Creating a Housing Finance System in West Bank and Gaza

by Larry Hannah, Tamara Lansky, and Michael Lea

BACKGROUND

The West Bank and Gaza (WBG) represents an unusual and challenging area in which to develop a housing finance system. The area was captured by Israel in 1967 and remained under Israeli control until very recently. With the signing of the Cairo Agreement in April 1994, the administration of Gaza was transferred to the Palestinian Authority (PA); and with the signing of the September 18, 1995, agreement, 40% of the West Bank came under the administrative control of the PA as well.

The PA collects taxes and provides public services in areas of WBG which are under PA jurisdiction. With the help of the donor community and international institutions, such as the European Commission and the World Bank Group, the basis for a legal and regulatory infrastructure is being created.

The private sector has experienced positive development since the signing of the Middle East Peace Accord in 1993. A number of companies have been established by local and Diaspora Palestinians, and a stock exchange was recently opened in Nablus. Six-hundred and seventy new companies were registered with the local authorities in the WBG during the first half of 1998, up from 600 during the same period of 1997.

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Economic Lag

However, the overall economy of WBG has failed to develop since the signing of the Peace Accord. Economic performance has not kept pace with the rapidly growing population with the result that real GNP per capita fell by more than 10% between 1994 and 1997. However, positive employment trends during the first half of 1998 suggest an improved outlook for growth in 1998. Based on preliminary data, the IMF believes that real GDP grew by 2.5% to 3% in 1998.

WBG suffers from one of the highest unemployment rates in the world. The rate of unemployment substantially increased after the peace accords to levels reaching one-fifth to one-third of the labor force. This situation improved somewhat in 1998 with unemployment falling to 23% of the Gaza labor force and 13% in the West Bank.

Much of the recent job growth in the WBG has occurred in the construction sector. Over the course of 15 months, construction employment rose from 17% to 23% of the labor force.

Severe Housing Shortage

During the past 30 years the construction of new houses in WBG was severely constrained due to formal restrictions on land and housing development, and low and uncertain incomes. Strong restrictions were imposed on the transfer of funds into WBG and on the establishment of local financial institutions.

Unlike other countries with housing shortages or populations unable to afford housing, Palestinian families do not usually opt for informal housing such as squatting on public land or renting in slums. Rather, the norm is to expand nuclear households, creating highly crowded conditions.

Over this period a severe housing shortage has developed in WBG. One-third of Palestinian households have more than three persons per room and 10% of the population lives in units with up to five persons per room. One-quarter of all households have no running water, one-fifth have no electricity and over one-third have no sanitation facilities.

Since the signing of the peace accord, housing construction has expanded dramatically. The level of real estate investment of more than 10% of GDP is towards the higher range observed in developing countries during the 1995 to 1997 period. The pace of activity is particularly noticeable in Gaza, where hundreds of multifamily units have been constructed. As the housing supply is far from meeting the need and demand, the high level of activity in this sector is expected to continue.

Lack of Home Financing

However, a significant number of housing units in Gaza remain unfinished or vacant due to a lack of end-user finance and problematic rental control laws which act as a disincentive for owners to rent out premises. The need for housing by many households cannot be translated into actual demand because of insufficient income, effective demand or the lack of long-term financing.

In the present economic and political environment in the WBG, commercial banks and other financial institutions are reluctant to commit significant financial resources to mortgage lending because of perceived high credit and liquidity risks. Also, the problematic legal environment has curtailed the development of the sector. Cultural impediments exist, including an aversion to borrowing and eviction being considered taboo in the Palestinian society.

All these factors limit demand for housing even from households who could otherwise afford housing. Nevertheless, by all accounts there exists significant demand for housing loans.

The Palestinian financial sector has mobilized a significant volume of resources since the signing of the peace accord. According to the Palestinian Monetary Authority, private deposits in domestic banks grew steadily between 1997 and 1998. Deposits at the end of July 1998 stood at US$2.1 billion, up 23% during the course of a year. The growth in credit issued to resident customers during the year slightly outpaced the growth in deposits, standing at approximately $550 million.

These promising numbers suggest that confidence in the banking sector has been maintained. However, the financial sector lacks the range of financial institutions, products and services common to many developing country markets. In particular, there is a relative lack of lending by the banks, as evidenced by the low loan-to-deposit ratio, and virtually no term lending, though this is starting to appear.

THE MORTGAGE MARKET

The mortgage market in West Bank and Gaza is almost entirely undeveloped. Although a number of banks have entered (or re-entered) West Bank and Gaza after the signing of the peace accord, they have not yet engaged in long-term mortgage lending. A few banks make short-term (3 to 4 year) housing-related loans, but security is not effected through a mortgage.

Interviews with banks in the region suggest that lending has been slow to develop for two reasons; (1) the time and expense necessary to develop the lending infrastructure and (2) concerns about the risk of lending in the region. The two major housing finance risks cited by the banks were credit and interest-rate risk.

The only financing being provided to home buyers in West Bank and Gaza is by developers who offer installment sale contracts. The developers offer such terms in order to sell their units, and they finance the necessary funds from the rollover of short-term loans. In so doing, however, they tie up their scarce and expensive capital, which slows down the rate of new construction.

Many developers offer installment sale contracts. The stated terms on these contracts appear quite attractive, with interest rates as low as zero percent. In reality, however, the implicit rates are often quite high, reflecting up-front fees and increases in the price of the unit.

There are a number of constraints to a rapid growth in the mortgage market. A major constraint is affordability. Available information suggests that relative house prices are very high, with payment-to-income ratios well in excess of 5. It is also very difficult to get accurate income data. Many Palestinians have two jobs, and the history of occupation has led to a culture of non-disclosure.

In addition, a low percentage of land is registered, and there remain costs and uncertainties associated with mortgage registration and foreclosure. The culture does not encourage borrowing.[1] Nevertheless, both developers and banks report a strong demand for housing despite the lack of financing as a principal constraint.

There is no observable market mortgage rate in West Bank and Gaza. The implicit rates offered by developers are clouded by the fact that they are forced to offer financing terms to sell their houses. The stated rate of interest charged by banks in West Bank and Gaza on short-term commercial loans is 9% to 12% in US dollars. However, the effective rate of interest is often quite higher, reflecting the payment of up-front fees and the method of interest calculation.

According to banks and developers, the current borrower preference is for fixed-rate mortgages. The mortgage rate has to compensate lenders for the credit, liquidity and cash-flow risks, operating costs and reserve requirements, as well as provide an acceptable return on equity for their shareholders.

THE PALESTINE MORTGAGE AND HOUSING CORPORATION

The Palestine Mortgage and Housing Corporation (PMHC) was created in 1997 to stimulate the development of a mortgage finance market and capital market in WBG. The business objective of the company is to generate profits for shareholders through its lending and insurance operations.

The development objectives of the company include the stimulation of mortgage lending by banks through re-allocation of the risks of mortgage lending, facilitating the flow of private capital into the production of housing and the development of a Palestinian capital market through bond issuance.

The PMHC will provide long-term funds for lending by banks and other primary market lenders (PMLs) in WBG through a Liquidity Facility (LF) subsidiary. It will also provide mortgage loan insurance for long-term loans initiated by commercial lenders through a Mortgage Insurance Facility (MIF).

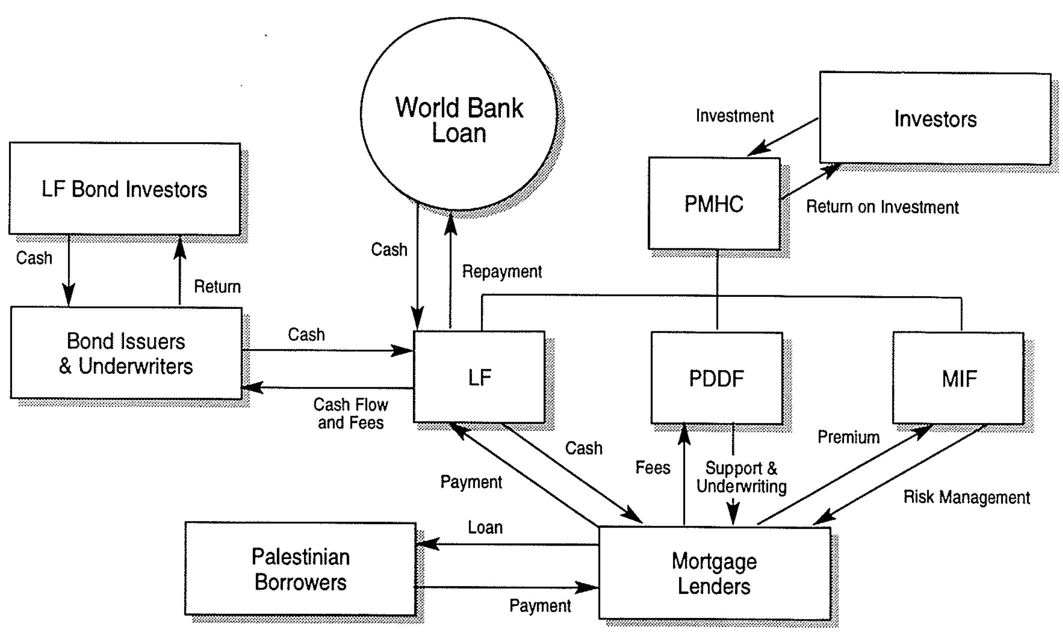
The organization structure is shown in Figure 1.

The PMHC will be a majority privately owned company. In addition to the founding members, the Palestinian Authority (PA) and the Palestinian Monetary Authority (PMA), the founding shareholders include the International Finance Corporation (IFC), Arab Bank, Palestine Development and Investment Company (PADICO) and Deutsche Investitions-und Entwicklungsgesellschaft mbH (DEG) and Consolidated Construction Company (CCC).

As of June 1999, a total of 12 institutions, including banks and developers, have committed approximately $30 million in paid-in capital. The target initial paid-in capital is $20 million and was to be allocated at the end of June 1999. The World Bank has also committed to provide a $17 million loan on IDA terms. Affordability will be addressed through creation of a housing assistance fund (HAF) by the PA.

The World Bank will provide $7 million in up-front grants to facilitate eligibility of marginal

Figure 1. Organizational Structure: Palestine Mortgage and Housing Corporation



borrowers.[2] Technical assistance will be provided by the Canadian Mortgage and Housing Corporation (CMHC) with funding provided by the Canadian International Development Agency (CIDA).

The Liquidity Facility (LF)

The LF will provide funds to qualified lenders, which in turn will make mortgage loans to qualified individual borrowers. In general its funding will be longer term (e.g., 7 to 15 years) than that available to most banks, facilitating liquidity-risk and interest-rate-risk management of mortgage lenders. Initially, all loans granted by primary market lenders to borrowers using the LF funding will be insured by the PMHC through the MIF.

As a liquidity provider, the LF should be exposed to minimal credit risk. The design of the LF is for it to be a collateralized lender, making loans to banks secured by a lien on their mortgage portfolios. In this manner, the LF would be protected by both the capital of the bank it is lending to and a priority claim on its mortgage assets.

Implementation of this design is complicated by the nature of mortgage registration in WBG. In practice, the LF will make a loan or establish a credit line to a bank to fund its mortgage lending. The bank will assign its interest in the mortgage loans to the LF as collateral.

The assignment will not be registered immediately, however. Rather, the lender will grant a special and irrevocable power of attorney to a person designated by the PMHC, allowing such designated person to act on behalf of the LF in effecting (i.e., registering) the assignment. In the event of default by the bank on its loan from PMHC, the company's representative will register the assignment and take possession of the mortgages to satisfy its claim.

The LF will raise funds initially through the World Bank loan and equity contributions from the founding investors. The LF will subsequently raise funds through domestic bond issues and foreign syndicated loans, and eventually through international bond issues.

Two incentives have been proposed to encourage LF business. Interest on its bonds will be tax exempt, and the bonds purchased by banks will be credited towards PMA reserve requirements. The LF will be a separately capitalized subsidiary of the PMHC. The amount of the initial capitalization has not yet been determined.

The Mortgage Insurance Facility (MIF)

The MIF will provide mortgage loan insurance to primary mortgage lenders against default in payment by the borrower, subject to certain terms and conditions. The loan insurance will be initially limited to single-family housing loans in excess of 50% loan-to-value ratio with a minimum term of seven years.

The MIF will develop detailed documentation, underwriting and servicing guidelines that PMLs must follow in order to be eligible for the insurance. The MIF is designed to operate on a commercially viable basis, with a premium structure sufficient to generate a reasonable return to private investors in the PMHC.[3]

The MIF will be a separately capitalized subsidiary of the PMHC. Because the MIF will be capitalized by the PMHC and replenished from on-going premiums paid by borrowers, lenders' risks will be reduced significantly. The lenders will also maintain an interest in providing good underwriting and servicing of the loans due to their continued 30% sharing of the credit risk. As conditions improve in the market, lenders may be able to retain a larger portion of the risk.

Initially, the product lines offered by the MIF will be limited to the following:

1. Homeowner new—singles and condos.
2. Homeowner existing—singles and condos.
3. Maximum insurance coverage of 70% of the amount of the loan.

Mortgage insurance is a critical catalyst for starting a housing finance system in WBG. Without some form of credit-risk insurance, lenders will not make housing loans in the area. Mortgage insurance can increase the likelihood of any or all of the following outcomes:

- Expanded homeownership, especially for households of limited means.
- Expanded employment by stimulating housing demand and construction.
- Improved standards for housing construction and improvement.
- Improved standards for mortgage loan underwriting and administration.
- Spreading and sharing of lender risks arising from mortgage default.
- Mortgage lenders induced to lend when they otherwise might not do so.
- Mortgage lenders induced to offer more affordable terms, more flexible eligibility criteria.
- Non-mortgage lenders induced to support housing by buying mortgage-related investments.
- Increased leverage (i.e., productivity) for external housing assistance funding.

A major project and business risk is the ability to price mortgage insurance. The suggested initial premium of 5% is at best a guess. It is based on the assumption of a 5% claim rate spread over the first seven years of the loan, 120% loss rate with 70:30 loss sharing. In the absence of any mortgage lending in the region, the likelihood and incidence of default and the losses per default occurrence are unknown.

There is also a high degree of political risk that can manifest itself in high default losses. Israeli border closings can adversely impact the ability of borrowers to pay. Political unrest can impact the willingness to pay. Setting mortgage insurance premiums at appropriate levels may be subject to political pressure (i.e., lowering them to make loans more affordable).

The uncertainty regarding future MIF losses was instrumental in the decision to use the concessionality (below-market interest rate) on the World Bank loan to build reserves, instead of subsidizing loan rates. A portion of the difference between the World Bank loan rate and the rate charged to banks will be added to the MIF reserve on a monthly basis.

An important policy decision made by the PMHC is to have banks be responsible for taking foreclosure action. The banks have an incentive to take action even after payment of an insurance claim, as they bear 30% of the loss. On-going PA support of the principles of contract enforcement and foreclosure is a critical element to the success of the project.

The PMHC will separately capitalize the LF and MIF subsidiaries. The risks faced by the LF and MIF will be quite different, and an important element of project design is to insulate the LF from the MIF credit risk. The insulation is necessary to ensure that the LF is viewed as a low risk so that it can obtain a high rating and raise funds on domestic and international bond markets at favorable rates.

An additional function of the PMHC will be the development of new products and the design and delivery of training events to lenders and educational seminars targeted at the Palestinian population.

PROJECT PROGRESS

The WBG housing finance project is quite ambitious in both absolute terms and relative to the capacity of the area in which it is being introduced. The project design encompasses a term lending program, a mortgage insurance program and extensive technical assistance for the facility and its customers (including financial institutions, borrowers and government officials).

All of these components are necessary although not sufficient conditions for creating a mortgage market from scratch. In addition to creating and staffing the facility, it has been necessary to find a long-term technical assistance partner in creating the PMHC and in the development of the legal and regulatory infrastructure for mortgage lending and capital market development.

As a result the project has taken a considerable amount of time to develop and implement. This is not surprising, given the daunting objective of creating a new mortgage market in the difficult political and economic environment of WBG.

The World Bank began work on the project in 1995. In addition to developing the project concept, the Bank provided technical assistance to improve the legal infrastructure for mortgage lending and real estate development. The World Bank loan was approved in April 1997. From the beginning, the intent of the project was for PMHC to be a majority private sector-owned institution. This structure was selected to ensure that the institution would be run on a commercial basis, prudently managing its risks and costs.

Government involvement was viewed as necessary to demonstrate a serious commitment to sector development and to facilitate necessary legal and regulatory reforms essential to the development of a private housing finance system.

The main counterpart of the Bank was the PA, which along with the Palestinian Monetary Authority were the founding shareholders. Initial efforts to obtain commitments from private sector shareholders were unsuccessful, in part due to the perception that government would dominate the institution.

IFC's Critical Role

The involvement of the International Finance Corporation (IFC), beginning in mid-1997, was a critical factor in moving the project forward. The IFC provided substantial technical assistance to survey and evaluate the legal, regulatory and tax environment, suggest and work for necessary changes, implement a business plan that established the two subsidiaries in order to ensure separation of risks, and performed a full survey of the market.

IFC acted as catalyst to bringing the other private sector investors/partners to the project, providing a significant degree of comfort to prospective private sector shareholders that the institution would be operated on a commercial, profit-making basis.

The IFC's efforts culminated with a conference in December 1997 at which the project concept and business plan were formally introduced and commitments for approximately $20 million in private sector equity contributions were obtained.

A major building block for the project was enlisting a technical assistance (TA) partner for the PM HC. The size and complexity of the project strongly suggests the need for comprehensive and on-going assistance.

Ideally, the TA partner would provide one-stop shopping covering insurance, funding, legal, systems, and primary market development assistance.

The project design called for a minimum two-year commitment by the TA provider, including on-site, resident staff. There are few institutions in the world that can provide such comprehensive assistance. The Canadian Mortgage and Housing Corporation is one such institution.[4]

In Canada CMHC operates a mortgage insurance program and a mortgage-backed securities guarantee program. While CMHC does not currently operate a liquidity facility in the strict sense of the word, it provides many component functions to its Canadian customers. In addition, as the principal TA provider, it can subcontract for additional and more focused assistance. Funding for CMHC is provided by CIDA.

A third major project component has been staffing. Attracting qualified staff to a start-up company is always a challenge, but even more so in WBG. There are not mortgage lenders from whom to draw staff, and it is not easy to find individuals to relocate into such an uncertain political and economic environment.

The PMHC was exceedingly fortunate to attract, as General Manager, Osama Ammouri, a Palestinian who has been working as a real estate developer and mortgage banker for the last 20 years in the U.S. In addition, two directors and several staff were hired at the beginning of the year.

THE INTERNATIONAL FINANCE CORPORATION

The mission of International Finance Corporation, part of the World Bank Group, is to promote private sector investment in developing countries that will reduce poverty and improve people's lives. IFC finances private sector investments in the developing world, mobilizes capital in the international financial markets, and provides technical assistance and advice to governments and businesses.

With 174 member nations providing capital, IFC helps the private sector in three ways: participating in financing projects through medium- and long-term loans and equity; mobilizing additional financing in international capital markets; and offering business analysis, advice, and technical assistance to support promising projects. IFC prefers to participate in projects and business ventures jointly rather than as sole investor. It helps to finance a wide range of enterprises—approving projects whose total cost may be as small as US$500,000 or as large as US$1 billion, depending on the size of the economy of a member country.

IFC provides more than finance. It may help a business identify its markets, refine its technology base, or identify promising partners. It may advise governments on how to improve the climate for private investment. IFC offers advisory services either as part of its investment, using grants by government technical assistance trust funds, or independently for a fee.

IFC is a major player in the financial sector. It invests in many types of financial institutions such as leasing and factoring companies, housing finance institutions, venture funds, brokerage firms and banks. It also provides advice to governments on creating an environment for sound financial sector development.

Government Role

The PA has played a major role in developing the institution. The government involvement demonstrates its commitment to housing finance sector development and the social importance of housing. The minority role of government is designed to demonstrate to both customers and investors that the company will be operated on commercial principles.

First and foremost, the government has strongly supported the concept since the early days of development. In particular, it has agreed to the majority private sector ownership and second tier approach, despite pressure to create a housing bank owned by the government as a direct lender in the region (in competition with established banks).[5] The PA is an investor in the project and guarantees the World Bank loan to the PMHC.

The company has received two important privileges that will lower its cost of funds and increase demand for its products. First, interest on its bonds will be tax exempt; and, second, bond investment by banks will reduce their PMA reserve requirements. The exemption is important if PMHC is to provide competitively priced funding for banks, as interest on bank deposits is exempt from taxes. Likewise, allowing banks to credit their bond investments toward PA reserve requirements (the reserves earn near zero percent interest and are effectively a tax on banks) will increase the demand by these investors.

PMHC will begin a pilot loan guarantee program during the third quarter of 1999. They will work with two to three banks to develop documentation and underwriting guidelines leading to the origination (with MIF insurance) of mortgage loans. Simultaneously, they will prepare the master loan and servicing agreements and legal documents to begin LF lending.

The business plan envisions the company raising funds in the domestic capital market in its second year. (Its first-year lending will be funded from the World Bank loan and equity.) The bonds will be listed on the Palestine stock exchange on which there are a number of equity instruments listed and traded. PMHC's bonds may be the first debt instruments listed and traded on the exchange.

Through its issuance of bonds, the PMHC can further capital market development, an important objective of the project. In addition, bond issuance will be a way in which funds can flow from resource-rich banks that may not be interested in mortgage lending to resource-short banks that are interested in entering the market.

After a long period of planning and development, the PMHC is finally nearing the point that it will begin operations. There are still significant obstacles to overcome, including completing the staffing and improving the legal and regulatory infrastructure but the hope is that once mortgage lending is started in the region, it will prove attractive to both borrowers and lenders.

NOTES

[1] Not all of the lands of Gaza and the West Bank are cadastered (subject to registration), and even those lands which are cadastered (and consequently subject to registration) do not necessarily accurately reflect the ownership of such lands. In addition, different rules govern property registration in West Bank and Gaza. Although the legal framework for foreclosure exists, it has not been tested in recent memory.

[2] The target borrowers are households with income of $400 to $600 per month purchasing houses in the price range of $25,000 to $30,000.

[3] The premiums charged will be set to cover operating costs and "normal," but not catastrophic, risks. Initial analysis suggested an average premium of 5% of the loan, which could be paid up front or financed in the loan. Further analysis of the required premium will be done during the implementation phase.

[4] The World Bank and IFC also approached the Federal Housing Finance Board (regulator of the Federal Home Loan Banks, a liquidity facility in the U.S.) and Cagamas, a liquidity facility in Malaysia.

[5] The experience in Jordan is noteworthy. The Jordan Housing Bank was owned by the government and benefited from substantial preferences. As a result it crowded out other lenders from the mortgage market.