



### Saudi mortgage law approved

On July 2nd the mortgage law was endorsed by the Council of Ministers. The law is a very important step in broadening home ownership. It will help to tackle one of the most pressing social issues for many in the Kingdom and will generate significant benefits to the economy. However, we think it will take some time before the full benefits of the mortgage law are realized and that the initial impact will probably not be substantial.

It has taken a number of years for the mortgage law to be approved. In part this is because it is complex legislation. Rather than one law, what was approved is a package of five laws that not only provide the framework for enforcement of mortgage contracts, but also cover mortgage registration and real estate financing companies. Detailed policies, implementing regulations and licensing arrangements are in the process of being drawn up and should be issued 90 days from the endorsement of the law. Mortgages will be based on an Islamic lease financing (ijara) model.

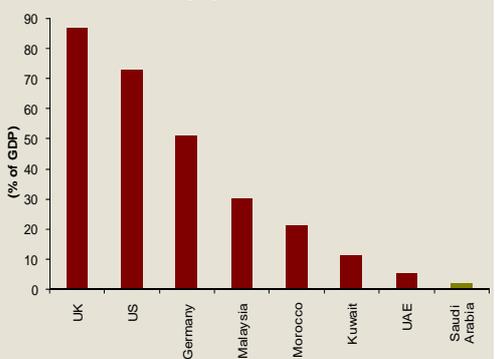
Estimates vary, but in general indicate that less than half of the Kingdom's population own their own homes. This is primarily because those on low and middle incomes have been unable to afford a property. In turn, this has contributed to shortage of housing for this market segment. As a result, rents have risen rapidly (by an annual average of 11.4 percent between 2007 and 2011) and the absence of affordable housing has become a central issue for many.

Housing finance from banks and some property developers has been available for some time, but generally lenders have adopted conservative standards, so mortgage penetration is low. Mortgage debt accounts for around 2 percent of GDP in the Kingdom, compared with more than 70 percent of GDP in the US and UK. The main concern of lenders has been legal uncertainty over foreclosure. The mortgage law codifies the foreclosure process and will therefore give housing finance providers greater confidence to lend. In the event of a bankruptcy, the mortgage is senior to all other loans.

Greater access to mortgages should also improve building standards and transparency, as developers have to be licensed and properties approved to be eligible for a mortgage. This will encourage developers to step up their presence in the market and, as they can buy construction materials such as cement in bulk, should reduce prices. The new law should also simplify property registration and put an end to overlapping claims, which have prevented the development of some lands.

Passing the mortgage law is not sufficient for there to be a vibrant mortgage market. In addition, there needs to be a process through which banks can take the loans off their balance sheets. The law provides for the creation of institutions that will buy mortgages from

Mortgage penetration

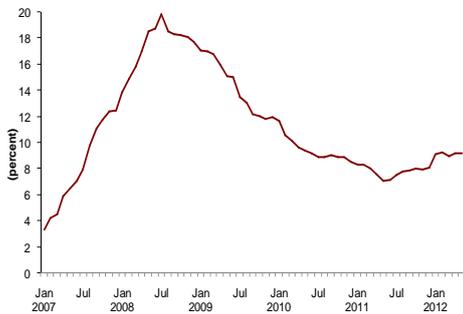


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Rental inflation



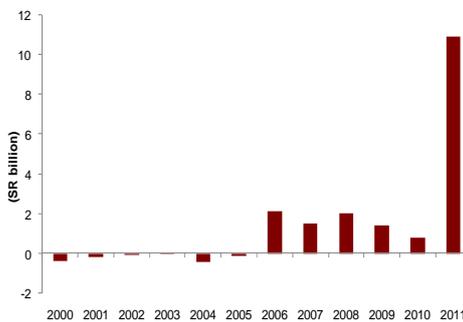
lenders and then securitize them so that they can be sold to investors. This process could potentially enliven the Kingdom's sukuk market, which would benefit all local companies. In the near term, however, the lack of a long-term sukuk market complicates mortgage pricing.

Widening home ownership has broader economic benefits. A home is an asset that an individual can use as collateral for borrowing. This borrowing could be used to finance small businesses or other productive ventures. A home is also an asset that could appreciate over time and therefore a potentially important source of wealth creation. Broader home ownership could also spur domestic consumption, as home owners are likely to spend more on furniture and household goods than landlords.

Although the long term benefits are clear, we do not think there will be a large immediate response, as lenders will test the mortgage framework before they become comfortable with it. It will take some time before this can happen, as it requires a new borrower to fail to honor their repayments consistently. Lenders may not be completely comfortable with the legislation until they can see the revenue they will obtain from the sale of a foreclosed property; the law states that foreclosed real estate will be sold through an auction system.

In addition, many potential mortgage holders will instead secure their housing finance through the Real Estate Development Fund (REDF). The REDF is the government's housing finance arm and its capital (and therefore its lending capacity) has been increased significantly in the past few years. Most recently, an additional SR40 billion was added in March 2011. Internal reforms have also taken place to ensure a more rapid disbursement of funds. Loans from the REDF will be cheaper than mortgages and probably more easily available to a wider range of borrowers, though some of the REDF's budget will be used to provide guarantees for mortgages issued by the private sector.

Net lending by the Real Estate Development Fund



Finally, while the mortgage law helps to address availability of finance, it will not have an immediate impact on the supply of housing or on affordability. In fact, over the short term higher demand stemming from the availability of mortgages could cause house prices to rise. It could also put upward pressure on the cost of raw land, which is already an impediment to the provision of housing for those on low and middle incomes.

Although we think it will take time for the full benefits of the mortgage law to be felt, there has been a clear positive impact on the stock market. This is likely to fade after the initial excitement dies down. Nonetheless, the long-term outlook for the sectors below has improved due to the passage of the mortgage law.

- **Banks:** Banks will be the main providers of mortgages and those with the largest penetration of the retail market should benefit the most.
- **Insurance:** Mortgage buyers will be required to take out an insurance policy to cover the risks associated with large long-term borrowing.
- **Real estate:** Many listed real estate developers are focused on specific projects and others already offer housing finance.



Nonetheless, the law should enable developers to play a larger role in housing provision in the Kingdom.

- **Cement and building and construction:** Over time the mortgage law should lead to greater housing construction, which will support the earnings of those companies that provide the necessary raw materials and construction services.

New mortgage companies are required to list on the stock market, a process that needs to be handled carefully to avoid the turbulence that has beset insurance company shares.

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