

Turkey: Rapid Progress Towards a Secondary Mortgage Market

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I. The Changing Face of the Turkish Housing Finance Industry

Since the publication of our article in the March 2005 issue of HFI, Turkey has progressed considerably in its endeavors to establish a functioning housing finance system. Yet Turkey's chronic housing-related problems of lack of building and occupancy permits, deficiencies in appropriate urban planning, and overall affordability, persist. A clear illustration of these is the fact that more than half of the housing stock in Turkey consists of dwellings without occupancy and/or building permits which causes the monetary value represented by a huge stock of real estate not fit to be introduced to the capital

markets, leading to poorly recorded transactions.

The urbanization that gained momentum in the 1950s led to an increase in the population in big cities, hampering a balanced urban distribution. Over the last five decades, the proportion of urban population to total more than doubled, as depicted in Table 1 below. This led to significant socioeconomic problems, and rapidly increased the investment requirements in urban infrastructure. At the end of 2000 for example, 23% of the total population was settled in Istanbul, and 44 % of the total urban population was settled in cities whose population is over one million. Adequate urban housing supply

could never keep up with the demand. Matters are made worse because 90% of Turkey's land is under serious earthquake risk, and an estimated 40% of the urban housing stock needing serious structural strengthening.

Affordability, on the other hand, seems to be the most striking issue regarding home ownership. According to 2000 census data, 68.2% of the total households own their houses, 23.9% of them are leaseholders, 2.1% of them live in government housing while 4.9% of them are neither leaseholder nor own their houses¹. Although the homeownership rate seems to be satisfying, this figure includes illegal squatter housing, summer homes, second homes, and

Table 1: Urban Population Growth

Years	Urban Population	Urban Population (% of total)
1955	6,927,343	28.79
1960	8,859,731	33.69
1965	10,805,817	34.42
1970	13,691,101	38.45
1975	16,869,068	41.81
1980	19,645,007	43.91
1985	26,865,757	53.03
1990	33,326,351	59.01
1997	40,882,357	65.00
2000	44,006,274	64.90

Source: State Institute of Statistics

¹ State Institute of Statistics

SECONDARY MORTGAGE MARKET IN TURKEY

Table 2: GDP figures of Turkey between 1976 and 2006 (estimated)

	Billion \$ (3)	Growth Rate	Mid-Year Population (1)		Per Capita GNP \$ (3)	Per Capita GDP In Purchasing Power Parity (2) (\$)
			x1000	% Change		
1976	54.7	9.0	40,915		1,312	1,795
1977	62.2	3.0	41,769	2.1	1,488	1,945
1978	68.4	1.2	42,641	2.1	1,604	2,081
1979	76.6	-0.5	43,531	2.1	1,760	2,198
1980	69.7	-2.8	44,439	2.1	1,570	2,288
1981	72.8	4.8	45,540	2.5	1,598	2,564
1982	65.9	3.1	46,688	2.5	1,412	2,750
1983	62.2	4.2	47,864	2.5	1,299	2,934
1984	60.8	7.1	49,070	2.5	1,238	3,168
1985	68.2	4.3	50,307	2.5	1,356	3,320
1986	76.5	6.8	51,433	2.2	1,487	3,552
1987	87.7	9.8	52,561	2.2	1,668	3,911
1988	91.0	1.5	53,715	2.2	1,693	4,042
1989	108.7	1.6	54,894	2.2	1,979	4,116
1990	152.4	9.4	56,154	2.3	2,712	4,566
1991	152.4	0.3	57,272	2.0	2,656	4,676
1992	160.7	6.4	58,392	2.0	2,752	4,973
1993	182.0	8.1	59,513	1.9	3,055	5,393
1994	131.1	-6.1	60,637	1.9	2,159	5,110
1995	172.0	8.0	61,763	1.9	2,783	5,487
1996	184.7	7.1	62,909	1.9	2,933	5,918
1997	194.4	8.3	64,064	1.8	3,030	6,298
1998	206.0	3.9	65,215	1.8	3,156	6,451
1999	187.7	-6.1	66,350	1.7	2,825	6,084
2000	201.5	6.3	67,420	1.6	2,987	6,820
2001	144.6	-9.5	68,365	1.4	2,111	6,155
2002	182.9	7.9	69,302	1.4	2,638	6,550
2003	238.4	5.9	70,231	1.3	3,396	6,993
2004	301.6	9.9	71,152	1.3	4,240	7,756
2005 (4)	357.7	5.0	72,065	1.3	4,964	8,428
2006 (5)	380.6	5.0	72,974	1.3	5,216	9,017

Source: SIS, SPO, OECD

(1) SIS mid-year population estimate

(2) Necessary data for the computations of Purchasing Power Parity are compiled by SIS and sent to OECD, and later by using the parity value computed by OECD Per Capita GDP is computed by SIS.

(3) Computations are made by using Central Bank FX rate.

(4) SPO estimate

(5) Projection

dwellings without a permit that constitutes more than 50% of home owners. Further amplifying the problem is Turkey's young population necessitating an immense increase in new household creation. The number of marriages has been breaking records over the last three years. Therefore, there remains a significant proportion of the population still underserved. Concerning access to the institutional means of housing finance, the picture is far from adequate: only 3% of the population is being served. The ratio of outstanding housing loans to GDP is around 1.5% in Turkey, whereas the range is 4 - 12% in Latin American countries, 1 - 22% in Middle Eastern countries, 2 - 59% in Southeast Asian countries, 71% in USA, 46% (average) in the EU².

II. Latest Developments in the Primary Market

Housing loans have been extended by commercial banks in Turkey since the 1950s. The initial players in the industry were state banks chartered to provide housing finance to urban populations. Private commercial banks started to extend housing loans in the 70s. The long-time leading player of the industry, state-owned Emlak Bank (literally Real Estate Bank) ceased operations in 2001. Its void is yet to be filled. The remaining state-owned banks are not vying to lead initiatives in the industry. Nevertheless, private players in Turkey's vibrant banking industry have gained significant headway in consumer products over the recent years.

As of today, most of the commercial banks extend (Turkish currency) YTL-based housing loans with maturities varying from 12 to 300 months. Products with over 120 months of maturity have been introduced only over the last 10 months, as the economy has improved. USD-based products, which for a long time dominated the longer-term segment, had been losing the favor of the consumers. Monthly interest rates on these products are presented in Tables 3a and 3b.

In October 2005, the average annual consumer price index increase stood at 7.54%, almost equaling the annual target of 8%.

Table 3a*: Monthly Interest rate for housing loans in YTL for maturities from 12 to 360 months

	12	24	60	120	144	180	240	360
Akbank	1.18	1.18	1.18	1.18	1.18	1.18	1.18	-
Bank Europa	1.05	1.05	1.05	1.05	1.05	1.05	1.05	1.05
Garanti	1.20	1.20	1.20	1.20	1.20	1.20	1.20	-
HSBC	1.14	1.14	1.14	1.14	1.14	1.14	1.14	1.14
Isbank	1.20	1.20	1.20	1.20	1.20	1.20	1.20	-
Oyak Bank	1.20	1.20	1.20	1.20	1.20	-	-	-
Yapi Kredi/Koçbank	1.20	1.20	1.20	1.20	1.20	1.20	1.20	-
Ziraat Bank	1.19	1.19	1.19	1.19	-	-	-	-

*Ranked in alphabetical order

Source: Bank statements, (November 2005)

Table 3b*: Monthly Interest rate for housing loans in USD for maturities from 12 to 240 months

	12	24	60	120	180	240
Akbank	0.70	0.70	0.75	0.75	-	-
Bank Europa	0.61	0.61	0.64	0.66	0.69	-
Garanti	0.70	0.70	0.75	0.75	0.75	0.75
HSBC	0.64	0.64	0.64	0.64	0.64	0.64
Isbank	0.70	0.70	0.75	0.75	0.75	0.75
Oyak Bank	0.69	0.69	0.69	0.75	-	-
Yapi Kredi/Koçbank	0.69	0.69	0.69	0.75	0.75	0.75
Ziraat Bank	-	-	-	-	-	-

*Ranked in alphabetical order

Source: Bank statements, (November 2005)

² Capital Markets Board of Turkey

Table 4: Consumer Price Index. Annual Percentage Change Between 01/1994 and 10/2005

	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec
1994	69.65	72.96	73.65	107.45	117.81	115.84	109.35	108.05	111.13	116.27	119.73	125.49
1995	125.89	122.42	119.67	88.41	79.81	80.73	80.63	83.25	85.84	84.21	81.53	76.05
1996	78.11	77.49	79.34	80.83	82.93	82.86	81.20	81.93	79.32	79.59	80.38	79.76
1997	75.72	77.65	77.30	77.16	77.46	78.05	85.23	87.79	89.86	93.16	95.82	99.09
1998	101.62	99.25	97.18	93.57	91.37	90.55	85.35	81.43	80.43	76.64	72.77	69.73
1999	65.90	63.93	63.54	63.85	62.97	64.27	65.00	65.40	64.27	64.70	64.55	68.79
2000	68.88	69.75	67.90	63.82	62.67	58.62	56.21	53.17	48.96	44.44	43.76	39.03
2001	35.92	33.42	37.51	48.27	52.39	56.10	56.33	57.50	61.80	66.47	67.29	68.53
2002	73.16	73.08	65.11	52.72	46.22	42.60	41.28	40.24	37.05	33.45	31.77	29.75
2003	26.38	27.01	29.41	29.45	30.74	29.76	27.44	24.91	23.00	20.78	19.25	18.36
2004	16.22	14.28	11.83	10.18	8.88	8.93	9.57	10.04	9.00	9.86	9.79	9.32
2005	9.23	8.69	7.94	8.18	8.70	8.95	7.82	7.91	7.99	7.52		

Source: SIS

The price increases in the housing sector was 10.11% in the same period, denoting the increased activity in housing sales. Industry experts³ attribute a significant portion of this increase to decreasing interest rates and more readily available housing loans. Oyak Konut market studies show a marked rise of around 40% in house

prices in selective high growth residential areas of Istanbul and Ankara compared to the 3rd quarter of 2004.

Falling interest rates after 2003 have increased the demand for housing and created an increase in house prices above average consumer price rates. The house

price spikes after the 2001 crisis were, on the contrary, below the consumer price rates due to the stagnancy in the economy and inconsistency in the market. There are some doubts as to whether a house price bubble currently exists, however. It should be noted that house prices have merely reached the pre-crisis levels in real terms. It

Table 5: Monthly percentage changes in consumer and housing prices between 01/2001 and 10/2005

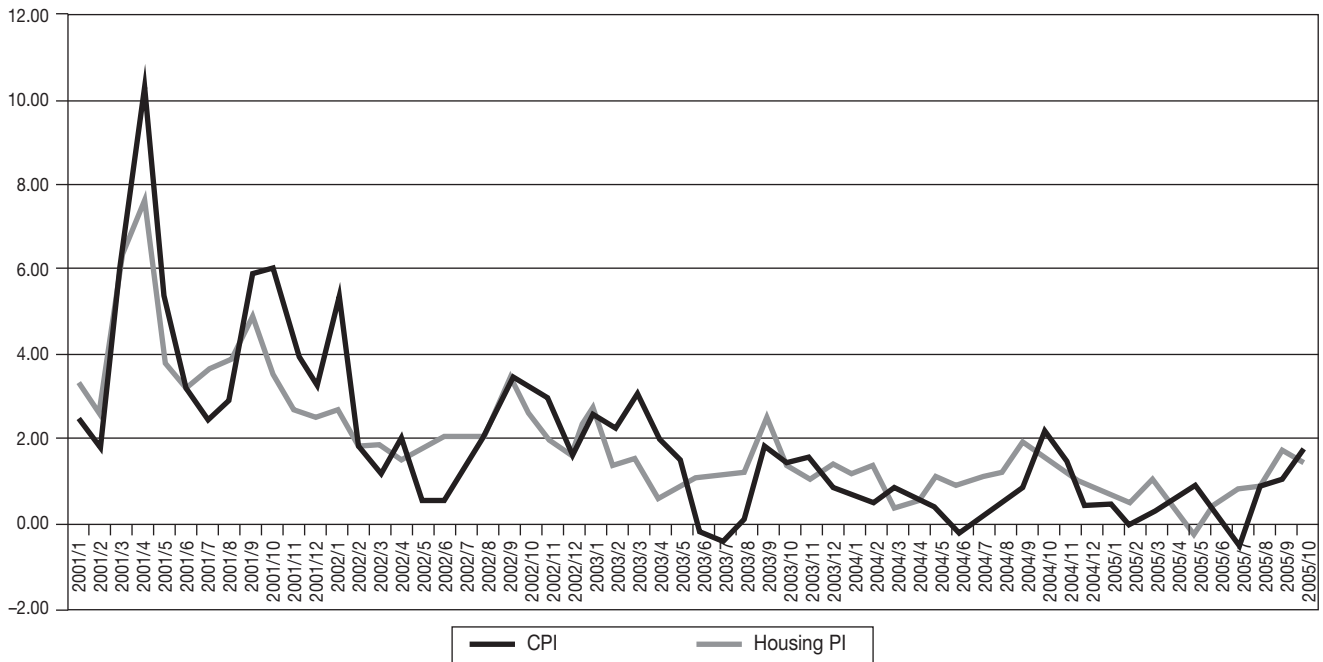
2001	CPI	Housing	2002	CPI	Housing	2003	CPI	Housing	2004	CPI	Housing	2005	CPI	Housing
1	2.49	3.36	1	5.32	2.71	1	2.58	2.84	1	0.74	1.17	1	0.55	0.67
2	1.80	2.58	2	1.77	1.86	2	2.26	1.37	2	0.55	1.43	2	0.02	0.51
3	6.09	6.16	3	1.18	1.91	3	3.10	1.59	3	0.88	0.38	3	0.26	1.08
4	10.31	7.68	4	2.05	1.50	4	2.09	0.60	4	0.59	0.48	4	0.71	0.38
5	5.06	3.77	5	0.58	1.68	5	1.58	0.89	5	0.39	1.15	5	0.92	-0.30
6	3.13	3.13	6	0.59	2.09	6	0.17	1.12	6	0.13	0.89	6	0.10	0.57
7	2.41	3.65	7	1.44	2.11	7	0.38	1.16	7	0.22	1.15	7	0.57	0.87
8	2.94	3.90	8	2.17	2.15	8	0.16	1.20	8	0.58	1.24	8	0.85	0.91
9	5.88	4.97	9	3.49	3.47	9	1.91	2.57	9	0.90	2.00	9	1.02	1.80
10	6.07	3.48	10	3.28	2.65	10	1.42	1.39	10	2.20	1.60	10	1.79	1.47
11	4.22	2.71	11	2.91	1.97	11	1.61	1.08	11	1.50	1.20			
12	3.23	2.45	12	1.65	1.59	12	0.88	1.42	12	0.45	0.90			

Source: SIS

(1) After the year 2004, 2003=100 basis index is used.

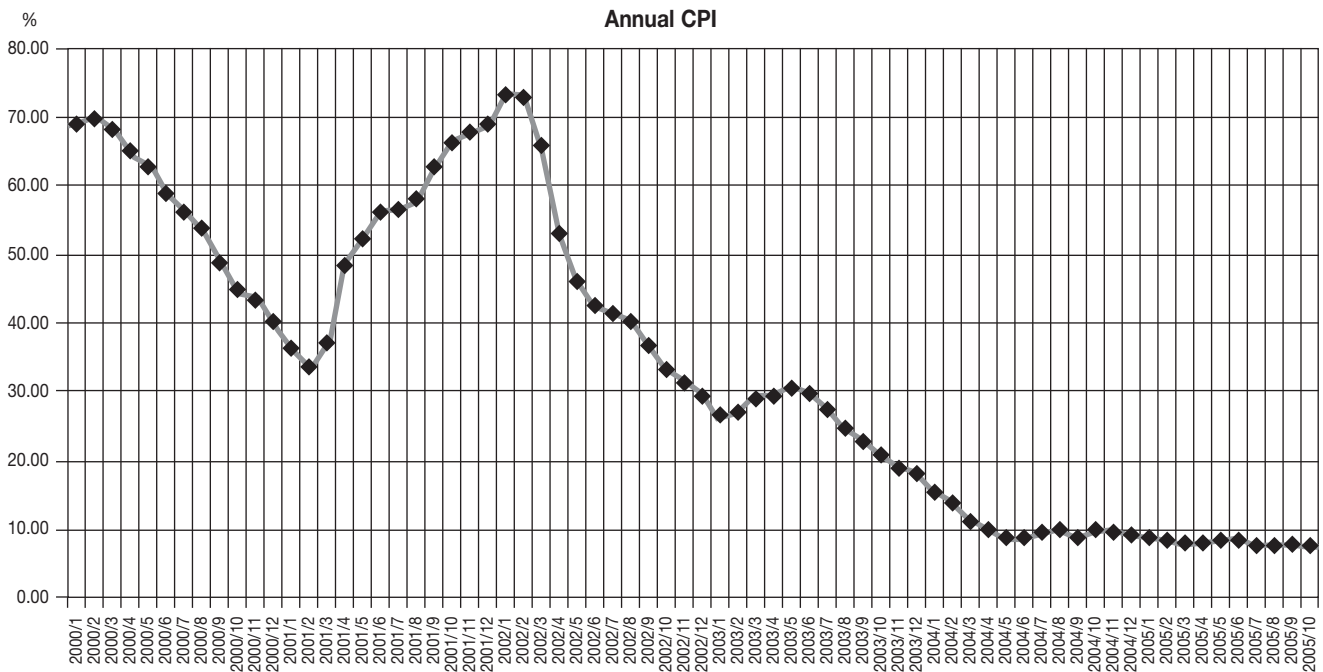
³ OYAK Analyses

Graph 1: Monthly percentage changes in consumer and housing prices between 01/2001 and 10/2005



Source: Undersecretariat of Treasury

Graph 2: Annual CPI from 01/2000 to 10/2005



Source: Undersecretariat of Treasury

is economically logical to expect house prices to continue to increase until interest rates reach a reasonable level. Government entities should educate consumers effectively in order to prevent an excessive demand which would eventually lead to a market bubble. Monthly housing prices as compared to the consumer price index since 2001 are shown in the Table 5 and Graphs 1 and 2.

With sovereign borrowing rates down from around 90% in the early 2000s to around 15% today, a primary income source for banks and financial institutions in Turkey is depleted. The banks in turn had to resort to increasing their exposure to corporate and consumer debt at unparalleled levels. As a result of that, the consumer loan portfolio of the Turkish banking industry grew by 152% per annum. 2003 was a key year as due to

the improving macroeconomic outlook, further progress towards EU membership accession, and a 3-year stagnancy in housing prices, demand for housing loans rose. This demand also led to a significant increase in house prices as mentioned above. This trend continued in 2005.

Consumer Loans

According to data collected from the Banks Association of Turkey, 2,790,663 persons used consumer loans of TRL 10,159 million during the second quarter of 2005. The total balance of customer loans outstanding amounted to TRL 19,538 million and the number of borrowers outstanding was 5,220,284 at the end of the second quarter.

Delinquency rates of Turkish consumer loans have historically been comparatively

quite low, around 2-3%. The non-performing portion of housing loans experienced by the dominant players in the industry were less than 1% even during 2001-2002, when Turkey experienced the worst economic crisis in its history

Outstanding consumer loans which are under legal follow-up amount to TRL 150.5 trillion, which accounts for 0.3% of total consumer loans. The breakdown of the total legal follow-up cases of automotive loans, real estate loans, general purpose loans and others in consumer loans under legal follow up are 45 percent, 14 percent, 39 percent and 3 percent, respectively.

In our March 2005 article, we detailed some of the structural impediments facing the development of an appropriately functioning housing finance system in Turkey, such as

Table 6: Consumer loans extended and outstanding consumer loans quarterly between Q1 2004 and Q2 2005.

TRY* Thousand	Type of Currency	Consumer Loans Extended				Outstanding Consumer Loans			
		Volume	No. of Users	Admin. Follow-up	Legal Follow-up	Volume	No. of Users	Admin. Follow-up	Legal Follow-up
2004 March	TRY	4,908,566	852,592	11	8,221	10,498,870	2,839,519	8,675	54,262
	FX	200,983	2,786	0	1,141	614,250	13,873	1,494	1,318
	Total	5,109,549	855,378	11	9,362	11,113,120	2,853,392	10,169	55,580
2004 June	TRY	6,383,728	913,428	145	10,528	13,939,985	3,146,779	10,650	60,534
	FX	227,508	2,821	0	697	686,189	13,684	1,379	1,386
	Total	6,611,236	916,249	145	11,225	14,626,174	3,160,463	12,029	61,920
2004 Sept.	TRY	4,142,952	679,480	0	16,142	15,086,062	3,350,606	16,627	74,426
	FX	212,878	2,679	0	797	733,628	14,345	1,598	1,393
	Total	4,355,830	682,159	0	16,939	15,819,690	3,364,951	18,225	75,819
2004 Dec.	TRY	4,906,381	938,657	0	20,917	15,924,234	3,518,789	14,220	104,042
	FX	360,696	3,702	0	1,145	869,803	15,372	2,015	2,367
	Total	5,267,077	942,359	0	22,062	16,794,037	3,534,161	16,235	106,409
2005 March	TRY	6,861,331	2,154,335	2,422	32,126	17,934,157	4,745,062	13,414	129,872
	FX	304,845	2,965	0	1,320	929,080	15,486	2,128	1,340
	Total	7,166,176	2,157,300	2,422	33,446	18,863,237	4,760,548	15,542	131,212
2005 June	TRY	10,159,357	2,790,646	9,864	27,017	19,537,164	5,220,231	25,652	150,540
	FX	374	17	0	0	665	53	0	15
	Total	10,159,731	2,790,663	9,864	27,017	19,537,829	5,220,284	25,652	150,555

(* as of 1.1.2005 1 TRY=1,000,000 TRL)

Source: BAT

Table 6: Breakdown of Consumer Loans According To Purpose

	April-June 2005		
	TRL million	Number of Persons	Percentage Share
Flow terms			
Automobile	1,676	92,408	16
Real estate	3,071	72,398	30
General Purpose Loans	5,399	2,625,483	53
Other	13	374	0.1
Stock terms			
Automobile	5,009	451,895	26
Real estate	6,073	209,104	31
General Purpose	8,279	4,292,100	42
Other	176	267,185	0.9

lack of a standardized appraisal system, lack of diversified primary market products, lack of long term funding sources, etc... There is a growing market expectation with regards to the removal of these impediments. The end consumer and lender expectations focus primarily on primary market practices, whereas eager investors

are seeking remedies for structural deficiencies of the capital markets and relevant instruments.

In the primary market front, title and registration regulations, foreclosure and bankruptcy law and its applications, as well as Consumer Protection Law have been the

center of attention. The above mentioned laws and regulations are in general extensive and have been brought in conformance with the European Union standards over the past decade. However some microscopic provisions in these regulations have been disturbingly inefficient.

The bankruptcy and foreclosure practices certainly play a crucial role in determining the value of the collateral. Although the Turkish bankruptcy and foreclosure law is very much in conformance with European Union standards, the liquidation process can last up to three years. This is a major constraint for investors who intend to invest in Turkish mortgage assets.

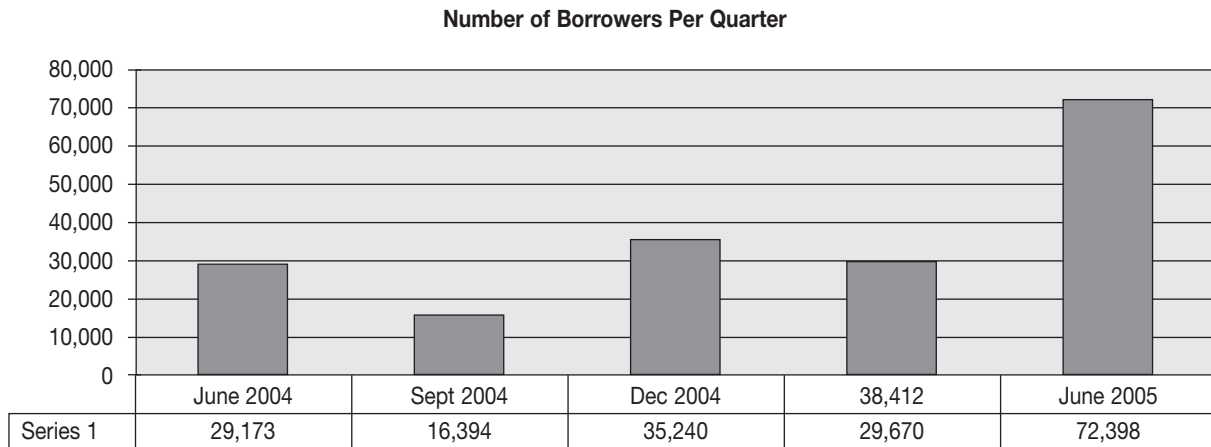
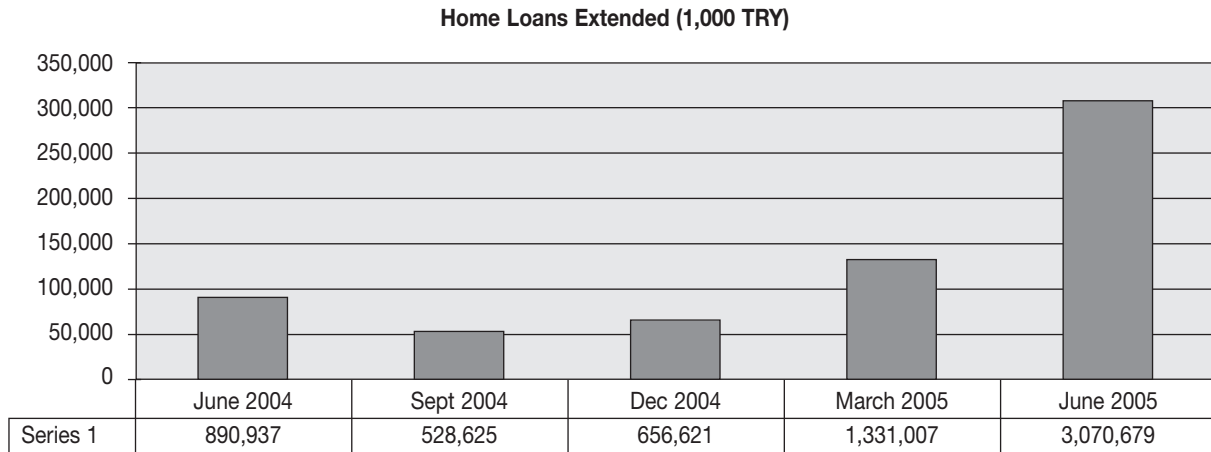
Yet another set of impediments is the significant costs associated with a typical housing transaction. Stamp duties, resource utilization fund, banking and insurance transactions tax, title fee, and notary expenses are some of these costs. These costs certainly do not help the banks in creating affordable housing loan products.

Table 7: Breakdown of home loans as a subset of consumer loans per quarter between Q2 2004 and Q2 2005

Home Loans		2005 June		2005 March		2004 Dec		2004 Sept		2004 June	
		TRY 1000	Number of borrowers	TRY 1000	Number of borrowers	TRY 1000	Number of borrowers	TRY 1000	Number of borrowers	TRY 1000	Number of borrowers
Amount Extended	TRY	3,070,679	72,398	1,158,795	28,691	464,920	33,825	420,919	15,547	786,745	28,399
	FX	-	-	172,212	979	191,701	1,415	107,706	847	104,192	774
	Total	3,070,679	72,398	1,331,007	29,670	656,621	35,240	528,625	16,394	890,937	29,173
Outstanding	TRY	6,073,167	209,104	2,783,753	124,648	1,982,439	213,120	1,790,614	93,498	1,594,815	83,206
	FX	-	-	523,611	5,304	456,657	5,669	379,143	4,381	331,025	3,929
	Total	6,073,167	209,104	3,307,364	129,952	2,439,096	218,789	2,169,757	97,879	1,925,840	87,135
Under Legal Follow Up (Foreclosure)	TRY		3,623		2,767		1,583		1,693		430
	FX		0		561		213		108		25
	Total	1.73%	3.623	2.56%	3.328	0.82%	1.796	1.84%	1.801	0.52%	455

Source: BAT

Graphs 3 and 4: Breakdown of home loans as a subset of consumer loans



Source: Banks Association of Turkey (BAT)

III. Secondary Market Practices

Secondary markets for fixed rate products in Turkey have long been fully dominated by the government's borrowing instruments, crowding out others from the marketplace. Turkish banks have issued asset backed securities in domestic capital markets in the past. However, several amendments in the tax regulations made that infeasible from 1994 on. In recent years several Turkish banks have become increasingly active in securitizing their non-housing consumer

loan receivables through off-shore vehicles. Yet Turkey still lacks a mortgage portfolio securitization experience. Consequently, at the present the entire credit, interest rate, and prepayment risks originating from housing loans are being borne by originating lenders in Turkey.

Lenders in Turkey fund the consumer loans through their savings deposit base. The average life of these deposits is still less than 6 months⁴. Funding loan products with 20-25 year terms through deposits with less

than 6 months creates an immense maturity mismatch in the banks' balance sheets, which in turn imposes an inherent cap that limits the growth of the outstanding loan balance due to the risk management regulations in place. In order to minimize this mismatch, banks either have to increase the maturities in the liabilities side or decrease the asset life. Either solution could be achieved through proper secondary market practices such as on-balance sheet or off-balance sheet securitizations. With the current legal

⁴ Banks Association of Turkey

environment, due to taxation and expenses, it is not possible to do a local on-balance sheet placement, which leads the banks to refer to off-shore off-balance sheet placements through certain special purpose entities. In case of off-shore placements however, the banks' mortgage portfolios do not qualify for an acceptable rating which forces them to provide for extensive credit enhancement. This decreases the returns on asset securitization, thus making it less desirable. The best solution for having the mortgage assets divested through proper secondary market practices is to securitize locally, under fair competition, with certain tax incentives (such as withholding tax, explained later), to local investors like banks, pension companies and insurance companies, through an on-balance sheet securitization. Off-balance sheet securitization is currently not defined under the Turkish legal system; however it is expected to be, with the upcoming regulation.

Institutions with long term liabilities such as life insurance and private pension companies in Turkey are also seeking alternative tools to invest in, in the mid-term, in view of diminishing returns on government debt instruments.

The public and private sectors in Turkey are clearly focused on developing a robust and liquid secondary mortgage market. This is evidenced in a 2002 directive outlining the requirements for purchasing loans, as well as the industry task force that has been examining the regulatory environment for mortgage lending and securitization. Primary market institutions have been disclosing strong interest in participating in a secondary mortgage market and a willingness to develop infrastructure supporting that. In order to create sizeable mortgage assets to be securitized, the banks will have to enhance their primary lending activities. However, currently, the lending institutions are limited to extending fixed rate home loans with very limited standardization of documentation,

guidelines and appraisal services. Although the rates have come down to 13.5% with 30 years of maturity from 26% with 10 years maturity earlier this year, the rates are still high (as compared to the inflation rate of 7.54%) to promote fixed rate products. Besides, the banks are lending at rates below their cost of capital, taking the risk of writing off losses for a few months, expecting to generate profits as rates continue to fall. If outstanding mortgage portfolios reach an acceptable level of quality and magnitude, with fair taxation, lenders will be able to securitize these assets locally as the government's domestic debt requirement is expected to diminish.

Under Turkish Law, there is no concept of a trust or a true passive Special Purpose Vehicle into which an originator of mortgages can transfer assets and have them be bankruptcy remote. Yet there is a precedent for asset segregation within a corporate structure, as Capital Markets Law permits the isolation of assets for mutual funds. Hence, isolation of mortgages may be achieved without a fully-fledged transfer to a Special purpose entity (SPE) or trust (if a similar regulatory structure could be established that encompasses the isolation techniques that mutual funds currently use). However, it is unclear whether the market would accept this solution.

The general reliance on International Financial Reporting Standards provides a sound framework for secondary mortgage activities. Moreover, these accounting standards are common to many countries with successful secondary mortgage markets.

However, there is a lack of standardization and mortgage specialization in the primary market. It is not clear if there are sufficient originations to support sustainable large-scale secondary market operations. Lenders are currently limiting their originations to upper- and upper-middle class borrowers only.

III.a. Current Regulatory Framework for Secondary Mortgage Markets

Instead of a single law, the housing finance system in Turkey depends on several laws, including foreclosure and bankruptcy, consumer protection, capital markets, tax, and banking laws. Certain aspects of each of these laws and regulations bring forth some serious impediments against a robust mortgage system in Turkey and have to be redesigned to a way that first of all promote the primary market which should be followed by secondary market practices to link the funding side of home loans to the capital markets.

The impediment associated with foreclosure law is mainly related to the enforcement practices. Although the law of foreclosure and bankruptcy is very extensive, high inflation and unpredictable interest rates have lead delinquent borrowers to use their legal rights to place an objection⁵, in order to delay the foreclosure process. Historically, the liquidation of Turkish mortgage assets took up to three years. With these implementation problems in place, banks typically prefer to work out the debt with the delinquent borrowers to restructure before filing a case. Since the delinquency rates in home loans have remained below 1% for the last 20 years, the foreclosure losses remained quite negligible on the banks' balance sheets. However, historically the typical borrowers were members of upper-middle income families with better payment willingness and capability. The significant growth in originations, as depicted in the previous sections, is expected to bring about a penetration into the less favorable market segments, increasing the delinquency risk (or credit risk). Although low inflation rates are expected to reduce the delinquent consumers' motive towards delaying the process, the above-mentioned implementation practices still exist.

⁵ Consumers' Right to Object: This refers to the right to object to the foreclosure court processes that the borrowers have. Typically the fees and expenses of objecting to court decisions are either equal or less than the cost of capital itself. Coupled with the devaluation of nominal amounts owed due to high inflation, the borrowers tend to deal with their payment obligations as late as possible, especially if the value of the real estate asset is appreciating, which is the expected case under an inflationary environment.

In order to be able to increase the market size by penetrating lower income segments there should be primary market products for households with different payment capabilities. Adjustable rate and indexed mortgages are the main products that would serve this purpose. Before the consumer protection law was released in 1995, adjustable rate mortgages were extended by several banks which has created an understanding of these types of products among the consumers. However, Turkish Consumer Protection Law now prohibits the extension of such loans. Only Housing Development Administration, by a special incentive given by the relevant government entity, can extend ARMs, which are highly demanded by the public in general at the moment. Certain concepts inherent with the ARMs such as increasing the outstanding debt balance or the debt not amortizing itself over the maturity due to the differences in the indices, create confusion among the borrowers from time to time, but there seems to have been a quite effective learning period both for Housing Development Administration (HDA) and the borrowers. Having only the fixed rate instruments to use, the market development would have been very limited.

The Consumer Protection Law also means that the lending institutions are equally responsible with the building developer itself for product deficiencies and late key delivery in campaign product sales which are associated with certain building projects, thus causing the lenders to act sceptically in their marketing practices.

Prepayment penalties, on the other hand, are also against the Consumer Protection Law. To maintain a high level of investor interest in the mortgage backed securities, prepayment risk should be minimized. A prepayment penalty on fixed rate mortgages is one way of doing so.

Another method of hedging the prepayment risk is to create subordinated tranches of mortgage securities which should be handled by the underwriters themselves. There is no detailed description of subordinate structured debt instruments in Turkey. The Capital Markets Board should

eventually draft secondary regulations regarding the subordinated securities.

Currently there is no defined standard of real estate appraisal services which the banks adhere to. Although there is a commonsense on the methodology, some dominant banks utilize in-house appraisers who do the valuation quite conservatively resulting in very high LTVs. On the other hand most of the banks utilize external real estate appraisers which leads to a lower LTV (around 70%). The external real estate appraisers have not been following any specific set of guidelines. In 2004, the Capital Markets Board issued a regulation for governing the conduct and practices of real estate appraisal companies. All the appraisal companies and appraisers will eventually need to obtain a license from the Capital Markets Board in order to perform appraisal services in Turkey. Since this is a very recent regulation, the number of licensed appraisers and companies are still very limited. Therefore, for a limited time, the banks will be free to use whichever company they choose for appraisal services.

There should be a set of guidelines to underwrite home loans. This requires a detailed description of origination, lending and servicing practices, such as consumer rating, using front end and rear end ratios, adequate documentation and reporting, etc. These should be identified through secondary regulations if not by the act itself.

Tax incentives are crucial for fostering the lending activities of the banks and creating a demand for secondary market products. Against some theories which propose a decline in real estate related tax returns, in practice, some amount of tax deduction may in fact generate an increase in tax returns due to an increased volume of transactions. At the moment there are a number of taxes and fees incurred with primary and secondary housing finance practices, namely, banking resource utilization support fees, banking insurance transactions fee, stamp fee, title fee, income tax (on MBS issuance and MBS investment), corporate tax on various housing finance institutions, issuance fees,

etc. As of 15 October 2005 the types and amounts of tax incentives are still being discussed at the parliament level.

III.b. New Regulation: Amendments in Certain Laws Regarding Housing Finance

The new regulation encompasses a set of amendments in several laws mentioned in the previous section. The draft bill is expected to be passed through the parliament by November 2005 to be in effect as of January 2006. The comments below are based on the draft as of 15 October 2005, as the draft can be altered during the parliamentary process.

The amendments envisaged in foreclosure and bankruptcy law are mainly concerned with reducing the delay in the process caused by the delinquent borrowers posting legal objections. In addition to decreasing the lapse times during which the delinquent can post objections, the fees associated with making the objections are also increased by the new regulation, discouraging objections. If the bank loses the case, all the fees and expenses are to be borne by the bank. However, if the objection is posted only for time-gaining purposes, it will be costly for the delinquent borrower.

With the new bill, the borrowers will also be able to borrow against their existing real estate property. Currently, home loans are extended only to borrowers who are involved in a real estate transaction at the title office. However, the borrowers will be able to borrow home equity loans as long as that is their first or second home. By home equity loans the real estate tax collections are expected to increase significantly, as the borrowers would need to update the value of their properties at the title offices. The income tax deduction facility on home equity loans is still being discussed.

The Consumer Protection Law is expected to be amended in two ways: First, adjustable rate and indexed mortgages will be extended by inserting an exception within Consumer Protection Law. The lenders will be able to develop any kind of ARM and DIM depending on the willingness

and ability of the borrowers to pay. Secondly, the absence of a prepayment penalty mechanism on fixed rate instruments will be removed for MBS issuance purposes.

There will be tax benefits on the borrower, issuer and investor sides. Some of these benefits are expected to be applicable for all parties and some on relevant transactions. Tax incentives on stamp duty, the banking resource utilization support fund, banking insurance and title registration fees are applicable to all the relevant parties. There is still an ongoing discussion among the relevant governmental agencies about the tax concession to be given to the borrower, through income tax deduction. A tax return over the interest portion of the monthly installments is a very important and necessary subsidy to be undertaken by the government. This incentive will allow that segment of the population which benefits from institutional means of housing finance to grow; the homeowners who have utilized institutional housing finance facilities (such as bank loans) are currently 8% of the total homeowners. The MBS issuers and investors are expected to benefit from corporate tax incentives on their issuance and interest rate incomes respectively. This specific tax benefit does not have a direct effect on the primary home loans market but is very crucial for the secondary market development. Since the MBS market will be the first non governmental secondary market instrument which will provide funding to lenders from the capital markets, certain tax incentives, such as withholding tax, corporate tax, stamp tax and some other fees and duties might be beneficial in order to attract investor appetite.

Although a regulation for private sector secondary market instruments exists, it was mainly obsolete due to taxation and crowding out effects. As real interest rates decrease along with the public sector's borrowing need, private entities will be able to issue debt instruments given that the rules of competition are fair and equal. Starting from 1 January 2006 a withholding tax on government bonds will go into effect, putting private and public sector borrowing on an almost equal footing from the taxation

perspective. It is expected that other fees and taxes would also be set in same proportions for all instruments regardless of the issuer.

Since the main players of mortgage business are banks in Turkey, they are likely to be the issuers of first mortgage backed securities. Since the concept of a trust and trustee, which is defined in the Anglo-Saxon legal system, does not exist in Turkey (which has a legal system derived from the Roman system of continental Europe), and cannot be defined by simply amending some law, the definition of a trust vehicle has to be done through creating a new law and changing the Civil Law along with it. This remains one of the long term targets of the government entities. For the time being the passive special purpose vehicle function will be performed by mutual investment funds. For the purposes of mortgage assets, they will be named as mortgage investment funds. These funds, just like the existing mutual funds established by banks on their balance sheets and managed by portfolio management companies, will be established within the banks' balance sheets, with no equity capital. The income statements will comprise cash flows generated by the underlying real estate assets. They will be bankruptcy remote just like their trust and covered bond counterparts. The rules and regulations with respect to the creation of asset pools, mortgage investment funds and managing the underlying assets will also be governed by the secondary regulations which are to be subsequently issued by the Capital Markets Board.

Apart from the banks issuing mortgage backed bonds (mortgage assets investment fund shares), the concept of a conduit will be introduced with the new regulation. The conduit type incorporations are named as "mortgage finance institutions" (MFIs). MFIs will be allowed to operate in a variety of ways, however two of them are expected to form the core of business: "Central home loan bank" and "private conduit" strategic business units. As a home loan bank function, the MFIs are expected to issue debt instruments to raise funds which then will be channeled to the commercial banks

for home loan purposes. As a private conduit, the MFIs are expected to buy out the confirming mortgage assets of the commercial banks, underwrite and securitize. The similar trust-like vehicle will also be utilized in the securitizations through MFIs.

III.c. Deficiencies of the New Regulation

Although it will provide crucial remedies to certain outstanding impediments against a robust mortgage system there are still certain amendments to be made.

First of all, the consumer protection law puts the banks under a similar scheme of responsibility with the constructor in the case of project based home loans. In other words if the banks offer special loan packages specifically geared towards a specific housing development project, they are as equally responsible as the developer for compensating for losses due to late key delivery or faulty production within 5 years after key delivery.

In order to build up a portfolio of mortgage receivables backed by securitizable real estate collaterals, the banks will prefer to extend home loans to homes with standards above average. In Turkey, these homes are typically found in certain development projects built by reputable constructors. However, the fact of being equally responsible with the constructor will definitely not help the banks. The definition of this responsibility should be loosened up, at least to put the lenders in a slightly less responsible position than the constructor, as they have to deal with a number of other commercial risks too.

Insurance is a very crucial aspect of a mortgage lending scheme. The insurance industry in Turkey is quite advanced and the current regulation is adequate to develop any kind of insurance policy. However, since the premiums are still high, any insurance policy which would add extra basis points on the interest rates are not welcome. If not a full coverage, partial mortgage insurance coverage should be added to the origination guidelines. Since

long term home loans do not have a long credit history in Turkey, this type of a partial coverage will increase the rating of the mortgage pool to be securitized.

Although a vast majority of the lenders in Turkey are commercial banks, leasing companies are also considered to be mortgage lenders by the upcoming regulation. Leasing companies are subject to a different set of rules and regulations which provide them with certain benefits which may cause unfair tax advantages against the banks. While drafting the

secondary regulations special attention must be placed on making all the lenders subject to the same set of rules.

IV. Conclusion

With decreasing inflation and interest rates, home loans are likely to get more affordable. However, this will take some time. Against all the expectations, the upcoming regulation is a set of amendments in some existing laws and regulations to remove some of the impediments which could, in

the future, set a barrier against an efficient mortgage lending scheme. For the time being, the amendments seem fairly adequate; however, they are likely to be in need of further improvements in the future. At this point, secondary regulations, which will follow the primary regulation, may be formed to fill in the gaps, This would decrease the need for further amendments.

Needless to say, the housing finance system in Turkey presents one of the most exciting market opportunities of our times.