf.

[184] Chung, Chae-Sun, *The Evolution of Mortgage and MBS Markets in Korea* presented May 28, 2009 at the Workshop on Housing Finance in South Asia (Jakarta, Indonesia), Asia Pacific Union for Housing Finance (APUHF) accessed at http://www.apuhf.info/.

[185] IBID.

the mortgage buying corporation is that is can reach non-bank financial institutions which are not necessarily in the primary line of control by central banks and other policy or regulatory bodies. At the same time, since non-bank financial institutions do not take deposits, a secondary market maker is able to improve their quality and market reach.

The primary reason that secondary markets take so long to develop is that the existence of a well developed banking system does not necessarily correlate with the existence of long term institutional investors like pension and life companies. The second reason is that securitization requires more than long term investors, it also requires that investors have a clear understanding of the risks that they have purchased and whether or not that risk is credit on the originator or the underlying obligor. All of this leads to the need for both prudential mortgage regulations which drill down from investor and mortgagee rights to the actual collections of monthly payments.[186]

The World Bank Group has been involved in working to launch mortgage refinance and liquidity entities in many emerging markets including IDB member countries like Jordan, Palestine, Egypt, and Algeria. The World Bank's view is that market evolution can take place in steps as covered bonds and loans secured by pledges of mortgages, the pfandbrief concept; do not require a fully developed mortgage market. But, once refinance and liquidity entities are in place, the market becomes more transparent and price benchmarks and yield curves emerge for the market as a whole.[187]

A5.9. State Administered Loan Programmes

Instead of providing market support mechanisms, many states find ways either to lend directly to their citizens or to provide loan guarantees. The loans may be for single family housing, conventional housing or non-conventional housing like manufactured housing in the United States or

[186] IBID. Chae-Sun Chung represented the Korea Housing Finance Corporation ("KHFC") at the Asia Pacific Union for Home Finance. KHFC, established in 2004, is conceived in a similar fashion to Fannie Mae, Freddie Mac and Cagamas. KHFC is also a government sponsored entity providing the following services supporting home finance: issuance of housing finance credit guarantees, mortgage purchases and securitizing mortgages. For more information access:
http://www.hf.go.kr/hfp/eng/about/history1.jsp

[187] *IFC and world bank experience in establishing mortgage refinance and liquidity companies*, presented at the Workshop on Housing Finance in South Asia, Jakarta, Indonesia, May 27-29, 2009 Asia Pacific Union for Housing Finance (APUHF) http://www.apuhf.info/.

self-build projects in emerging markets. Loan programmes range from highly concessionary to market based programmes .

Some of the wealthy countries among the IDB member states enjoy well developed banking systems and high percentages of citizens in their middle and upper classes. These countries like Kuwait do not elect to pursue the mortgage sale and securitization models. Instead, they provide direct concessionary loans to citizens (male heads of household) who seek housing. Kuwait offers citizens a Real Estate Loan for Purchasing a House or Building a Joint Parcel. The transaction size is capped currently at KWD 70,000 (approximately US$250,000) under conditions that are meant to serve the more needy citizens and avoid leveraging real estate speculators or citizens whose housing needs have been satisfied. The loans may be used for construction, and must not be used for rental housing (although citizens may build a multi-unit property so long as they occupy the main unit). Construction is governed by state bodies and the loans are administered by the State Savings Bank.[188]

Despite the wealth of the state, programmes like the Kuwait program have not been able to resolve significant housing backlogs, and applicants often wait for as long as one year to be approved and funded.[189]
In the United States the federal Department of Housing and Urban Development ("HUD") offers a slate of loan programmes to encourage the construction of apartments or specialized communities centring on healthcare, manufactured housing or other sub-segments. These loan and guarantee programmes are meant to fill gaps that the private sector lenders are not willing or able to fill. The criteria vary and terms may extend to forty years with financing up to 90% of the project value, even 100% for specialized non-profits operating in the housing sector.[190] In addition to housing loans and guarantees for the multifamily sector, HUD provides housing vouchers to low and moderate income families to allow them to lease properties in the event or relocation due to the redevelopment of an

[188] Accessed at http://www.e.gov.kw/SCB_en/Pages/ServiceContent/3143BuyingHouseLoan.aspx.
[189] Al Salman, Mohammed, Mohammed al-Khaldi, Osama Al-Qatari, Ahmed Al-Shemmari and Jarrah Al-Mutairi, *Housing application processing reduced to 5 years* (Kuwait, Al-Watan Daily, January 26, 2012) issue No. 1326, p. 1.
[190] For more information, see http://www.commercialloandirect.com/multifamily-fha-loans-rates.html.

existing subsidized project, family unification or other social purposes prioritized by the Congress and President in their mandates to HUD.[191]

This section concludes that direct lending and credit support programmes require one of three elements:

1. Either the state has a substantial tax base and capacity to continue taxing in support of the program; or,
2. The state has strong debt raising capacity and can fund its programmes directly or indirectly through the capital markets; or,
3. The state is blessed with a disproportionate amount of natural resources to the number of citizens and is able to fund programmes from the sale of or reinvestment of sale proceeds in the natural resources sector.

The third element is unique to a small number of countries. The first element bears political risk if the taxation is too high and perceived as too great a transfer of wealth in a short period of time. Finally, the second element bears with it the cautionary tale of Greece in 2011 in which too great a foreign debt to fund domestic expenses and social programmes may prove unsustainable.

A5.10. Models of Private Specialized Financing Institutions

Although they are now perceived as upscale communities, Columbia, Maryland and Irvine, California were originally master planned targeting middle income citizens. These communities and funding concepts like the multi-family securitization and tax credit business in the US demonstrate how the private sector in the United States has cooperated with the public sector to create solutions to support middle and moderate income finance. These provide a contrast to Habitat for Humanity and its Habitat Fund.

A5.10.1. Master Planned Communities

In the late 1950's large land owners in Maryland and California, respectively The Rouse Company ("Rouse") and The Irvine Company ("Irvine")[192] embarked on the development of master planned communities

[191] For more information, see
http://www.novoco.com/hud/hud/affordable_housing_programmes .php.

[192] Rouse and Irvine are largely agreed to be the originators of the master planned community concept in the post war era. Their concept has now been widely copied around the world including within IDB member countries.

as a form of green field real estate development. The target was to serve middle income citizens with a blended offering of single family and multi-family housing in a fully integrated community. Each company took a slightly different approach reflecting its unique history: Rouse acquired 14,000 acres of land, whereas Irvine repositioned 20,000 acres of land from ranching and orange groves to mixed use supporting a residential core. The planning phases took several years and the first actions took place in the early 1960's.

Rouse assembled their site to create the new town of Columbia in Maryland near Washington, D.C. and Baltimore. As the region was well endowed with large companies and universities, Rouse was able to focus on the key elements of housing and complementary real estate uses including public space, retail, office, places of worship, and light industrial.[193]

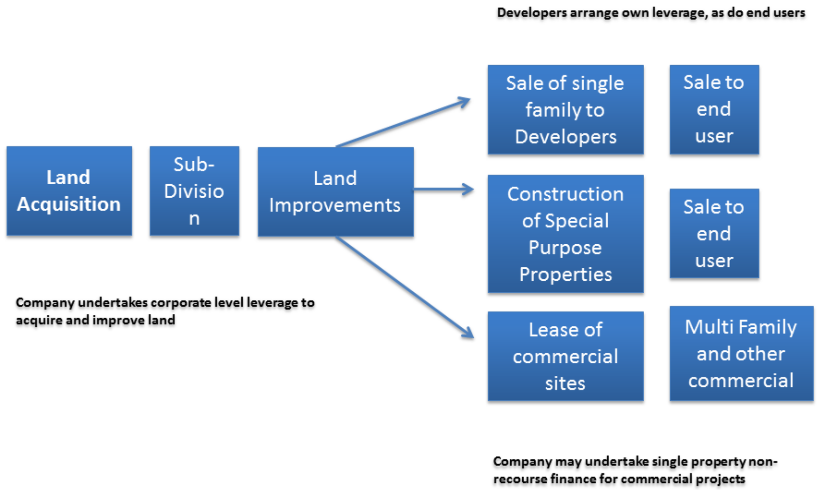
Irvine, however, already controlled underdeveloped land about one hour south of Los Angeles. Since the nearest employers and centres of education were not easily accessible, Irvine convinced the University of California system to establish a new science focused branch (opened in 1965) on land donated by the company, and then attracted several large corporations to low cost sites adjacent to the university site. Radiating from the university site, Irvine designed the plan for housing and the same complementary real estate uses defined by Rouse.

Both the Rouse and Irvine plans followed the same concepts of new urban development trying to control sprawl, reduce waste and improve residential quality of life. Both the planned communities required substantial infrastructure development and then construction of core facilities. As a result, both turned to long term lenders, life insurance companies. In the case of Irvine, they were solely lenders. Rouse gave an equity stake to one Life Company.

Rouse was a public company from 1956 until its acquisition by General Growth Properties in 2004. Rouse preferred to be a real estate operating company ("REOC") to remaining private or becoming a real estate investment trust ("REIT"). As a REOC, Rouse was free to retain earnings and apply cash generated from property operations to operations and development. In addition, as a REOC, Rouse did not face restrictions on its activities and could operate non-real estate activities in support of its

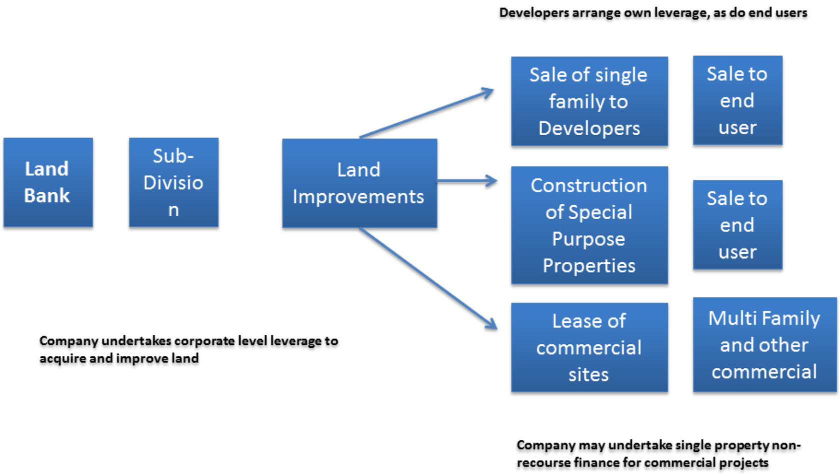
[193] For more information, visit: http://columbia.exploremd.us/tourism/history/.

Figure A5.10: Rouse Company Process



Source: SHAPE™ Financial Corp.

Figure A5.11: Irvine Company Process



Source: SHAPE™ Financial Corp.

master planned community. The Rouse model is widely seen in emerging markets and Emaar and Orascom Development are examples in the MENA region, whereas Sime Darby provides a different example in Southeast Asia. Irvine took a similar route as a REOC, albeit a private company.

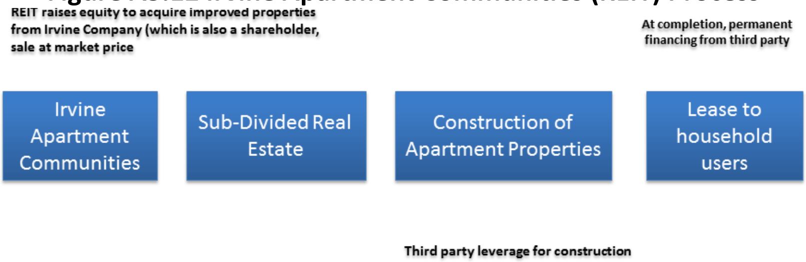
In the real estate recession of the early 1990's Irvine found that bank and life company funding were difficult to rise. Therefore, Irvine, in 1993, spun its apartment units into a REIT. This allowed Irvine to raise new capital from the public markets in order to continue development operations without depending upon the banking markets.

Irvine limited the REIT to apartments in order to avoid the restrictions on operating activities and dividend pay-outs required under REIT rules.[194]

Both Rouse and Irvine engage in a subsidiary financing strategy of delivering fully serviced lots to housing developers. The later must arrange their own bank or other financing to build, and then sell the property onwards to the market.

Irvine was not the only party focus on the apartment sector: There are 15 apartment REITs with market capitalization over US$64 billion at December 31, 2011 and three manufactured home REITs with market capitalization of over US$ 3 billion at December 31, 2011. Another 17 REITs specialized in house financing with market capitalization of more than US$ 37 billion.[195]

Figure A5.12 Irvine Apartment Communities (REIT) Process



Source: SHAPE™ Financial Corp.

[194] Vrana, Debora, Irvine Apartment REIT Restructured, Los Angeles Times, November 3, 1993, accessed at **http://articles.latimes.com/print/1993-11-03/business/fi-52872_1_irvine-apartment-communities**.
[195]See: http://www.reit.com/IndustryDataPerformance/PerformancebyPropertySectorSub-Sector.aspx.

A5.10.2. Multi-Family Finance

Master planned communities can achieve scale for large numbers of people in a defined location. They also demonstrate the efficacy of creating a high credit quality obligor based on quality and basis of real estate; the use of shareholding companies (Rouse) and REITs (Irvine Apartment Communities) for financing housing development. But, multi-family housing is critical in every country, and in the United States, it serves over 15 million households.[196]

"Private" sector finance for multi-family housing in the US is dependent upon close coordination with the public sector. Private sector companies like GE Capital has long worked with public programmes to provide multi-family housing for different income cohorts. GE Capital has long been a major investor in low income housing tax credits. These were discussed above and allow the company to shelter some of its tax liabilities by having effectively paid multi-family developers for credits and generating a cash inflow into the developer community.

GE Capital also relies upon the GSE's Fannie Mae and Freddie Mac to support its lending to the multi-family sector. The GSE's different lending, guarantee and securitization programmes assure that private sector lenders are able to have liquidity as well as fund larger deals. Transactions originated for investment by Fannie Mae and Freddie Mac in the multifamily sector has:

> "… performed much better than that of other players in the multifamily market and the single-family mortgage market more generally. As of 2009, the GSEs' current multifamily mortgage and Mortgage Backed Securities (MBS) portfolios had distress rates of less than 1%, compared to roughly 7% for Commercial Mortgage Backed Securities (CMBS) and roughly 11% for the single-family market as a whole."[197]

[196] Recap Real Estate Advisors, Government-Sponsored Enterprises and Multifamily Housing Finance: Refocusing on Core Functions, October 2010 Commissioned by the National Housing Conference, accessed at www.nhc.org/media/files/Recap_NHC_GSE_Core_Functions.pdf.

[197] The Joint Center for Housing Studies of Harvard University, State of the Nation's Housing 2010, p.26. Accessed at http://www.jchs.harvard.edu/publications/markets/son2010/son2010.pdf cited in Op. Cit. Recap.

During the run up to the crisis a large number of investment conduits were formed by leading investment banks and led to the increased issuance of CMBS. The basic idea replicates basic MBS. An important source is the securities crafted by independent investment banks as well as Freddie and Fannie. Some of these securities could not have been issued without support from different government programmes as well as private mortgage or monoline insurance[198].

Without any form of third party support, Recap points out:

> "…that Private capital sources appear unable to consistently provide loans of the needed length. Capital requirements generally limit banks to offering 3-5 year terms, based on their capital sources. Life insurance companies offer 5-10 year fixed rate loans. Conduit lenders during the past decade provided up to 10 year fixed rate loans,…"[199]

A5.10.3. Habitat for Humanity ("H4H")

Established in 1976, H4H is a faith based not-for-profit enterprise. H4H presumes that the technology exists to make good quality low cost housing available anywhere on the planet. The original H4H model of "partnership housing" involved three elements: volunteers and future housing residents jointly building the desired type of home; delivering a house with no profit to the "builder"; and charging no interest on and relevant loans. Since inception, H4H has been able to build 400,000 homes. The H4H "model" has been adopted in multiple countries via Habitat for Humanity International and now delivers funds to projects through its own funds, namely the Fund for Humanity and its MicroBuild Fund[200and 201.] To understand H4H's scale, it has been among the top twenty home-builders in the United States despite its highly decentralized model.[202]

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[198] Op. Cit. Recap. Recap points out that the complexity and abuse of many of these structures in the run up to the crisis made the impact of the crisis worse.
[199] IBID.
[200] Accessed at http://www.habitat.org/how/historytext.aspx.
[201] *"Habitat's MicroBuild Fund established to provide capital to microfinance institutions for housing improvements and technical assistance,* September 22, 2010, accessed at: http://www.habitat.org/newsroom/2010archive/09_22_2010_hfh_microbuild_fund_establish.aspx.
[202]Cameron, Sonia, Dean Saldanha and Sukhey Dosanjh, *Strategic Analysis Habitat for Humanity Greater Vancouver,* Kwantlen University College November 16, 2006, accessed at http://www.soniacameron.ca/H4H.htm.

The H4H model is derived from a core and basic model set from the head office. Delivery is via locally incorporated non-profit or not-for-profit organizations. Local H4H affiliates raise funds which will be used for both local operations, and ten percent of which will be forwarded on to the head office in Atlanta for use overseas.

In the diagram below, Cameron et al (2006) show how the local affiliates have autonomy in qualifying "clients"; finding sponsoring suppliers, which are typically involved in the home building business and may donate supplies, services and labour; organizing construction which includes "sweat equity" from the client; and, collections to recycle funds for future clients. The model is summarized as combining supplier / donor + buyer / user + buyer / donor (local affiliate). Gaps in funding from suppliers and clients are covered by H4H interest free loans secured by a mortgage.[203]

Cameron et al pointed out a number of weaknesses in the H4H model. The first is that H4H competes in charity market for funds. As a result, natural disasters, economic downturns, and other factors may all slow or reduce H4H's capacity to provide services. Moreover, H4H as a charity has no owner, therefore there is an agency arrangement between the management, affiliates and donors.

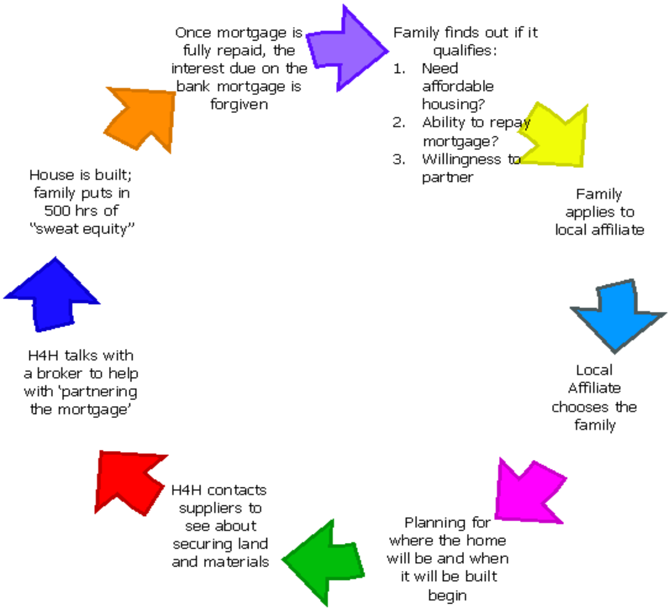
The agency risk links fundamentally whether or not the donors or affiliates perceive the central office to benefit the mission or itself more than the purpose of the overall organization. If the agency risk is deemed to be too great, then this will impact on donations to H4H.[204] An unusual risk that is inherent in the H4H model is that it is faith based and this may impact on receptiveness to H4H or on client understanding of its motivations: housing or proselytization?

Because the H4H parent and affiliates operate as charitable entities, they are not taxed. Even their supplies may be exempted from sales or value added taxes. Even this is a form of implicit subsidy.

The curious conclusion of survey of private sector investment in housing finance is that it necessarily relies on connecting to government policy. In many cases for profits or scale, the private sector looks to the public sector for specialized services like securitization, subsidies explicit and implicit, and funding.

[203] IBID.
[204] IBID.

Figure A5.13: H4H Model



Source: Cameron et al.[205]

A5.10.4. Models of Large Scale Housing Project Finance

One of the key barriers to housing finance is the high price of undeveloped or unsuitably developed land. In these cases, the delivery of low-cost apartments often appears to be more effective than building houses.[206] There are several different ways to do so, one of which is the TOKI process in Turkey. Another is the path taken in Brazil for urban development.

Large scale housing finance is often exemplified by Companie Metropolitana de Habitacao ("COHAB") which was responsible to build approximately 150,000 flats, mostly mid-rise walkups on public land with private builders in Sao Paulo. Smith reports that the problem with municipal projects is the risk of:

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[205] IBID.

[206] Rahman, Aun, Challenges of providing Low-Income Housing Finance – Insights from Pakistan delivered to Asia Pacific Union for Housing Finance (APUHF) conference. Accessed at: http://www.apuhf.info/.

"…inadequate maintenance, uneven enforcement of the rules, patronage political and otherwise, gradual physical deterioration, and a slow reversion to what in Sao Paulo has become known as the 'verticalized slum'."[207]

The argument from the Brazil experience is that mass scale apartments results in the risk that these do not necessarily achieve a certain quality middle class life, but a slide to slum living. As a result, Brazil now prefers a decentralized approach to housing with taxes being transferred from sales taxes to municipalities which may then pursue independent policies flexibly to address housing needs.[208]

The outcome of the survey drives three important conclusions:

1. Housing finance for any economic segment is problematic in many countries because the legal and financial rules are not sufficiently deep or modern to facilitate the sector;
2. As Smith observes:
   "Markets will generally produce as 'affordable' housing what can be afforded by middle- class households. This is neither elitism nor discrimination; rather, it reflects that the value of urban land equals the difference between what a developed home is worth, and what it costs to develop that home."[209] And,
3. As a result, even for the middle income segments, delivering housing finance requires some form of direct or indirect government subsidy.[210]

Mitlin (2008) states the problem, which creeps into the middle classes in many emerging markets:

> "In most urban areas in high-income nations and many middle-income nations, good quality, legal housing is expensive. Most of it would not have been built without mortgage finance; middle-

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207 Op. Cit. Smith, Sao Paulo.

208 Santa Rosa, Junia, *Models of Informal Housing Finance: Brazil Low Income Housing Finance: Brazilian Experience*, New Delhi, January 27, 2010 accessed at www.apuhf.info. The presenter represented the Institutional Development and Technical Cooperation Department Ministry of Cities, Brazil.

209 Op. Cit., Smith, Brazil.

210 Hoek-Smit, Marja C., *Subsidizing Housing Finance for the Poor*, Paper prepared for Development Initiatives Group July 2008, accessed at

income households, and even most upper-income groups, need mortgages in order to buy it or long-term finance in order to build it. In most cities in Africa, Asia and Latin America, low-income households cannot afford legal housing or good quality housing. They either rent (usually in poor quality overcrowded dwellings) or buy, or build in illegal settlements. They cannot get conventional housing finance because their homes are in illegal settlements and they lack the income or formal documentation that housing finance agencies require."[211]

Even in the wealthier parts of the MENA region, there is a challenge putting the SEW into place as it may not have a meaningful economic return compared to other non-social investments. And, the SEW may have high associated land costs.[212]

In their study of housing finance needs in Africa, the FinMark Trust correlates the impact that urbanization has on demand and the strain that this puts on infrastructure. Because a key constituent in urbanization is the growing middle class, their tastes and demands affect both prices and components of demand.[213]

Addressing Smith's LEPS issues is the only way that sensible mortgage to GDP ratios can be attained. This means investment in property data and transfer processes that allow for a timely and cost efficient transfer of property ownership. And, this links fundamentally to strength of legal rights in a particular country.

If the property and legal elements are in place, then access to finance has to be addressed. Building robust and efficient housing finance markets requires clear mortgaging laws, and tools behind them to support banks wishing to provide mortgage credit. These banks will want to be able to sell loans legally or to securitize transactions. Both often require reform of banking laws and expansion of capital market laws. Even improved financial markets are not going to succeed without a diversified local market investor base. Presumptively, these reforms free banks to reach more deeply into the market and serve more customers.

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211 *Mitlin, Diana, Finance for Low Income Housing and Community Development accessed at* http://www.globalurban.org/GUDMag08Vol4Iss2/Mitlin.htm#_edn1.
212 Op. Cit., LaSalle.
213 Op. Cit. FinMark Trust.

But, in many emerging markets, non-performing loans ("NPL") can be as high as ten percent of total assets. If a more efficient financial framework allows more credit, is this an invitation for NPL to skyrocket?

Banking and financial market capacity have to strain with issues of supply in the market and cost to deliver property, which has two unique elements – the cost of the land and the cost to build the improvements. Whether on the sell side, the bank, or the buy side, the consumer, for all of these processes to work well, consumers must be educated about their rights and their financial capacity.

Many of the problems raised here may be addressed with the assistance of multi-lateral development banks including the World Bank, the IDB, the Asian Development Bank, and the African Development bank. Their core competencies include providing guarantees, funding long term infrastructure, and even providing support to nascent capital markets.