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# HOUSING FINANCE INTERNATIONAL

The Quarterly Journal of the International Union for Housing Finance

- The Global Financial Crisis and the Turkish Housing Market
- Non-Recourse Mortgages and the Prevention of Housing Bubbles
- Home Improvement Grants in Trinidad and England
- Housing and Urbanisation in Algeria between 1966 and 2008
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- Islamic Finance and its Application in Housing Projects

International Union for Housing Finance

# Housing Finance International

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# Editor's Introduction

↳ By Andrew Heywood

The world looks a distinctly less stable place than it did a month ago. First there was Bahrain, closely followed by a stream of Middle Eastern countries with constituencies seeking a democratic way forward. At the time of writing the political situations in Libya and Bahrain look very uncertain. Question marks over the stability of the region and about future oil supplies have left their mark on financial markets and on the price of oil.

The full human, environmental and economic fallout from the earthquake in Japan has yet to become apparent. What is certain is that the dislocation of markets and trade will leave few unaffected. The additional spectre of the Japanese authorities battling to contain a nuclear disaster merely renews questions over the exploitation of an energy source that generates by-products such as Plutonium 239 whose half-life spans 24,000 years into the future, and whose lethal propensities stretch way beyond.

In Europe uncertainty continues over the ability of the Euro zone to maintain the confidence of financial markets, with Spain suffering a further rating agency downgrade in March this year. In the US it appears that the Obama administration is making further efforts to mitigate the dampening effects of the housing market on economic recovery by grappling again with the twin problems of negative equity and mortgage default. Here in the UK there appears to be a growing consensus that house prices are set to fall further over the next 12 months and perhaps beyond.

At times like this taking the longer view and exercising considered judgement are both very important and very difficult. Nevertheless, as always, Housing Finance International (HFI) attempts to take the broader view with a series of articles whose scope takes in the Turkish housing and capital markets, the housing issues that have faced Algeria since independence, housing improvement in Trinidad, Islamic finance, non-recourse mortgages in Spain and mortgage fraud.

In the first of a pair of articles Yener Coşkun examines the causes behind the relative immunity of Turkey to the effects of the international banking crisis. He cites the lack of development in the use of the capital markets to fund Turkish housing and mortgage markets as a significant factor in the relative lack of effect of the crisis on Turkey, but points to a number of other negative consequences that also follow.

The problems of the Spanish housing and mortgage markets have received world-wide attention and it is good to see that commentators are beginning to look forward to preventing or mitigating future house price bubbles. Manuel Castilla argues that the almost universal use of full-recourse mortgages in Spain contributed to economic and social impact of the housing bubble. He recommends greater use of non-recourse mortgages as a more appropriate way of reconciling the interests of lender and borrower.

An article focussing on a single state in the Caribbean has been something of a rarity in HFI. We are therefore particularly pleased to present an article on housing subsidies in Trinidad. Kathleen Scanlon assesses the extent to which subsidies improve the housing conditions of the lowest income groups. She points out that houses in Trinidad are often self-built and lack basic amenities. Formal housing finance is unavailable to many because their incomes are too low. Now the approach is to help residents to improve the homes they have by offering grants to cover 50% of the costs. Ms Scanlon provides a comparison of the grant system in Trinidad with past and current English practice and offers conclusions as to whom the Trinidad system helps and how much.

Acidi Abdelhak and colleagues offer a fascinating study, focussing on the development of housing provision in Algeria; a country that exhibits marked contrasts, notably between urban and rural areas and North and South. Tracing the vicissitudes of housing policy since independence in 1962, the article paints a picture of real improvements to housing conditions including access to mains services such as sewage and electricity, in spite of persistent regional disparities and unresolved demand issues.

Mortgage fraud is seldom a priority for lenders on a rising housing market when market share and competition are inevitably the main focus. Nevertheless, it is the frauds that are perpetrated close to the top of the market that gain the headlines and cause the headaches on the way down. Beverley Houlbrook is at the centre of much anti-fraud activity in the UK and offers a professional analysis of recent trends in the UK and the US. She sets out two high-profile case studies to provide real insight into how fraudsters work, and how their activities can be minimised.

Sarah Gooden provides an excellent introduction to Islamic finance in this edition of HFI. She provides a useful contrast between "western" and Islamic finance in terms of their approach. In doing so she reminds us that many of the moral strictures against charging interest that inform the Islamic approach were once shared by Christians as well as Muslims. The article shows how Islamic scholars and financial experts have co-operated to offer a modern and viable alternative for those who believe that their faith should inform and guide their financial dealings.

# Contributors' Biographies

**Mr Yener Coşkun** is senior specialist at the Capital Markets Board of Turkey and holds MRICS designation. The author spent 10 months at Wharton School and PhD Candidate at Ankara University Real Estate Development Department. Yener Coşkun has two published books and several journal articles on capital markets and housing finance.

**Mr Manuel Castilla** is Professor of Law & Economics at the Universidad de Granada Law School. He is also Director of the Family Firm Department at its Business School. He holds a PhD from the Università di Bologna and a Master of Law (LL. M.) from the University of Chicago Law School.

**Ms Kathleen Scanlon** has been a member of the LSE London research centre at the London School of Economics for ten years. An economist and experienced social-science researcher, she specialises in housing finance, comparative housing studies and housing policy. She has edited two books on social housing in Europe and is currently co-ordinating a study of the effect of the financial crisis on mortgage markets in Europe.

**Dr Acidi Abdelhak** (PhD) is Associate Professor in regional and urban planning in the Department of Urban Planning, at Badjimokhtar University of Annaba in Algeria. He is a head manager of urban Graduation Studies. He is a member of several research projects focusing on housing and urban sociology and he is supervising students from graduation to post graduation researches.

**Dr Brakchi Souad** is a lecturer in urban planning in the Department of Urban Planning, at Oum El Bouaghi University in Algeria. She is a member of several research projects focusing on urban planning.

**Dr. Khamchoul Kamel** is an associate professor in statistical Geography at Badjimokhtar University. He is a member of several research projects and supervises graduate and post-graduate students.

**Ms Beverley Houlbrook** began her career in 1985, within HSBC. In 2001 she became principal analyst with the bank's credit analytics department before taking on dual responsibilities in 2005 as credit and risk portfolio manager for mortgages. In 2008 she took up the position of senior business consultant at Callcredit where Beverley was charged with educating banking, insurance, retail and telecoms sectors of fraud prevention and credit products and services. In March 2010 Beverley joined CoreLogic Solutions as a fraud consultant, taking ownership of the FraudMark suite of products in the UK. Beverley is heavily involved with implementing improved fraud management processes within the mortgage sector.

**Ms Sarah Gooden** is a partner in the Banking and Finance department of the UK and international law firm Trowers & Hamlins LLP. She is co-head of the firm's Islamic Finance group and is recognised as a legal expert in social housing finance. She has advised a number of Islamic banks, particularly in relation to real property investment, and advises social housing providers on the full range of financing used in the UK social housing sector.

# The Global Financial Crisis and the Turkish Housing Market: Is There a Success Story?[1]

↳ By Yener COŞKUN[2]

## 1. Introduction

Turkish households traditionally prefer to invest in real estate over other investment alternatives. Demographics, immigration to urban areas, urbanization, industrialization and urban renewals are known to have significant effects on the domestic demand for real estate in Turkey. Foreign direct investments (FDI) have also led real estate markets to grow since the 2000-2001 banking crisis.

After the crisis, particularly in the 2003-2007 period, the Turkish economy demonstrated an extraordinary period of economic growth due to several reasons such as EU full membership candidacy, improving political and economic stability and increasing liquidity resulting from increases in direct and portfolio investments.

Rising residential prices, increasing the supply of residential units and shopping centres growing FDI to domestic real estate market (particularly for commercial real estate investments) and production growth in social housing (by the HDA/Housing Development Administration of Turkey) are the positive indicators of dynamic real estate markets in this period. In addition to this remarkable period of market movement, there are many underlying reasons for the strong housing demand in Turkey (i.e. young population and inward migration, renewals, growing demand for affordable housing and niche residential demand etc.) which are important for a long - term market development. On the other hand, the demand for industrial and commercial real estate also seems strong in Turkey thanks to a dynamic socio-economic structure.

It has been observed that the global financial crisis has had destructive impacts for both developed and developing countries. In this context, it seems that Turkey is positively decoupling from other countries due to a limited negative impact of the global financial crisis on its financial and real estate markets. In this article, we consider, from the perspective of national mortgage markets, whether there is a success story for Turkey; does the picture imply a different story other than the successful crisis management?

The paper is organized in four sections. The next two sections are dedicated to the analysis of the importance of the real estate and housing market for the Turkish economy. In sections four and five, we analyze the impacts of global financial crisis on the Turkish economy and also on the housing sector specifically. The last section is reserved for concluding remarks.

## 2. Real Estate and the Turkish Economy

### 2.1. Fundamentals

The area of Turkey is 778,000,000 km². 26% of this area is forest and 12.3% is pasture area. The rest is the (rural/urban) cadastral area which contains 480,000 km² in total. The Residential area is about 5% (40,000 km²) and the rural area is about 56% (440.000 km²). There are approximately 35,000,000 parcels and 600.000 registers in Turkey (Bank and Mataracı, 2004: 3).

Çete et al. (2010: 627) indicate that the percentage of the completion of the cadastre surveying is 88.1% as of 2009. It is said in the Ninth Development Plan that activities related to the completion and digitalization of cadastral information, which enable the operation of land markets in the agricultural sector and constitute an infrastructure for the administration and control of agricultural policies, will be finalized (State Planning Organizations, 2006: 91).

Both the construction and real estate sectors have critical functions for the growth/ development process of the Turkish economy. In terms of housing finance/construction activities, the real estate economy affects the level of economic activity, employment rate etc. In this context, the economy requires constant real estate investments due to increasing economic growth, immigration to urban areas,[3] renewals[4] etc.

### 2.2. Demographics

Population growth and inter-regional migration have been and will be significant drivers for the Turkish real estate markets. The last census

[1] This article is essentially based on the working paper "An Analysis of the Opportunities and Weaknesses of the Turkish Real Estate Market" (17th Annual ERES Conference,Milan/ITALY), see, Coşkun (2010c). The findings, interpretations, statements and conclusions expressed herein are those of the author alone and do not necessarily reflect the views of the the institutions connected with the author.

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[3] From the beginning of the 1950's, big cities have faced extraordinary rural immigration in Turkey. It is expected in the near future that socio-economic transformation of the country may also increase the rural immigration.

[4] 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 (Karakaş ve Özsan, 2005: 37).

counted a population of roughly 70.6 million at the end of 2007. In 2007 the fertility rate was at 2.2 (children per woman) compared to an average fertility rate of 1.5 for the EU-25 countries. With currently more than 53% of inhabitants younger than 30 years, this ensures a steady expansion in the number of people of working age. These demographic trends will have a strong impact on housing demand as well as on commercial real estate (Deutsche Bank Research, 2008: 7).

Deloitte (2009: 77) estimates that the rapid population increase and the need for earthquake-resistant housing projects ensured overall growth and construction volume reached €24 bn in 2007. Jones Lang Lasalle (2008: 5) underlines that over the last decade Turkey's urban population has increased by some 10 million dwellers, while Istanbul alone has grown by nearly 2 million new inhabitants.

**Figure 1** Real Growth Rates of GDP and Main Components (2003-2009/1)

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009-1 |
|---|---|---|---|---|---|---|---|
| GDP | 5.3 | 9.4 | 8.4 | 6.9 | 4.7 | 1.1 | 13.8 |
| Agriculture | 2.2 | 2.7 | 6.6 | 1.3 | 7.0 | 4.1 | 3.0 |
| Manufac. Ind. | 8.4 | 11.9 | 8.2 | 8.4 | 5.6 | 0.8 | 18.5 |
| Construction | 7.8 | 14.1 | 9.3 | 18.5 | 5.7 | 7.6 | 18.9 |
| W. sale. & Retail. Trade | 11.4 | 13.8 | 9.5 | 6.3 | 5.7 | 0.9 | 25.4 |
| Financial Inter. | 5.1 | 14.0 | 13.6 | 14.0 | 9.8 | 9.1 | 10.8 |

*Source:* BRSA (2009: 11)

## 2.3. Real Estate and Construction Activities

The fall of inflation and interest rates after 2001, as well as increasing liquidity led to the rise of investments in real estate and construction activities (Undersecreteriat of the Treasury, 2009: 61). According to TurkStat (Turkish Statistical Institute), the construction sub-sector has made a contribution to the gross national product at a rate 3.5% - 5.3% through its activity between years 2004 – 2006.[5]

As seen in the table, the construction sector is one of the leading sub-sectors for the GDP growth. Particularly between 2004 and 2006, the construction activities seem critical for GDP growth. Construction sector also provides employment opportunities. According to the State Planning Organization (2006: 45), the share of the construction sector, where an average of 1,1 million persons are employed, in total employment was realized as 5.3% as of the end of 2005.

## 2.4. FDIs and M&A Deals

FDI inflows to Turkey in the construction and real estate, renting and business activities sectors have exhibited an upward trend in recent years. In 2008, inflows in construction took 4.9% and real estate, renting and business activities 4.5% of the shares from total FDI inflows to Turkey. After 2002, real estate, construction and retail trade businesses in Turkey started to grow fast. The growth rate of population, immigration from rural to urban areas, the need for more earthquake resistant buildings particularly in the areas close to the fault lines and urban regeneration were the main determinants that stimulated investments in real estate and construction sectors (Undersecreteriat of the Treasury, 2009: 60).

According to the Dealwatch data, there were 259 deals in Turkish M&A market in 2008. In 2008 the most active sectors were manufacturing (87 deals), transportation (44 deals), real estate (26 deals). On the other hand, total net real estate purchases were 13 billion USD between 2003-2008. As of the end of 2008, of the 21,079 companies with foreign capital, the majority (6,210) operated in the wholesale and retail trade businesses, while 3,757 operated in the manufacturing sector and 2,408 in the real estate leasing business (Undersecreteriat of the Treasury, 2009: 7, 12, 28).

On the other hand, Turkey is among the top countries who export construction services. According to the leading international industry magazine "ENR Engineering News Record", with 31 companies among the top 225 contracting companies, Turkey ranked second in the world after China in 2009. In the period of 1972-2009 about 700 Turkish contractors have completed over 5.000 projects in 75 countries. The total value of the projects undertaken by Turkish contractors abroad reached 155 billion USD in the same period (Subaşı, 2010: 1).

# 3. Housing Market and the Turkish Economy

## 3.1. Housing Production and Gap

Most housing in Turkey is produced by private developers, public, quasi-public (cooperatives) or private organizations. There are also substantial amounts of shanty houses or units of housing settlements around the city centres or provinces that are built by private persons but they are deemed to be illegal one way to another and are without occupancy or construction permits. However they usually benefit from the limited public utilities provided by the local councils. Spontaneous settlements in Turkey are a result of the socio-economic and demographic pressures, which accelerated in the last three decades (Halıcıoğlu, 2005: 1).

However, although the figures change depending on how they are estimated it is generally accepted that there is a housing supply shortfall in Turkish housing market. As seen in the table above, Turkey seems well behind most of the countries which are comparable to her according to housing starts, housing completions and building permits criteria.

According to the data from TurkStat and the State Planning Organization, Turkey's housing requirement as of today is about 2.5 million either for renewal or conversion projects or quality house production projects. Due to population growth and continuing urbanization, Turkey will require an additional 5.5 million housing units by 2015. Added to the existing housing deficit, this represents a requirement for more than 500,000 new housing units annually. Furthermore, with a growing

[5] Available at: http://www.turkstat.gov.tr/Pretablo.do?tb_id=55 (10.04.2010).

**Table 1: Comparison of Housing in Turkey and Selected EU Countries (2004-2006)**

| Country | Housing Starts | | | Housing Completions | | | Building permits | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 |
| **Denmark** | 29,426 | 31,400 | 26,922 | 27,152 | 27,580 | 26,327 | 30,694 | 35,618 | 29,180 |
| **Germany** | n/a | n/a | n/a | 278,019 | 238,977 | 248,435 | 268,123 | 240,468 | 247,541 |
| **Spain** | 691,027 | 716,219 | 760,179 | 496,785 | 524,479 | 584,881 | 687,051 | 729,652 | 865,561 |
| **France** | 363,400 | 410,200 | 420,900 | n/a | n/a | n/a | 460,800 | 511,700 | 561,700 |
| **Poland** | 97,000 | 102,038 | 137,962 | 108,123 | 114,060 | 115,187 | 105,831 | 115,862 | 160,545 |
| **UK** | 227,875 | 226,766 | 231,583 | 203,376 | 209,560 | n/a | n/a | n/a | n/a |
| **Switzerland** | 52,652 | 57,340 | 60,232 | 36,935 | 37,958 | 41,989 | 30,923 | 31,928 | 35,416 |
| **Greece** | n/a | n/a | n/a | n/a | n/a | n/a | 80,842 | 95,032 | 81,301 |
| **Turkey** | n/a | n/a | n/a | 39,540 | 64,126 | 65,800 | 72,005 | 114,254 | 108,109 |

n/a: not available.

*Source:* European Mortgage Federation (2007: 126-130)

economy and rapid urban expansion, there is a need for commercial/office/professional buildings (Turhan, 2008: 4). Deutsche Bank Research (2008:1) forecasts that the 5.3 million (+3.7 million households, +1.6 million replacements) new housing units will be needed between 2007 and 2017 and another 500,000 additional housing units will be needed each year from 2018 to 2027 (For analysis of the other estimates see, Coşkun, 2009).

## 3.2. Problems in the Housing Market

Real estate represents a hedging instrument rather than a short-term investment instrument, particularly from the perspective of middle and lower - income residents'.[6] According to the rural area perspective and the generally accepted housing investment understanding, real estate is accepted as the most valuable/preferred asset category in Turkey. The motive behind this consumer behaviour is related to the protection of savings from adverse impacts of high inflation rates and negative real interest rates which have dominated the Turkish economy since the 1970s. One of the most critical results of this trend is that the real estate economy is growing at the expense of the financial economy in Turkey. Hence, financial assets/markets could not develop as expected in the country.

Simply considering the irregular housing practices would be enough to understand the wrong/inadequate real estate policies practised in Turkey. In this context, taking permits to use buildings as a criterion, it is estimated that 67 out of 100 buildings are illegal in Turkey (Turhan, 2008: 5-6). Keleş (2004: 560-561) estimated that the number of irregular housing[7] reached 2,200,000 in Turkey in the early 2000s.

The housing problem is an unsolved issue in Turkey. Article 57, titled "right to housing", of The Constitution of the Turkish Republic (1982) says that the State shall take measures to meet the needs for housing, within the framework of a plan which takes into account the characteristics of cities and environmental conditions and supports community housing projects.[8] Therefore, the housing issue is also constitutionally connected to the mission of the State. Consequently, it is expected that the State should help households to solve their housing problems. To solve the housing problem, the State currently prefers to finance (and directly produce) social housing through the Housing Development Administration (HDA/TOKİ) in Turkey.[9]

Another policy option for solving the housing problem is using financial subsidies in the form of tax and financial incentives like in the case of U.S. primary and secondary mortgage markets. But inefficiencies in the mortgage markets (see, 4.1) and the budget deficit of the country have prevented the use of this option.

The other policy option for the State is to reduce cost of development by increasing suitable land for building. Reducing cost of development is the most important way to reduce the cost of housing. According to estimations, cost of land of a typical housing construction (or development projects) is ranging between 30%-50% in the urban area. Public property consists of the majority of the total land in Turkey.[10] Therefore, it seems that government is the major landlord in Turkey. However, because of the absence of effective land management[11] and land-use

[6] Akkaya et al. (2005: 46) argue that REITs are probably the best inflation hedge instrument. Ucal and Gökkent (2009: 9) indicates that home ownership is regarded as an anti-inflationary hedge. But Önder (2000: 923) found evidence that residential real estate investment in several neighbourhoods in Ankara [the capital city of Turkey] does not behave as hedges for expected and unexpected inflation.

[7] We mean informal settlements (squatter settlement) or gecekondu in Turkish.

[8] Available at: http://www.anayasa.gov.tr/images/loaded/pdf_dosyalari/THE_ CONSTITUTION_OF_THE_ REPUBLIC_OF_TURKEY.pdf, 18.04.2010.

[9] HDA runs affordable housing programs by developing housing projects in cities with housing shortage and sells them out on a cost only basis with no profit and sometimes with a subsidy. HDA's primary task is to provide housing for the lower and middle income classes at affordable rates (European Mortgage Federation, 2007: 116). The HAD produced 423.854 housing unit between the period of 2003-2010. The institution is seeking to build between five and ten percent of Turkey's housing needs over the next five years (Available at: http://www.toki.gov.tr/english/hda.asp#strategy and http://www.toki.gov.tr/ozet.asp, 16.07.2010). To analyze policies and financial structures of the HAD is out of the context of this paper. But, particularly taken into account of absence of secondary mortgage market, we think that financial sustainability of the affordable housing (production of low cost housing) programs of HDA seems questionable in the long term.

[10] According to National Property Head Office (2009: 8), the total area of the country is 815.000 km² and state land consists of 57,59 % of the total land.

[11] General Directorate of Land Registry and Cadastre underlines that there is no effective national land management policy in Turkey (General Directorate of Land Registry and Cadastre, 2009: 55).

regulations/practices, the amount of marketable public properties is decreasing particularly in the urban areas. Hence the cost of land and irregular housing in urban areas are increasing in Turkey. Therefore, in the current regulatory framework, it does not seem realistic to use this option for solving the housing problem.

Therefore, we believe that current public policies should be reviewed to design sustainable housing finance and supply systems in Turkey. In the following issue of the Journal (Summer 2011), we plan to present an advantage/disadvantage matrix and policy suggestions for the current problems of the Turkish real estate market. So, it would be useful to re-design public policies taking into account this analysis and relevant suggestions.

## 4. Global Financial Crisis and Turkish Economy

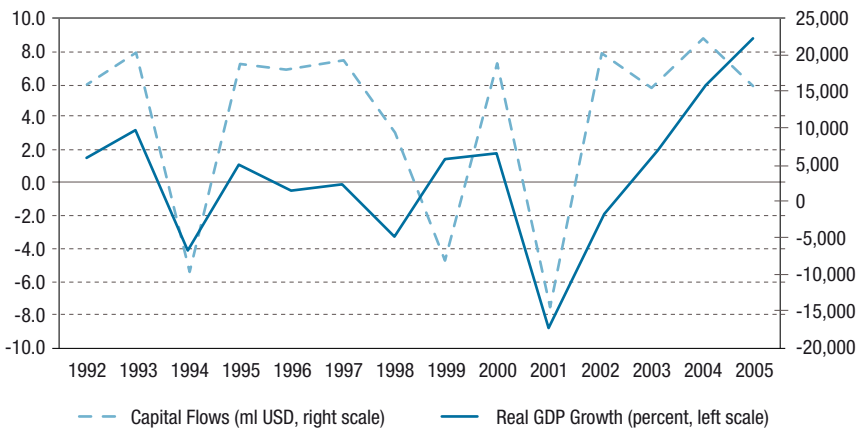
### 4.1. Post 2000-2001 Banking Crisis Period

As a member of G-20 countries, Turkey is the 17th largest economy in the world. The GDP at the end of 2008 reached 741.8 billion USD. Various international research reports argue that Turkey will be among the ten largest economies in the world in the 40 years to come (State Planning Organizations, 2009: 3).

By virtue of the rapid and uncontrolled financial liberalization approach that occurred in the 1980s, Turkey has faced several financial crisis arising from the banking sector. 1982-1985, 1994-1995 and 2000-2002 were the crisis periods for Turkish economy. There were also several financial pressure periods after 1980s. The last crisis of the country, namely 2000-2001 banking crisis, was the most destructive one which has radically changed both the economic and political situation of the country.

As can be observed from Figure 2, expansion and crisis periods follow the same pattern as capital flows, which indicates that the growth pattern of the Turkish economy has become highly dependent on capital movements (Çulha, 2006: 5). The short term capital movements (hot money), largely focused on stocks and government securities, may be counted to be the most critical component in the growth pattern of the Turkish economy. Intensive portfolio investments[12] in the domestic financial markets were observed particularly during 2003-2007 growth period[13] thanks to both the increasing liquidity surplus in the global economy and also the increasing stability/positive outlook of the Turkish economy.

**Figure 2 Capital Flows to Turkey and Real GDP Growth (1992-2005)**




*Source*: Çulha (2006: 6).

**Table 2: Balance of Payments (2005-2009/9), Billion USD**

| | 2005 | 2006 | 2007 | 2008 | 2009/9* |
|---|---|---|---|---|---|
| **CURRENT ACCOUNT** | -22,1 | -32,1 | -38,2 | -41,8 | -14,6 |
| Foreign Trade Balance | -33,0 | -41,0 | -46,7 | -53,0 | -25,0 |
| Total Export of Goods** | 78,4 | 93,6 | 115,4 | 140,8 | 107,6 |
| Total Imports of Goods** | -111,4 | -134,6 | -162,0 | -193,8 | -132,6 |
| Coverage Ratio (%) | 70,4 | 69,6 | 71,2 | 72,7 | 81,2 |
| Balance of Services | 15,3 | 13,7 | 13,3 | 17,2 | 16,5 |
| Balance of Income | -5,9 | -6,7 | -7,1 | -8,2 | -7,9 |
| Current Transfers | 1,5 | 1,9 | 2,2 | 2,1 | 1,9 |
| **CAPITAL&FINANCIAL ACCOUNT** | 19,5 | 32,1 | 36,6 | 36,4 | 1,4 |
| Foreign Direct Investments | 9,0 | 19,3 | 19,9 | 15,8 | 9,0 |
| Portfolio Investments | 13,4 | 7,4 | 0,7 | -5,0 | -4,9 |
| Other Investments | 14,9 | 11,5 | 24,0 | 24,6 | -8,7 |
| Reserve Assets | -17,8 | -6,1 | -8,0 | 1,1 | 5,9 |
| **NET ERRORS&OMISSIONS** | 2,6 | 0,0 | 1,6 | 5,4 | 13,2 |

*Cumulative figures for the last 12 months.
**Including shuttle trade, non-monetary gold and goods procured in ports by carriers.
*Source:* Central Bank of the Republic of Turkey (2009a: 14).

[12] The Banking Regulation and Supervision Agency (BRSA) (2009: 20) shows that portfolios of foreign residents to Turkey is 105,6 bn USD in December 2007 and 62 bn USD in 2009 June. In the latter case, the share of stocks and government securities in investment preferences of foreign residents is respectively 38,2 bn USD and 16,4 bn USD which are consist of 89 % of total investments. In December 2007, the share of stocks and government securities in investment preferences of foreign residents was 95%.

[13] According to BRSA (2008: iii), quarterly basis consecutive growth performance of Turkish economy reached 27 th quarter in 2008/Q3.

In addition to portfolio investments, FDI were also soared after the 2000-2001 crisis. As seen in the above table, total FDI between the 2005-2009/9 period is 73 billion USD. This level of FDI represents enormous development for the Turkish economy, comparing 9.6 billion USD FDI in the 1954-1999 period (see, Undersecreteriat of Treasury, 2008: 20). As the global credit crisis reflected to the entire world, Turkey's economy grew slower by 1.1% in 2008 when compared to previous periods. Turkey's economy shrank by 13.8% in the period mentioned (BRSA, 2009: 11).

It is underlined in the reports analyzing Turkish economy that long - term economic outlook of the country is positive due to the growing economy, demographics, EU candidacy of the country inter alia. But it is also important to note that there are still strong internal and external factors increasing the fragility.

## 4.2. Global Financial Crisis and the Recovery in Turkish Economy

According to S&P/Citigroup BMI Global Index, Istanbul Stock Exchange (ISE) posted the worst decline in the first quarter of the 2008, with a 36.62 %. (Standard and Poor's, 2008: 6). On the other hand GDP growth rates were 0.7 % and % - 4.7 % in 2008 and 2009 (TurkStat, 2010a: 356).

But comparing crisis countries, one may observe that Turkey has relatively better economic conditions at the end of 2010. First of all, there were no financial firm failures, toxic assets, or asset purchase programmes etc. in Turkey. Although the numbers do not seem satisfactory, comparing with November 2008 both the use of capacity in manufacturing industry and the value of export increased in October 2010. Monthly real return index of ISE has produced very good gain after November 2008.[14] More importantly there are 21 IPO and an evolving corporate bond market in ISE in the year 2010.[15] According to TurkStat (2010a: 176) the unemployment rate also declined to 11.4% in August 2010,[16] from 14 % in 2009.

After first shock of the global crisis, it seems interesting to note that Turkish real estate markets, and specifically the housing sector, showed better than expected performance.[17] In this context, it has increasingly been observed that Istanbul is becoming a rising star in the global real estate markets. Istanbul was the 44th in the Global Metro Monitor ranking, profiled the 150 metropolitan economies, in the pre-recession performance ranking (1993-2007). But it is the top-ranked metro in the recovery performance ranking (2009-2010) (Global Metro Monitor, 2010: 20, 40).

In the first nine months of 2010 compared to the first nine months of the previous year, according to the Construction Permits, the number of residential buildings increased from 57,989 to 64,335 increasing by 10.9 %. At the same period, floor area of residential buildings reach from 53,944,805 $m^2$ to 71,352,953 $m^2$, increasing by 32.3%. In the first nine months of 2010

**Table 3: Global Crisis and Turkey: Selected Indicators (2008/8-2010/9)**

| Term/Year | Istanbul Stock Exchange Real Return Index* | Use of Capacity in Manufacturing Industry (%) | Export (mn USD)** |
|---|---|---|---|
| **10/2010** | 6,99 | 75,3 | 10.982 |
| **09/2010** | 5,26 | 73,5 | 8.914 |
| **08/2010** | 1,50 | 73,0 | 8.522 |
| **07/2010** | 5,07 | 74,4 | 9.574 |
| **06/2010** | 0,49 | 73,3 | 9.539 |
| **05/2010** | -4,54 | 73,3 | 9.796 |
| **04/2010** | 8,32 | 72,7 | 9.397 |
| **03/2010** | 2,45 | 67,3 | 9.888 |
| **02/2010** | -5,66 | 67,8 | 8.264 |
| **01/2010** | 6,23 | 68,6 | 7.832 |
| **12/2009** | 6,24 | 67,7 | 10.055 |
| **11/2009** | -6,88 | 69,8 | 8.903 |
| **10/2009** | 4,77 | 68,2 | 10.096 |
| **07/2009** | 8,23 | 68,9 | 9.034 |
| **06/2009** | 3,89 | 67,9 | 8.342 |
| **05/2009** | 18,34 | 67,5 | 7.349 |
| **04/2009** | 18,18 | 64,0 | 7.566 |
| **03/2009** | -4,67 | 59,7 | 8.162 |
| **02/2009** | -3,75 | 58,7 | 8.434 |
| **01/2009** | 1,02 | 60,9 | 7.884 |
| **12/2008** | 2,32 | 64,9 | 7.722 |
| **11/2008** | -11,44 | 71,8 | 9.396 |
| **10/2008** | -25,93 | 75,8 | 9.723 |
| **09/2008** | -10,30 | 77,3 | 12.793 |
| **08/2008** | 12,57 | 80,0 | 11.047 |

* Based on Consumer Price Index (TÜFE).
** The total export declined to 102 billion USD in 2009 from the level of 132 billion USD in 2008.

*Source:* http://www.tuik.gov.tr/Gosterge.do?id=3592&sayfa=giris&metod=IlgiliGosterge, http://www.tuik.gov.tr/Gosterge.do?id=3526&sayfa=giris&metod=IlgiliGosterge (16.09.2009 and 05.12.2010), http://www.tcmb.gov.tr/imalat/KKO.html (05.12.2010).

[14] For a comparision between other world exchanges and ISE see, Central Bank of the Republic of Turkey (2009b: 15).

[15] Available at: http://www.imkb.gov.tr/Data/IPOData.aspx (05.12.2010).

[16] Available at: http://www.tuik.gov.tr/OncekiGostergeler.do (05.12.2010).

[17] An analysis of the first impacts of the global financial crisis to Turkish economy and mortgage markets, see, Coşkun (2010b: 241-245).

compared to the first nine months of the previous year, according to the Occupancy Permits, the number of residential buildings dropped from 52,185 to 38,820, decreasing by 25.6 %. At the same period, floor area of residential buildings reduced from 44,627,128 $m^2$ to 35,565,942 $m^2$, decreasing by 20.3% (TurkStat, 2010b). On the other hand, despite the global crisis, the number of house sales increased 531,746 units in 2009 (TurkStat, 2010c). But after a reasonable time-lag, it seems that the number of house sales will be below 2009 house sale levels number at the end of 2010.

Both Reidin Turkey Composite House Sales Price Index and Reidin Turkey Rental House Price Index peaked in March 2008 and continued to fall the first quarter of 2009. After this period, both indexes have showed increases. In this context, Turkey Composite House Sales Price Index increased to 92.6 in September 2010 from 87.4 in January 2009. At the same time, the Reidin Turkey Rental House Price Index has slightly increased to 91.6 from 89.1 (Reidin, 2010: 3-5).

Therefore, although the signals are mixed, it seems that the housing market shows signs of recovery. From the housing market perspective, we can claim that the growing affordable housing productions of HDA may probably create positive impacts to the economy. It is also important to note that the growing number of luxury residential investments may probably help to recovery, particularly in the Istanbul market.

The Turkish economy is one of the high risk profile emerging economies due to its structural economic problems and specifically highly dependence on short term portfolio investments. The country has experienced many crises during the process of liberalisation period after the 80's. But it seems that the Turkish financial markets and real estate sector have showed relatively better performance in the process of global financial crisis. To analyse the current position of the Turkish financial and housing markets in realistic terms, one may ask whether there would be a success story based on a fundamental transformation in the market structure and/or a successful crisis policy or whether Turkey is one of the luckiest survivors of the global crisis.

## 5. The Primary Reason for the Recovery: Inefficient Finance-Real Estate Link

Statistical data has shown that financial crisis has unavoidably created negative impacts to macro-economic variables in Turkey. But as far as it seems, this effect is relatively limited due to sound banking system, less financialization in households/companies/state sectors and, more importantly, inefficient real estate finance links in the country.

### 5.1. Overview of Primary Mortgage Market

In developed countries, housing finance is available for new as well as existing units, and at low spreads which reflect the low risk premium thanks to collateral. In countries with underdeveloped mortgage finance infrastructure, financial markets tend to serve only upper income groups, new construction, and owner-occupied housing. In countries with non-existent mortgage finance, housing and real estate development in general are only built incrementally; hence they are often seen to be "unfinished" but are occupied by middle and lower income residents. Further, a developing country often excludes a significant portion of its potential market participants because of poor access to credit. This defect reduces the number of participants in the market, the number of transactions that take place, and the amount and quality of information in the market (Galal and Razzaz, 2001: 13).

According to some opinions, housing loans or institutional housing finance has only a 3% - share within the total number of private homes in Turkey (Tüsiad, 2005: 83 and Referans Newspaper, 2006 and 2008). In other words, self-finance is the fundamental finance method in the Turkish housing finance system. However, despite the contributions of the real estate market to long term savings and overall economic growth, the link between the real estate market and domestic financial markets seems weak in Turkey when compared with more developed countries (Coşkun, 2010a: 30). From the perspective of the primary mortgage market, the amount of housing credits is low in Turkey comparing EU countries. In this context, in 2007 (one of the best years in the Turkish housing market) while housing loan/GDP ratio was 40.8% in EU 27 countries, the ratio was only 3.9% in Turkey (Central Bank

**Table 4: House Sales Statistics (2008-2010)**

| Periods | The Number of House Sales |
|---|---|
| 2008-I | 112.168 |
| 2008-II | 113.088 |
| 2008-III | 109.333 |
| 2008-IV | 92.516 |
| 2008 Total | 427.105 |
| 2009-I | 108.861 |
| 2009-II | 194.743 |
| 2009-III | 111.913 |
| 2009-IV | 116.229 |
| 2009 Total | 531.746 |
| 2010-I | 85.857 |
| 2010-II | 90.270 |
| 2010-III | 83.697 |

*Source:* TurkStat (2010c).

**Table 5: Household Liabilities to GDP in Selected Countries (2005-2007)**

| | Household Liabilities Excluding Housing Loans/GDP* (%) | | | Household Liabilities/GDP** (%) | | |
|---|---|---|---|---|---|---|
| | **2005** | **2006** | **2007** | **2005** | **2006** | **2007** |
| **Lithuania** | 4,1 | 6,7 | 8,6 | 13,2 | 19,3 | 25,9 |
| **Czech Rep.** | 4,7 | 5,3 | 6,2 | 14,3 | 17,3 | 21,4 |
| **Hungary** | 6,8 | 9,2 | 10,9 | 16,9 | 21,1 | 23,2 |
| **Latvia** | 7,7 | 9,3 | 9,3 | 27,1 | 38,3 | 43,3 |
| **Poland** | 9,7 | 10,7 | 13,1 | 15,1 | 18,2 | 23,7 |
| **Italy** | 12,3 | 12,7 | 13,0 | 27,6 | 29,2 | 30,3 |
| **Greece** | 12,4 | 14,2 | 13,2 | 36,2 | 41,0 | 40,9 |
| **Portugal** | 13,9 | 15,1 | 16,5 | 67,3 | 74,3 | 78,6 |
| **Spain** | 19,1 | 20,8 | 21,2 | 68,6 | 76,8 | 80,4 |
| **EU 27** | 15,3 | 15,3 | 15,0 | 54,6 | 56,4 | 55,8 |
| **Turkey** | 5,7 | 6,6 | 7,8 | 7,7 | 9,7 | 11,7 |

(*) The figure for Turkey as of June 2008 is 8,4.
(**) The figure for Turkey as of June 2008 is 12,6.

*Source:* Central Bank of Turkey (2008: 23).

of Turkey, 2008: 23). On the other hand, in terms of overall household liabilities Turkey also seems well behind the European countries.

On the other hand, according to the European Mortgage Federation (2007: 122), residential mortgage debt per capita was € 30, € 100 and € 170 in Turkey, in the period of 2004-2006. In the same period relevant figures were € 650, € 860, € 1.170 in Croatia and € 3.080, € 4.100 and € 5.140 in Greece. Although Deutsche Bank Research (2008: 21) says that low mortgage loan-to-GDP ratios indicate the large growth potential on the market, Binay and Salman (2008: 23-24) provide evidence that average income individuals are not able to purchase average homes in Turkey given current maturity and nominal cost of home credits. Those who can enter into a loan contract must be on the upper quartiles of the income distribution.

Therefore, comparing even relatively small countries in Europe, the Turkish mortgage market can be classified as underdeveloped in terms of using primary market mortgage finance. It is also important to note that middle and lower income residents' access to housing credit is limited in comparison to higher income groups.

An unintended effect of an inadequately functioning primary mortgage market is that it affects the willingness of developers to construct home-ownership units, which over time, can lead to a shortage of housing units, particularly at the more affordable price points. Construction companies and developers build housing units that they know they can sell (Özsan ve Karakaş, 2005: 20).

**Table 6: Securities Issues Registered with the CMB Turkey (1986-2008), million USD**

| | Stocks | MFPC | ABS | PFS | BB&PGB | Other | Total |
|---|---|---|---|---|---|---|---|
| **1986** | 152 | 0 | 0 | 0 | 90 | 167 | 409 |
| **1987** | 219 | 53 | 0 | 0 | 89 | 437 | 797 |
| **1988** | 256 | 37 | 0 | 0 | 167 | 338 | 798 |
| **1989** | 458 | 76 | 0 | 0 | 46 | 505 | 1,086 |
| **1990** | 1,576 | 328 | 0 | 0 | 127 | 377 | 2,407 |
| **1991** | 1,064 | 16 | 0 | 0 | 174 | 358 | 1,612 |
| **1992** | 774 | 13 | 2,106 | 0 | 112 | 271 | 3,277 |
| **1993** | 867 | 485 | 4,781 | 0 | 216 | 174 | 6,524 |
| **1994** | 1,261 | 74 | 1,420 | 0 | 68 | 22 | 2,844 |
| **1995** | 1,122 | 93 | 2,491 | 0 | 28 | 81 | 3,816 |
| **1996** | 1,256 | 110 | 511 | 0 | 29 | 84 | 1,990 |
| **1997** | 2,010 | 226 | 151 | 0 | 65 | 36 | 2,489 |
| **1998** | 2,670 | 504 | 42 | 0 | 0 | 10 | 3,226 |
| **1999** | 1,616 | 421 | 0 | 0 | 0 | 0 | 2,036 |
| **2000** | 4,823 | 4,438 | 0 | 0 | 20 | 6 | 9,287 |
| **2001** | 1,375 | 3,126 | 0 | 0 | 121 | 55 | 4,676 |
| **2002** | 1,061 | 1,597 | 0 | 0 | 56 | 71 | 2,785 |
| **2003** | 1,172 | 4,071 | 0 | 27 | 0 | 9 | 5,279 |
| **2004** | 2,690 | 4,621 | 0 | 209 | 0 | 0 | 7,520 |
| **2005** | 2,977 | 1,783 | 0 | 693 | 0 | 9 | 5,269 |
| **2006** | 7,704 | 2,388 | 0 | 4,155 | 0 | 106 | 12,205 |
| **2007** | 6,783 | 1,593 | 0 | 388 | 0 | 328 | 9,092 |
| **2008** | 7,686 | 1,557 | 0 | 8,306 | 0 | 423 | 17,972 |

MFPC: Mutual Fund Participation Certificates, ABS: Asset Backed Securities; PFS: Pension Funds Shares, BB&PGB: Bank Bills&Bank Guaranteed Bills, CMB: Capital Markets Board of Turkey.

*Source:* Capital Markets Board of Turkey (2009: 39).

## 5.2. Overview of Secondary Mortgage Market

Although housing credit had revived with the construction boom in the period 2003-2007, there has been no securitization market for mortgage credits since the 1990's.

It has been observed in the Turkish economy that capital market finance broadly depends on stock financing rather than (corporate) bond financing, as seen in the table above. Because of the crowding-out effect, private sector fixed income (and securitization) markets can't work effectively in Turkey. According to the European Mortgage Federation (2007: 116, 138), while the typical mortgage rate in the euro area is 4.5%, the rate was 19.6% in Turkey in 2007. In the period of 2004-2006, mortgage rates in Germany were respectively; 4.6%; 4.2 %; 4.6 %. In the same period those rates were respectively; 17.5%; 15%; 19.6% in Turkey. Although interest rates were gradually decreasing in Turkey, domestic financial markets are still mainly influenced by the negative impacts of crowding-out effect.

Although there is no active secondary market for mortgage credits, it is generally believed that Mortgage Law No. 5582 (2007) and related secondary regulations provide an effective regulatory framework for Turkish mortgage market.[18] But, the current mortgage system does not provide long-term and affordable credit to low income households. Therefore, the non-functioning of mortgage finance is the reason for the rising costs to households, creditors and construction firms.[19] Related to this problem, being highly dependent to the high – cost credit markets would be the reason of finance shortage in the time of slowing economy in the Turkish mortgage sector.

[18] In addition to the absence of the private sector initiatives, there are no government sponsored entities in the secondary mortgage markets aiming to play the role of Fannie Mae/Freddie Mac in the U.S. Therefore we strongly emphasize that the lack of such an organization is one of the important obstacles for the market development.

[19] In this respect, it is important to note that tax regulation may create incentives for the households and credit institutions and hence help to create efficient mortgage markets. Taking into account that Mortgage Law No. 5582 has no effective tax incentives to primary/secondary mortgage markets, we suggest that the Law should revise based on a new tax policies aim to develop mortgage finance.

It was observed during the global financial crisis that structured products may increase the risks to financial markets. Turkish financial markets have no such problem simply because of their primitive characteristics. Although there are structured products/transactions in the market, mostly hedging purposes, lack of securitization and less developed corporate bond markets mean no structured product issuance in the domestic market. Therefore, in addition to the above explanations, this picture also clearly shows why there were no crisis conditions in the Turkish financial markets.

## 6. Conclusion

It has been observed during the global financial turmoil that many countries have experienced both huge financial losses and extra-ordinary negative impacts on their housing sectors. According to figures, Turkey has faced relatively limited negative impacts during the crisis. In this article, we ask whether there is a success story and about the puzzling points in the picture. By analysing the primary/secondary mortgage markets' structure, we argue that the reason of the limited negative impacts on the Turkish housing sector is related to small and inefficient mortgage economy in Turkey rather than a successful crisis management or market dynamics.

Because of the fact that capital markets have been displaying dysfunctional characteristics, the Turkish economy was not exposed to significant problems during the global financial turmoil (Coşkun, 2010a: 30). So, Turkey has faced limited negative impacts from the global financial crisis. The lack of securitization/ structured product markets and also inefficient housing credit market may have seemed good news for Turkey during the financial turmoil. But the Turkish mortgage market is structurally less developed as part of her less developed financial markets. Also, the mortgage market requires a better policy framework to create a sustainable solution to the housing question of Turkey.

In the following issue of the HFI Journal (Summer 2011) we plan to present an advantage/disadvantage matrix and policy suggestions for the current problems of the Turkish real estate (and housing) market. We believe that the policy suggestions related to increasing the efficiency of the whole real estate markets may help policy makers in both Turkey and other developing countries. For further research, we would like to suggest that researchers could examine the measures of optimal mortgage market functioning for Turkey.

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# Non-Recourse Mortgages and the Prevention of Housing Bubbles - A Proposal for a Change in the Default Rule on Mortgage Liability in Spain

↳ By Manuel Castilla[1]

## 1. Introduction

**1.1** In recent times, the situation of economic weakness in which many individuals who are liable to credit institutions as a consequence of the contraction of mortgage loans[2] have been left has attracted the attention of the Spanish mass media. This is the result of the fact that like in most jurisdictions mortgages in Spain are constituted with both the mortgaged property and all the present and future assets of the same debtor as collateral. At a time in which unemployment is rising to unprecedented levels, the issue is one for public concern. This concern is being spurred by the process of deflation in the Spanish property market, which has made the obligation of debtors to respond with their full assets relevant.

**1.2** So far, the discussions on the liability of mortgage borrowers have been confined to the assessment of its implications for the fairness of the relationship between the two parties to such contracts. Yet this paper is based on the hypothesis that ad extra effects are even more significant from the standpoint of legislative policy. Thus, our work is geared towards the analysis of its impact on the operation of the whole real estate market.

**1.3** The current financial crisis has highlighted the close link that exists between micro and macro finance in contemporary capital markets. Since the financial markets are conditioned by the securitization of retail loans and the subsequent global spread of their risk, efficient lending of those is a condition for the health of the entire system.

**1.4** It is also clear that the Spanish property market has not worked properly. Many factors have alternatively or jointly been proposed to explain their exuberant –and perhaps extravagant- performance in the recent decades ranging from monetary policy, to demographics, through to the specifics of zoning regulation in Spain. However, the way the Spanish system of mortgage financing for home ownership may have contributed to this process has been overlooked. As we intend to describe in the following pages — it is the first objective of this paper — that system is characterized by the absence, in practice, of limits to the liability of individuals[3] who finance the purchase of their home by means of a bank mortgage.

**1.5** The objectives of description of positive law cited in the preceding paragraph are ancillary to the ultimate goals of this article. Specifically, we hypothesize that the main private law policy instrument available to Spanish legislators in order to prevent future housing bubbles is precisely the redefinition of the mortgage liability, making credit institutions bear the risks of irrational inflation in the real estate market.

**1.6** Therefore, unlike most of the previous research on the issue of mortgage recourse, which has been focused on its relation to the act of default, this paper is concerned with its effects on the incentives for the proper work of the real estate market price discovery function.[4]

**1.7** In order to achieve those objectives I will proceed as follows. In Part 2, I provide both an overview of what the current law on mortgage liability in Spain is and its legal origins. In Part 3, I discuss how the Real Estate Bubble developed in Spain considering the spread of the irrational belief in the infallibility of this type of investment. I use Part 4 to show how the private law of house financing can affect the incentives for lending practices and how the securitization process may interfere with the incentives so drawn. Finally, in part 5, I suggest a legal reform that makes non-recourse mortgages the most common form of real estate financing in Spain.

## 2. The positive law of mortgage recourse in Spain

**2.1** The Spanish Mortgage Law (the so called "Ley Hipotecaria") determines the unlimited personal liability of the debtor provided by Article 1911 Civil Code as the default rule for mortgages in Spain. Thus it gives the lender the possibility of charging both the realizable value of the property covered

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[2] See J. I. NAVAS OLÓRIZ, *El hipotecado frente a la banca*, El País, Propiedades, 14 of May 2010.

[3] Yet such a limited responsibility does exist in practical terms for "professional" borrowers – real estate developers and builders – who are typically funded through corporate entities in which the only substantial asset is just the land on which they intend to build.

[4] See A. C. GHENT, M. KUDLYAK, "Recourse and Residential Mortgage Default: Theory and Evidence from U. S. States", Federal Reserve Bank of Richmond Working Paper No. 09-10. See M. FELDSTEIN, "How to Save and "Underwater" Mortgage", The Wall Street Journal, August 7, 2009.

by the guarantee, and the remainder of goods that constitute the assets of the lender real estate.

**2.2** However, parties to the loan may opt out of the unlimited responsibility rule. Mortgage Law itself dispels any doubt about it in its article 140 according to which the parties could "validly agree to secure the only on the mortgaged property" so that "the responsibility of the debtor by virtue of the mortgage loan shall be limited to the amount of mortgage assets, and will not reach the other assets of the debtor's estate".

**2.3** The limited liability mortgage is far from being an extravaganza in the Spanish legal system. In fact, the modern doctrinal interpretation of the figure identifies it as being a regular mortgage, which only differs from the default mortgage in that it limits the property that may be taken by the creditor[5]. This implies that the disposition of the mortgaged property does not produce any change in the condition of the borrower as a debtor.

**2.4** Despite its absence in the reality of the Spanish real estate market, the possibility of limiting the liability of a debtor for a particular loan is not a last-minute legal innovation. In fact, the implementation of the figure in article 140 of the Mortgage Act dates back from the reform of its original text in 1944, in a period of autarchy in Spanish economic and legislative history that cannot be regarded as characterized by a boom in legal and financial experimentation.

**2.5** It is particularly interesting to note that the origin of the figure can be traced to Cuban law. Far from being an exotic anecdote, this fact does suggest the key role that limited liability mortgage can play in the real estate market, especially in the Spanish property sector currently. In anticipation of the arguments that support this claim, the reader should note that the figure was implanted in Cuban legislation during the Great Depression, as part of a package of measures to protect mortgage holders, which, propelled by the context of deflation in the housing market[6], reached the Cuban Constitution itself.[7]

**2.6** Spanish lawmakers at the time - when the law was enacted - welcomed the innovation and expressed their conviction that it would provide "significant benefits for many legal entities which, in defence of their own goals, just want to affect certain properties to fulfil their obligations"[8] and that was "granted […] without any breakdown for potential creditors"[9]. Yet despite this optimism in the 1940's the weight of the figure in the reality of the Spanish property market can hardly be more insignificant seventy years later.

**2.7** While no direct statistical information about mortgage loans of this type being granted, indirect evidence suggests that, at best, the practical use of the figure is marginal. In fact, a search of Spanish case law databases does not reveal a single resolution which relied on the precept being analyzed. Although this could be attributed to a low litigation rate of the figure, that is an unlikely explanation, especially when anecdotal evidence is taken into account. Particularly - proper consideration must be given to the claims from someone representing the Spanish Notaries[10], stating that he had never authorized a single document that would contain a non-recourse mortgage in his entire career. So, one may only pragmatically conclude that the figure has been historically statistically insignificant if it has actually ever been used.

**2.8** Whatever the historical use of the limited liability mortgage, what is interesting for the purposes of this research is that there is no trace of their use by banks in the financing for the period of expansion of the Spanish residential property sector, initiated at the end late 1980s.

## 3. The Real Estate Bubble in Spain

**3.1** The rise of the Spanish property sector since 1986 has created an unprecedented gap in the contemporary history of the country between real estate prices and the median disposable income of its citizens. Most independent analysts of the real estate market agree that this high increase in prices is in itself a housing bubble[11]. In Spain, the voices that already dare to deny the existence of the bubble[12] are decreasing and, rather than refute the deflation of the market, just discuss the severity of the price adjustments to come.

**3.2** Real estate bubbles have been considered the most harmful and cruel of all asset bubbles[13]. There are good arguments for accepting the two adjectives, particularly in the case of the current Spanish property market. As for the first one, consider that in terms of the wealth of Spanish households, the weight of real estate is almost six times that of financial assets[14]. Thus, the decline in value of the property produces significant effects on the demand for goods and services that are not property, following the so-called "wealth effect."

**3.3** In addition, housing bubbles are socially cruel due to the generational inequalities that they produce. Since housing is an asset that is usually acquired by generations of young adults, when the purchase is made at prices inflated by a bubble, there is a dramatic transfer of wealth to the generation of mature adults, who tend to be the owners of both the already existing buildings and the land.

**3.4** During the rising phases of the bubble the dramatic decline of disposable income left to the younger generations after the periodic payment of their mortgage loans is mitigated by the perception of wealth increase that arises from the increase in their property's prices. In fact, in that phase of the bubble, many of the borrowers confident in the sustainability of the process will use their mortgages to finance the acquisition of goods and services other than real estate, further increasing their total financial burden. But once the price "bubble" begins to burst, the effects of massive indebtedness of the young owners, shows all its cruelty.

[5] In the modern Spanish legal doctrine no one seems to defend LA RICA's thesis according to which article 140 LH would have created an "independent mortgage, which could survive the extinction of the principal obligation to guarantee" (See, *Anales de la Academia Matritense del Notariado*, IV, pp. 281 et seq.) anymore.

[6] The measures that were taken in Cuba seem to have been inspired by the rescue program for real estate debtors implemented in the United States in 1933 with the Home Owner's Loan Corporation Act (HOLC) which was intended to provide some relief for them. (see J. D. ROSE, "The Incredible HOLC? Mortgage relief during the Great Depression", *Federal Reserve Board Working Paper*. January 15, 2010).

[7] In particular, the relevant provisions in Cuban law are the Act from April 3, 1933; the Decree of January 7, 1936; and even a transitional provision of Title IV in the Cuban Constitution of 1940 (See J. J. PETREL SERRANO, Comentarios al Código Civil, M. ALBADALEJO (dir.), Tomo VII, Vol 8º: Artículos 138 a 197 de la Ley Hipotecaria (2004) Edersa, 2004, footnote 1, citing M. NIN, "La Hipoteca de Responsabilidad Limitada", R. C. D., 1947, pp. 292 y et seq.).

[8] Introductory Speech to the Spanish Parliament for LH Reform Act of December 30, 1944 (See J. J. PETREL SERRANO, Comentarios al Código Civil, nota 5).

[9] As seen in the Explanatory Memorandum of the Reform Act of 1944.

[10] In Spain a Notary is specialized lawyer with a key role in real estate contracts.

[11] Robert SCHILLER has to be credited for anticipating the global housing bubble (see "Is There Bubble in the Housing Market?", *Brookings Papers on Economic Activity*, 2 (2003), pp. 299 et seq.). His ideas can be fully applied to the Spanish situation.

[12] See footnote 2.

[13] See S. ROACH, "America's ominous housing bubble", *Financial Times*, 9 of December of 2004.

[14] According to the *Summary of Indicators* published by the Bank of Spain (May 19, 2010), the housing wealth of Spanish families reached 576.3% of GDP, while net financial wealth did not exceed 93.9%.

**3.5** For starters, the prices of houses similar to those already acquired by young buyers begin to lose the high values which raised the confidence in the ongoing revaluation of the "investment" made. When the process of deflation is in a more advanced state, many of the debtors, beginning with those who bought at the peak of the bubble, realize that the value of what they owe banks for their property exceeds its market value. If, as in the Spanish case, the mortgage loans involve borrowers' obligation to respond with all their assets, borrowers cannot pay off their debt by walking-away or jingle mail.

**3.6** To put the issue in terms of risk, Spanish real estate owners contractually take the risk of deflation in house prices so that when asset prices decrease, they suffer an impoverishment impacting on their patterns of spending and therefore impacting on the growth of the whole economy.

**3.7** Therefore, it might well be that the Spanish property bubble has only started to show its harmful social effects. Decreases in residential property prices still do not seem dramatic enough – or at least not, when considering their increases in the years of inflation in the bubble – to produce all the harmful effects expected from the loss of wealth and the non-fulfilment of the expectations in the revaluation of the properties. However, the course of events in other countries that have experienced the impact of a housing bubble anticipates that those social effects might be socially difficult.

**3.8** Housing bubbles are an issue of major regulatory concern. Any legislator has to deal with both their prevention and the remedy of their negative impact by using his powers in every regulatory area and, in particular by defining some sets of mortgage rules and standards.

**3.9** In this paper, we are concerned specifically with the rules that determine what the liability on the mortgage loan imposes in terms of the risk of deflation in the housing market among the parties. There are good reasons to believe that an efficient allocation of that risk may both contribute to prevent the occurrence of bubbles and to mitigate its social consequences.

**3.10** Obviously, in the Spanish case, it is too late for a regulation devoted to prevent such a bubble that has already begun to burst. However, the period of the Spanish economy that is about to begin seems appropriate for the political discussion of rules directed at reducing the likelihood and intensity of future housing bubbles.

**3.11** Our arguments to link the allocation of responsibility for the mortgage loans and real estate price trends come from what behavioural economics and cognitive psychology teach about the limits of neoclassical economic models. These have as their main weakness the omission of those attitudes and biases in the human behaviour that cannot be explained as the result of a rational assessment of the circumstances in which they are adopted or carried out.

**3.12** In the past decades, we have seen a redefinition of the neoclassical view of human behaviour whose use in the legal analysis is increasingly significant. The progress of the behavioural economic analysis of law is based on what social scientists have learned in the last two decades about how humans make decisions in the real world and the observable differences between their actual behaviours with what models of rational choice would predict.

**3.13** Human behaviour is not always rational in the specific sense that economists give to this term. Instead decision making is filtered by bias, prejudice and valuation heuristics that make this process quite different from what has been presumed by most economists for years. By using the tools of behavioural economics, it is possible to predict those situations in which human decisions do not adhere to neoclassical models[15]. The fact that human behaviour is not always rational does not make it random. On the contrary, irrational "deviations" of human behaviour can be predicted.

**3.14** Robert SCHILLER was the first to describe how irrational decision-making processes produce asset bubbles in general[16] and real estate bubbles in particular[17]. According to his ideas, at the centre of any speculative bubble there is a feedback mechanism that is supported by the expectations of revaluation of some assets. This feedback mechanism would result in the amplification of the so called "stories" that justify the bubble. Thus, his explanation of the bubble is based on the spread of what he calls "stories of a new era" amongst the masses.

**3.15** The "story of a new era" that has driven the global real estate bubble is in general terms applicable to Spain. Yet, we believe that the Spanish case has a "story" of its own whose spread was made easier by the fact that its economy has experienced a long period of high growth in residential property prices that dates back to the eighties. In our view, the long duration of this period has settled in the minds of many Spaniards a very strong association between the ideas of economic value and residential property. That particular item of the Spanish ideological superstructure would have made any good "story" stand a good chance of succeeding. And in fact, there is a story behind the Spanish bubble. This is our version: "Once Spain joins the Euro, real estate prices will dramatically rise to catch up with European prices. This is going to be the result of many factors, but there at least three that no sensible man can deny: first, many retired Europeans are going to decide to live here, attracted by our climate and lifestyle; second, now that we are monetary partners with the richest countries of the EU, our economic development will be boosted until our income levels match theirs; finally, in the coming years, we will receive an even larger contingent of non-EU-workers that will be needed to sustain that growth. Thus, we will need many new houses for which there are going to be many buyers with a higher level of income than Spaniards have today. Well, if for some unforeseeable and unlikely factors all of the above goes wrong, you, as a buyer, do not have to worry very much about it because unlike financial assets, real estate is tangible and, as such it does not lose value; the worst thing that can happen to you is not to obtain a capital gain in the short run".

**3.16** The effects of the "story" are far reaching. In fact, it affects both believers and non-believers of the "story". That happens because many investors make their decisions guided by their expectations about the behaviour of other market participants rather than a direct evaluation of assets' fundamentals. There is no need to resort to formal game theory to realize that even those who do not believe the "story" have incentives to participate in the upswing of the market, hoping that the "believers" will eventually buy their assets, and in doing so they contribute both to a further increase in demand and to the spread and confirmation of the "story."

**3.17** In view of those mechanisms, one can consider "bubble stories" as another example of Merton's "self-fulfilling prophecy"[18]: a proposition which is, in its beginning, a false

[15] See C. SUNSTEIN (ed.), *Behavioral Law and Economics*, Cambridge, 2000, p. 1.

[16] See R. A. SCHILLER, *Irrational Exuberance*, Princeton, 2000.

[17] See R. A. SCHILLER, "Understanding Recent Trends in House Prices and Home Ownership", *Department of Economics Yale University, Cowles Foundation Discussion Paper*, nº 1630, October 2007.

[18] See R. K. MERTON, *Social Theory and Social Structure*, New York, 1968, p. 477.

definition of a particular situation, but causes a behaviour that makes the original false definition to become real nonetheless. In fact, if the feedback effect of bubbles occurs, it is largely because the "prophets" of the "new era" will use the actual developments of facts as undeniable evidence that they were right in their predictions.

**3.18** To formalize the manner in which the "story of a new era" of a bubble is born, lives and dies, it seems only appropriate to use the term "meme", introduced by Richard DAWKINS[19], the theorist of evolution. Stretching the metaphor of his "selfish gene", DAWKINS sets out the concept of "meme "to refer to those ideas that can be replicated, from individual to individual, and evolve, adapting to the environment in which they exist. Once memes are inserted into a brain, they "colonize" it and produce certain behaviours in the owner of that brain that causes him to contribute to "colonize" other people's brains. The process is analogous to the survival and transmission of virus among humans.

**3.19** Memes differ among themselves in their mechanisms of transmission, consequences and conditions of extinction. In the case of the "story of the new age in real estate", its contagion seems to have been fast, its consequences very harmful and its extinction a social challenge.

**3.20** The vast spread of the "Real Estate Meme" during the last bubble has made the assumption of rationality in unsophisticated participants in the real market arguable. In fact, the contract law principles of contractual freedom and equality between the parties, do not reflect the actual psychological conditions in which most homebuyers have agreed to mortgage their loans.

## 4. Private Law and the incentives for sensible real estate lending practices

**4.1** The striking lack of non-recourse mortgage loans in Spain can be partly attributed to the irrational belief in the infallibility of the real estate investment. Since borrowers do not contemplate the possibility of a decline in the value of property, there is no point for them in negotiating the implementation of article140 LH. For someone "infected" with the "story", it makes no sense to pay the interest premium necessary for the lender to assume the risk of deflation in the housing market since that risk is not considered significant.

**4.2** Yet, rather than the genesis of the contractual allocation of real estate deflation risk to private-borrowers, what is relevant to our paper is its probable consequences on the development of the housing bubble.

**4.3** The fact that the risk is attributed to a contractual party or another can indeed have consequences on both how a bubble occurs and the social damage that elicits. It is our deductive hypothesis that making unsophisticated borrowers take the risk of real estate deflation while freeing professional lenders from it seems an additional element in the set that has led the bubble of Spanish property prices to exorbitant levels. Our contention is in the general context of how law and economics explain the way the system manages the risks to maximize the collective welfare.

**4.4** GUIDO CALABRESI[20] proposed several decades ago a very intuitive framework to identify what makes specific assignment of legal entitlements preferable to others. Thanks to his work we know that when you cannot prohibit conduct with the potential to produce social harm, the legal system should minimize it by legally managing market and parties incentives.

**4.5** The correct legal definition of market incentives is based on the common sense rule according to which each person knows best what he or she needs. Hence, by providing them with the right incentives, the legal system contributes to create the largest social welfare possible. However, not everyone has the same level of knowledge about a particular situation. Therefore, in order to prevent the damage the law ought to use the person who is in the best position to conduct a cost-benefit analysis in relation to a particular conflict. To encourage that person to use his best knowledge, it is sufficient to assign him responsibility for that damage, so he has the right incentive to minimize the loss.

**4.6** Bringing this general analysis to the case of the risk of deflation in the housing market in question, the damage roughly equates the difference between the purchase price of the property and the market price once the deflationary process is over. To make that risk be borne by individuals does not seem the best way to prevent the development and intensification of bubbles. In fact, the contractual allocation of that risk to mortgage consumers seems to produce a strengthening of the dynamics of the bubble, since it frees of it those most capable of making a rational assessment of its economic significance.

**4.7** Credit lenders are in a better position and have better conditions to withstand the irrational effects of the "story" that supports the bubble. One can predict that should they bear the risk of deflation in the mortgaged property, they would be more cautious in the release of credit, rejecting overly optimistic valuations of the real estate collateral and decreasing the percentage of the appraised value of what they are willing to finance. Thus, the allocation of the risk of deflation in real estate to credit institutions should be helpful in modulating housing demand, slowing the upward momentum of real estate bubbles.

**4.8** A very likely objection to our hypothesis could be drawn from the U. S. experience with non-recourse mortgages. Even though there seems to be some contradictions as to what the law regarding mortgage recourse is in every single state of the U. S., it seems clear that ten to fifteen of them have implemented some kind of non-recourse legislation. Yet the U. S. property market has experienced a major real estate bubble.

**4.9** However, one must take into account how the behaviour of the U. S. real estate lenders seems to have been directly affected by the process of securitization of their loans[21]. So far, it has been empirically evidenced how the originate-to-distribute model led to lax loan screening by lenders in the subprime market[22]. It has also been suggested that the securitization process caused the expansion of credit in the subprime market[23]. We believe that how the originate-to-distribute chain could have directly affected real estate prices is yet to be empirically researched. However, when considered together, the two studies quoted above seem to suggest that securitization did indeed play a key role in U.S. originators' incentives to fund the real estate market by freeing them of the risk of its deflation. Therefore, the evolution of the U. S. real market cannot be taken as evidence to discredit our hypothesis.

[19] See R. DAWKINS, *The Selfish Gene*, New York, 1976.

[20] In Spain his work was published as G. CALABRESI, *El Coste de los Accidentes*, Barcelona, 1984.

[21] On the (?) incentives in the origination of U. S. mortgage loans see R. P. MALLOY, "Flawed Economic Assumptions: Critical Perspectives: Mortgage Reform and the Fallacy of Self-Correcting Markets", *Pace Law Review*, 30 (2009). pp.79 et seq.

[22] See B. J. KEYS, T. K. MUKHERJEE, A. SERU, V. VIG. "Did Securitization Lead to Lax Screening? Evidence from Subprime Loans", *Quarterly Journal of Economics*, 125 (2010), pp. 307 et seq..

[23] See A. MIAN, A. SUFI, "The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis", *Quarterly Journal of Economics*, 124 (2009), pp. 1449 et seq.

**4.10** Our analysis is confined to the Spanish real estate market. In Spain, the securitization of mortgage loans has not altered the traditional patterns of the banking business. Unlike the U.S. banks, Spanish banks do maintain in their balance sheets most of the risk in the loans that they securitize. That feature seems to be critical for the incentives in loan origination.

## 5. Proposal: making the non-recourse mortgage the default rule

**5.1** The contractual allocation of the risk of real estate deflation to mortgage borrowers that frees lenders of it seems an important element in the vicious cycle that feeds back the rising phase of a housing bubble. The question to be asked, then, is what should be the legal response to it.[24]

**5.2** It must be taken into account that if mortgages with unlimited liability in Spain have become so predominant, it is because contractual parties have decided to neglect the possible limitation of borrower's responsibility ex article LH 140.

**5.3** RONALD COASE[25] taught us that if there were no transaction costs, the legal system would only need to identify and enforce property rights in order to reach the allocation of resources which provides optimal social welfare. Individuals alone would achieve such an optimal outcome through their own agreements in perfectly competitive markets, regardless of the initial assignment of their respective legal positions. In that ideal environment, an optimal real estate private law would be constrained to define and implement property rights, leaving the parties free to contract in the way they deem appropriate.

**5.4** However, in the real world legal transactions do not occur the way the archetype of perfect competition assumes, but are constrained by transaction costs. Those costs do have an impact on economic relations so that they can prevent the agreement of a contract that would define the optimal social incentives for all the parties involved[26].

**5.5** That is precisely what happens in the case of consumer mortgage loans and their responsibility clauses. Although the assignment of the risk of deflation in the housing market to the lender could be a better agreement for the sake of the price discovery function, the asymmetry in the information available to contract parties prevents such an outcome being reached. Since credit institutions enjoy better information about the risks of real estate market deflation, they will discount a higher value for it than individuals and since they typically predispose the contractual clauses of the loan, they will systematically pass to consumers the risk of deflation in real estate. Furthermore, since consumers are very likely to irrationally neglect deflation risk no competition from other banks willing to uptake is expected.

**5.6** The issue is a textbook example of those situations in which the legislator should provide the definition of contract rights that would agree with the market place in the absence of transaction costs limiting the agreement between parties.

**5.7** The issue becomes a normative one about what should be the precise legal response to the practical disdain for article LH 140. Since regulators can choose between different regulatory techniques to make credit institutions more aware of the risk of housing deflation, we must discuss which of them provides the socially optimal answer.

**5.8** To simplify the issue, we will consider the alternative regulatory measures at both extremes of the range of government intervention intensity in the mortgage loan market: first, the repeal of article LH 105, forcing the lender to always bear the risk of deflation and, second, the rules of mandatory information for mortgage borrowers on the consequences of their decision and the alternatives offered by mortgage regulation.

**5.9** The problem with the "aggressive" legal option –the imposition of the mortgage lender with limited liability– is that it does not take into account that, in certain situations, the imposition of unlimited liability to the borrower can fulfil a beneficial social function. It is generally accepted that it encourages the proper care of the property by the borrower. Although we consider this to be a minor effect, it cannot be excluded that the inclusion of this covenant could sometimes make economic sense. However, its ban could restrict access to mortgage financing for those who, for some reason could not indicate their willingness to properly care for the mortgaged property.

**5.10** The mandatory provision of information to the borrower is the common instrument of regulatory protection of any type of "weak" borrower. The rules that make use of this regulatory strategy are based on the view according to which consumers can make the right decisions when given the information they lack. This type of regulation has the advantage of inducing the adoption of those conditions that are more efficient most of the time, while allowing an opt-out from them whenever the parties deem it appropriate to their interests. We see no reason not to extend this strategy to the covenant of the mortgage liability in this analysis. While the reference to information duties is rather vague, it must specify what types of informational tools should be used for the regulation of deflation risk in mortgages.

**5.11** The disclosure rules that we propose should have a dual purpose. The first one would be to increase the relevant data available to each of the parties in negotiating the contract. Secondly, to "combat" irrational biases of individuals, which can persist even when they have the correct information.[27]

**5.12** The first purpose can be achieved by rules that require information to be presented in a manner that is friendly to their cognitive framework, by emphasizing the key factors and simplifying the less relevant details[28]. Specifically, we propose that contracts made with mortgage consumers incorporate a standard clause aimed at informing consumers about the responsibility they are assuming in their contracts and their possible consequences in the future.

**5.13** The second purpose may be more difficult to achieve. Even when mortgage holders receive the right information, certain cognitive biases may prevent them from making the right decision. For what is relevant to our goals, one must be highlighted: the so-called "status quo" bias. Experimental research shows that in the

[24] The benefits of a dual regimen allowing both recourse and non-recourse mortgages have been theoretically shown by HARRIS the costs of a legal intervention that prohibits the choice between them using the example of California's subprime crisis (see R. HARRIS, "Recourse and Non-Recourse Mortgages: Foreclosure, Bankruptcy, Policy", SSRN-id1591524 ).

[25] See R. H. COASE, "The Problem of Social Cost", *Journal of Law and Economics*, 3 (1970), p. 1 y 2.

[26] As Richard EPSTEIN notes, if the Coase theorem assumes zero transaction costs it is not because you frequently find this situation in real life but because it offers the right counterpoint to understand the effects of law in a world where transaction costs do indeed exist (see R. A. EPSTEIN, "Holdouts, Externalities, and the Single Owner: One More Salute to Ronald Coase", *Journal of Law and Economics*, 36 (1993), p. 555).

[27] On the limitations in the rationality of the parties to a home mortgage, see J. MIXON, "Fannie Mae/Freddie Mac Home Mortgage Documents Interpreted as Nonrecourse Debt (with poetic comments lifted from Carl Sandburg)", *California Western Law Review*, 45 (2008), p. 82.

[28] The Annual Percentage Rate (APR) required in the consumer credit context is a good example of such regulatory strategy.

course of a contract negotiation people tend to prefer those clauses that are considered to comply with the existing "status quo". Most people tend to identify default rules as part of that "status quo" so that they are reluctant to opt-out from them[29]. This fact and the effect of inertia that is associated with it is both an additional explanation of the complete dominance of limited liability mortgages in the Spanish housing market and a critical element to take into account in the design of the regulatory strategy aimed at protecting consumers in this sector.

**5.14** Thus, proper regulation of consumer mortgages that seeks to level the position of both sides of the contract may not be limited to require provision of correct information, but also has to break the inertia of contracting the mortgages with unlimited liability by reversing the relation between articles.105 LH and 140 LH by considering the latter the default rule. This change would require both parties to negotiate against the "status quo" of legislation when they intend to extend the liability for a mortgage loan to all the assets of the debtor.

**5.15** Finally, linking both regulatory strategies - a standard mandatory mortgage clause should be created, which should be expressly accepted by the borrower in order to put at risk his non-mortgage assets.

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[29] See R. KOROBIN, "Behavioral Economics, Contract Formation and Contract Law" en C. SUNSTEIN (ed.), *Behavioral Law and Economics*, pp. 118 et seq.

# Home Improvement Grants in Trinidad and England

↳ By Kathleen Scanlon[1]

## 1. Introduction

In the last 50 years, ideas about how to improve the housing of the poor have changed markedly in most developed countries. The preferred practice in the 1960s was to demolish dilapidated, 'worn out' old housing and replace it with new build. In urban areas this often took the form of large council estates. Now, however, the emphasis is on retaining and repairing existing buildings where possible, for several reasons. The large estates proved to have their own problems: they were expensive to maintain and manage, and the concentration of needy families on single-tenure estates often led to social problems. Also, demolition and new build are much more costly than repairing existing structures--repair is generally more sustainable both financially and environmentally, and the cost of repair is often shared with the owner rather than borne exclusively by the state.

In developing countries as well, demolition and replacement of sub-standard dwellings, and especially of self-built informal housing, was standard practice in the 1950s and 60s (Abbott 2002). One of the first writers to question this approach was John Turner, whose findings in the 1960s influenced the World Bank. He wrote that upgrading rather than new-build preserves communities, provides larger dwellings, can house more people more quickly, and makes better use of indigenous resources than new-build, even if the individual dwellings are of lower standard (Turner 1967).

The most significant change in housing subsidy policy and design in developing countries over the last few decades has been a general shift away from direct provision of housing and towards the 'enabling policies' that were endorsed in 1988 by the UN General Assembly (Mayo 1999). In this context, 'enabling' refers to establishing a framework for a range of non-state, market actors to become involved in housing provision. The World Bank has been a key advocate of this policy change, which is encapsulated in policy papers including Housing (World Bank 1975), Learning by Doing (World Bank 1983) and Housing: Enabling Markets to Work (World Bank 1992). More recent experiences of enabling policies have been documented by Imparato and Ruster (2003) and Rojas (2010).

This paper describes one such enabling policy, a programme in Trinidad that subsidised housing improvements made by low-income owner occupiers. It traces parallels with historic and current housing subsidies in the UK, and compares and contrasts the issues faced by policy-makers in the two countries.

## 2. Economic rationales for housing subsidies

Under certain conditions of market failure, it is efficient for governments to provide subsidies to individuals. In the case of housing, two types of market failure may be particularly relevant. The first is the case of 'merit goods'—that is, those goods which society believes all people should have, whether or not they are able to pay for them. Policy statements such as 'Everyone has a right to decent housing' implicitly define good housing as a merit good, and could justify the provision of subsidies to allow owners to upgrade. However, given that funds for such subsidies are always limited, it is necessary to select which improvements are to be funded—and here it is helpful to examine whether certain housing improvements might have positive externalities.

Goods with positive externalities are those whose value to society as a whole is greater than their value to the individual who pays for them. Housing improvements that produce positive externalities generally lead to benefits in terms of public health and/or environmental impact. In general, the more dilapidated the housing stock the more likely there are to be positive externalities associated with improvements. Examples include

- Installation of indoor toilets and connections to sewerage systems (improves public health)
- Improving electrical wiring (reduces fire danger)
- External decoration (affects values of neighbouring homes)
- Improvements to roofs and guttering (reduces erosion from uncontrolled run-off)
- Installation of insulation and energy-efficient heating systems (reduces carbon emissions).

The greater the positive externalities of any particular improvement, the stronger the argument for subsidising it.

## 3. Housing and housing subsidies in Trinidad

Trinidad is a Caribbean island located off the coast of Venezuela. It has a population of about 1.2 million and a land area of about 5000 km$^2$.

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Compared to many of its Latin American and Caribbean neighbours the country is relatively wealthy--oil and gas has recently been found and GDP growth is strong. But income inequality is extreme. The GDP of Trinidad and Tobago, at US $21.2 bn in 2009, was a bit less than 1% of UK GDP in the same year (US $2.2 trillion). Per-capita GDP in Trinidad, at $15,841, is less than half the UK figure of $35,165.

Improving the country's housing is a major part of the government's stated goal of achieving developed nation status by 2020 ('Vision 2020'). There are two housing markets: the legitimate formal dwellings, and the larger informal market. Most of the housing in the country is owner-occupied, but prices in the formal housing sector are too high for low-income families (median house price in 2009 was TT$ 856,000 or €109,000, while median income was TT$ 50,760), and there is a dearth of land for legal new construction. Thus much new housing is self-built, often in squatter settlements. The dwellings lack sanitation and other services, do not meet building codes, and residents often do not have legal title. Squatter areas are concentrated in inner cities or on the slopes of the hills around Port of Spain. In this area the lack of proper drainage is a serious issue, as it increases the risk of devastating mudslides. The squatter settlements are generally fairly low-density, with average plot sizes of about 5000 $m^2$, generally occupied by a single house.

Both squatters and low-income owner-occupiers with title have difficulty securing finance for improving their homes. Although the Trinidadian mortgage finance system is one of the most developed in the region, it serves only middle and upper income groups. Squatters by definition do not hold title to their land, so would not qualify for mortgages to finance home improvements in any case. Owner-occupiers with legal title are also often excluded from formal mortgage finance because of low and/or erratic incomes, and fund repairs and improvements with short-term consumer loans or through community-based mutual aid societies known as sou sous. Mortgage penetration is very low; recent statistics are not available, but in the three years from 2000 to 2002 only 4,924 new mortgages were granted by all Trinidadian financial institutions (Housing sub-committee 2003).

## 3.1 The Home Improvement Subsidy

In 2002 the Inter-American Development Bank (IDB) and the Trinidadian government agreed a US$ 40 million programme to address these issues. Its goals were 'to improve housing for lower-income groups, to make public expenditure on housing more efficient and equitable, and to provide incentives and assist institutions, both public and private, in their transition to new, more market-driven roles' (Programme Monitoring and Coordinating Unit 2010). In negotiating this loan, the IDB wanted to promote the idea of 'incremental housing' to Trinidadian decision-makers—many of whom preferred to continue the previous approach of knocking down informal dwellings. The programme, known as the 'National Settlements Program Second Stage Phase 1' (NSPSS1), had three components. The first was a project to improve administration and technology in the government departments dealing with housing. The second was a scheme to regularise long-term squatters (those who had occupied their plot since 1998).

The third element was a home-improvement grant for low-income owner occupiers, which is the subject of this paper. The grant was meant to help households from the lowest four income deciles to improve their homes. Households with a total income of under TT$ 7000/month (about €900) were eligible to apply for the grant, which had a maximum value of TT$ 20,000 (€2,600). The beneficiary was required to match the grant one-for-one—that is, if they received TT$ 15,000 in grant they had to come up with TT$ 15,000 from their own savings. There was a provision to allow applicants to use 'sweat equity' (their own labour) as their matching contribution, but this seems not to have been used in practice. Beneficiaries were free to spend more than TT$ 20,000 but only that amount would be matched by subsidy.

Originally the plan was that the housing subsidy element of the programme would support both the construction of new housing and the upgrading of existing dwellings, with about 80% of the funds going to new housing. In fact, however, more than 97% of the subsidies in terms of value went to home improvement. This was in part because the subsidy for new construction was only available for homes that cost less than a certain limit, but this ceiling proved to be too low for market conditions, particularly given the high construction standards required; in addition, the new houses were built in small quantities which did not allow builders to exploit economies of scale.

Some 3,265 households received subsidies for home improvement over the course of the program, or about 1% of all households in Trinidad. The original aim was to target families below the estimated poverty line or below the 4th income decile. Under the programme's regulations, however, much more affluent families were eligible. Median household income in 2009 was TT$ 50,760 and the upper limit of the fourth income decile was TT$ 43,200, but the maximum qualifying household income in 2010 was TT$ 84,000 (about €10,700), which fell somewhere in the 8th or 9th income decile, according to Trinidadian government calculations.

Ensuring that only the poorest households receive subsidy is a widespread problem with this type of programme. In Chile, for example, some 14% of beneficiaries of a housing subsidy programme were found to be from the top fifth of population in terms of income (Gilbert 2003). Also, the existence of a savings requirement (analogous to the Trinidadian requirement for a matching contribution from the recipient) meant that some 35% of Chilean beneficiaries were single, rather than the families that were the target group. 'Those able to save quickly get subsidies more quickly than those living in greater poverty or with larger outgoings' (Gilbert 2004).

## 3.2 Application, verification and monitoring procedures

The application form required applicants to demonstrate that they could provide matching funds (on a one-to-one basis) for the desired home improvements. The form stated that the applicant's own labour could be considered for part or all of their own contribution, but it is not clear on what basis this labour was to be costed. There was no geographical targeting, nor were there questions about household wealth, and it seems likely that some of the subsidy funds went to households with low incomes who nevertheless possessed substantial savings. There were more qualified applications than funds available, and the final selection was by a random lottery, with about 41% of eligible applicants receiving subsidies.

## 3.3 Outcomes

Table 1 presents information on applications for the Home Improvement Subsidy over the eight-year life of the programme. The figures were calculated on the basis of information provided by the Trinidadian government department that administered the funds. More than two-thirds of applicants were judged to be eligible, but of these fewer than half received a grant because of the limited funds available. Some 61% of beneficiaries received the maximum grant of TT $20,000.

Some 29% of applications were refused; Table 2 sets out the reasons for refusal. By far the most common reasons for refusal were those relating to documentation: either 'insufficient documentation' or 'insufficient proof of ownership' were cited as grounds in 56% of refused cases. The data do not allow us to distinguish between those applicants who were actually owners but

simply did not have the required paperwork, and those who did not own the property in question. In terms of resources, 15% of applicants were refused because they had insufficient savings, while somewhat fewer (9%) were turned down because they earned too much.

The grant required a one-to-one matching contribution from the beneficiary, for at least three reasons: first, it encouraged beneficiary households to develop a pattern of saving and gave them a financial stake in their project; second, it made the project budget stretch further; and third, it was easy to administer. But this requirement could be expected to effectively exclude the poorest households, as they would not have the money to provide a matching contribution – and their housing conditions meant they would benefit most from the grant.

Data on beneficiaries shows that they were not predominantly from higher-income groups, but nor were they from the poorest households. The average household size was 2.9 members, and the median annual household income was TT$ 42,000. This was well below the maximum eligible income of TT$ 84,000 and near the top of the fourth income decile, so just within the target range. Some 53% of recipients in this sample had declared incomes below TT$ 43,200, which was the upper bound of the fourth income decile. Nevertheless, these households had managed to accumulate enough savings to match the grant amount—which in many cases was equal to their annual household income.

The mean grant paid was TT$ 17,100 while the median was TT$ 20,000. Some 61% of beneficiaries received the maximum amount of TT$ 20,000. Of those who received the maximum, the great majority (68%) put in a contribution greater than the grant amount—that is, they paid more than $1 for every $1 of grant received.

Table 3 shows which categories of improvement accounted for 5% or more of projects. Roof works was the single most important category; plumbing and foundations were the most expensive project types.

Actual costs exceeded projected costs in a substantial majority of cases (79%). The average overspend was TT$ 5479, which represented 14% of the budgeted costs for these projects. Only 15% of households spent less than expected.

## 3.4 Designing a successor programme

The Trinidadian government and the Inter-American Development Bank are now in the process of negotiating a successor programme

**Table 1: Applications for Trinidadian Home Improvement Subsidy, 2002-2010**

| | | |
|---|---|---|
| Total number of households in Trinidad (2000 census)* | 328,000 | 409 |
| Number of applications for HIS | 11,193 | (3.4% of households) |
| Eligible and received grant | | 29% |
| Eligible but did not receive grant | | 42% |
| Ineligible | | 29% |
| Total number of grant recipients | 3,265 | |

Most recent available. Number of households unlikely to have grown, as total population has been static since 2000.
*Source:* Data provided by Government of Trinidad and Tobago

**Table 2: Reasons for refusal of Home Improvement Subsidy applications**

| Reason for refusal | % of refused applications |
|---|---|
| Insufficient documentation | 30 |
| Insufficient proof of ownership | 26 |
| Did not attend interview | 21 |
| Insufficient savings | 15 |
| Not interested | 9 |
| Income too high | 9 |
| Scope of works not admissible | 4 |
| Had already benefited from another grant programme | 3 |
| Proposed improvements already completed and paid for | 1 |
| Not a citizen | 0.5 |

*Source:* Data provided by Government of Trinidad and Tobago

Total of all grounds for denial is greater than the number of refused applications as some were ruled ineligible on more than one ground.

**Table 3: Reasons for refusal of Home Improvement Subsidy applications**

| | Total number of projects | % of all projects | Average project cost |
|---|---|---|---|
| Roof | 1722 | 29 | $15,020 |
| Doors | 690 | 12 | $14,511 |
| Ceilings | 544 | 9 | $25,000 |
| Electrics | 472 | 8 | $14,663 |
| Tiling | 342 | 6 | $10,054 |
| Windows/framing | 312 | 5 | $14,800 |
| Plumbing | 297 | 5 | $32,929 |
| Foundations | 275 | 5 | $33,241 |

*Source:* Data provided by Government of Trinidad and Tobago

to the NSPSS1. In doing so they are reviewing the following issues:

- Which households should receive the subsidy? Good targeting should minimise both leakage of subsidy to higher income groups and deadweight loss (funding things that the beneficiary would have bought anyway).
- What is the appropriate level of owner contribution, and conversely the appropriate level of grant? This depends in part on whether the priority is to improve the worst of the housing stock or to stretch the budget as far as possible.
- What improvements should be eligible? To date the scheme imposed few limitations—only exterior alterations such as the installation of fencing or swimming pools (!) were not permitted.
- Where should funds go? The Trinidad scheme was open to residents from anywhere in the country, with no spatial targeting. Anyone who had an income below the ceiling, held title to their land and had enough savings to match the grant (or who had recently invested in improvements worth as much as or more than the matching amount required) was eligible, and final selection of beneficiaries was by lottery.

## 4. House renovation subsidies in England

At first glance the Trinidadian housing sector has little in common with that of England, where there are virtually no informal dwellings and low-income families are housed predominantly in the social and private rented sectors. But a short review of English housing subsidy policy over the last 60 years shows that London has faced many of the same issues as Port of Spain. The Trinidadian housing subsidy programme bears striking resemblances to English policies of the 1950s-1990s, which were very much more generous than the current system, and through which many billions of pounds of grants flowed to private home owners in the years since 1949. These similarities perhaps stem in part from Britain's historic role as colonial power. This left deep traces on the legal and governmental structures of the island, which gained independence in 1962.

After World War II the English housing stock was in generally poor condition. Much of the housing, especially in inner cities, was poorly built, and was suffering from years of under-investment and, in some areas, war damage. 'In the immediate post-war period, housing rehabilitation, or "patching up", as it was disparagingly called, was discouraged' (Balchin & Rhoden 2002). But by 1949 it was recognised that rehabilitation could reduce the housing shortage, and the Housing Act of 1949 introduced improvement grants for private owners. Its provisions were subsequently modified by various pieces of legislation, with several changes of terminology, and the Housing Act of 1969 significantly broadened the grant system.

The grants were funded by central government but disbursed by local authorities. Two types of grant were available: mandatory grants for installation of basic amenities such as indoor toilets and baths, and discretionary grants for work such as essential repairs, damp-proofing and re-wiring. The grants had to be matched pound-for-pound by the applicant, and recipients of the discretionary grant had to bring their homes up to a 12-point fitness standard. The emphasis was on the condition, value and age of the house (it could not be less than 10 years old), but there was no income or wealth limit for applicants. This system was similar to the Trinidadian programme in that grants were given for a range of renovation and repair jobs, and applicants had to match the grant with monies of their own. But while grant funding was guaranteed in England for certain types of work (indoor plumbing), in Trinidad there was no guarantee of receiving a grant, and no type of renovation work was given priority over another. Also, there were no income criteria at this time in England, although they were introduced later.

In the belief that expenditure on rehabilitation would produce a better return if it were spatially concentrated in the most needy areas, the government introduced legislation in the late 1960s and early 1970s to allow local authorities to designate target areas covering 300-800 houses, where resources would be concentrated. This also reflected the view of some scholars that it would be irrational for owner-occupiers to invest in improving their homes if their neighbours did not do so as well (for example, Davis & Whinston 1961). In Trinidad, on the other hand, the issue of spatial targeting is only now being raised; housing subsidies under the NSPSS1 programme were distributed randomly across the country.

In the early 1970s there was controversy in several English cities about cases in which speculators purchased rental properties, evicted the tenants, renovated the properties with the aid of grant funding and sold them on for a profit (see House of Commons debate 26 July 1972). The fact that there was no means test for beneficiaries contributed to this phenomenon, as did the fact that the division of a house into two or more flats was deemed to be an alteration that was eligible for grant. In 1974 restrictions were introduced on the resale of properties. If within five years the beneficiaries sold their properties, or left them empty, they would be liable to repay the grant with interest. In 1980 these restrictions were rescinded for main homes. In Trinidad there were no restrictions on resale of the improved dwelling, but subdivision of existing dwellings was not eligible for grant and therefore the particular issue of the behaviour of speculative landlords, and the consequent political pressure for change, did not arise.

After 1982, recipients in England were no longer required to contribute 50% of the cost, as grant could cover up to 90% of eligible expenditure. This change was designed to allow very low-income owner-occupiers to benefit from the grant. In Trinidad the current 50% limit may be changed in the next version of the programme.

In reading reports of the housing policy debate in the 1960s and 1970s, one is struck by two things: First, the scale of disrepair in the English housing stock was very large, and was seen to be a national problem—indeed, a source of national shame. Second, owner-occupied homes seemed to be viewed not as potential financial assets but rather as costly burdens; there was a view that many owners would not invest in the improvement of their own homes if the government did not offer them incentives to do so—and indeed, sometimes not even then. In some English cities the grants failed to attract enough applicants—or at least enough applicants in the right places. In the mid-1970s Birmingham City Council carried out exterior refurbishments (known as 'enveloping') of groups of dwellings in target areas, to try to encourage owners to take up grants to rehabilitate the interiors (Balchin & Rhoden 2002, p. 77). And a 1979 study of Housing Action Areas found that '(i)n the 471 HAAs declared up to the end of that year, only one-third of households (and one-fifth in London) took up improvement grants, since even with 75-90 per cent grants, households still had to find large cash sums because eligible expenditure limits were too low' (Balchin & Rhoden 2002, p. 75). In addition, home owners reportedly found the system complex and confusing, and the application procedure overly bureaucratic.

The Trinidadian programme, in contrast, has not suffered from a dearth of applicants; more than twice as many eligible households applied than there was money available. The initial stages, at least, of the Trinidadian application process appeared to be fairly simple (the application form was only two sides of A4), but Table 2 shows that 56% of refused applications were turned down for reasons to do with lack of documentation—although this does not of itself necessarily point to an excessive level of bureaucracy. It is not clear whether the degree of improvement carried

out (or not) by neighbours affected Trinidadians' propensity to apply for grants.

In the 1980s the generosity of the English system began to be scaled back, and the maximum grant rate was cut from 90% to 75% in 1983. Surprisingly, as late as 1989 applicants' income and wealth were not explicitly taken into account in determining eligibility, although the limitation of subsidy to houses in poor repair could be argued implicitly to have targeted low-income owners. The 1989 Act introduced a new regime of means-tested grants; these were mandatory if the building was declared 'unfit for human habitation' and renovation was shown to be the best option (Wilson 1996). At first there was no upper limit on the grant amount; it was later capped at £50,000, then £20,000. Local authorities faced a dilemma as more households applied than there were funds available, and the law required them to decide applications within 6 months. Almost all local government expenditure in England is funded by grants from central government, and local authorities cannot raise their own funds through taxation, so to keep expenditure within budget many local authorities operated queuing systems of dubious legality (Leather and Morrison 1997). Mandatory grants were abolished in the late 1990s, and the whole system was further reduced in scope.

In England the availability of government grants for repair or renovation of private homes is currently very limited. These grants are given by local authorities, but they are not required by law to offer them; the only mandatory grant is given for making changes to a home to enable a disabled person to live there. Since 2002 local authorities have had the flexibility to determine their own eligibility criteria, to decide whether to require a means test, and to give assistance other than grants, under The Regulatory Reform (Housing Assistance) (England and Wales) Order 2002.

Table 4 gives figures for expenditure in England on home renovation grant in the years 1996/97 to 2008/09. Most grants are discretionary (that is, not to do with improvements to accommodate disabled persons), and the number of these has fluctuated between 64,000 and 120,000 per annum since 1996. While there is no clear trend in the number of grants, the average grant amount has fallen fairly steadily over the period (and more so if inflation is taken into account). The average grant was £5,154 in 1996/97, but by 2008/09 had fallen to less than half that (£2,070)—not a great deal more than the £1580 (TT$ 15,000) that the average grant beneficiary in Trinidad received. The average value of mandatory grants for facilities for disabled people, on the other hand, rose over the same period.

**Table 4: Number of and expenditure on home renovation grants in England, 1996/97 – 2008/09**

| | Discretionary ( for non-disabled) | | | Mandatory (for disabled) | | |
|---|---|---|---|---|---|---|
| Year | Number | Amount (£000) | Average grant (£) | Number | Amount (£000) | Average grant (£) |
| 1996/97 | 73,940 | 381,090 | 5154 | 20,060 | 92,230 | 4598 |
| 1997/98 | 105,260 | 310,300 | 2948 | 21,990 | 100,410 | 4566 |
| 1998/99 | 108,920 | 313,900 | 2882 | 22,180 | 107,100 | 4829 |
| 1999/00 | 120,420 | 320,040 | 2658 | 22,720 | 116,530 | 5129 |
| 2000/01 | 98,910 | 296,830 | 3001 | 24,730 | 130,720 | 5286 |
| 2001/02 | 82,060 | 288,460 | 3515 | 25,510 | 145,120 | 5689 |
| 2002/03 | 67,950 | 259,060 | 3813 | 30,100 | 173,780 | 5773 |
| 2003/04 | 64,400 | 246,620 | 3830 | 37,170 | 201,980 | 5434 |
| 2004/05 | 68,080 | 229,800 | 3375 | 38,550 | 210,310 | 5456 |
| 2005/06 | 66,100 | 231,540 | 3503 | 34,940 | 221,340 | 6335 |
| 2006/07 | 97,080 | 266,150 | 2742 | 37,270 | 232,830 | 6247 |
| 2007/08 | 100,910 | 236,710 | 2346 | 38,130 | 250,100 | 6559 |
| 2008/09 | 118,360 | 245,050 | 2070 | 41,790 | 284,840 | 6816 |
| **Totals** | **1,172,390** | **3,625,550** | | **395,140** | **2,267,290** | |

*Source:* Department of Communities and Local Government live tables 313 and 314

In addition to the local authority improvement grants, central government in England has since 2000 funded a scheme known as Warm Front to help owner-occupiers install energy-efficient heating systems and upgrade insulation. This scheme has a budget of £959 million for the period September 2008 – September 2011 (NAO 2009). The maximum grant available is £3,500, and households must be receiving certain state benefits and include an elderly or disabled person or a child to qualify. In about 75% of cases the Warm Front grant covers the full cost of the work.

## 5. Conclusion

The English and Trinidadian housing systems differ in significant respects, including

- The extent to which residents have legal title to their dwelling
- Age and construction type of the housing stock
- Self-build versus developer construction
- Incidence of squatting
- Predominant tenure of lower-income households (in England they are more likely to live in social housing, in Trinidad in owner-occupied or squatter dwellings)

Nevertheless, cutting through the thicket of bureaucratic terminology around their housing grant schemes reveals some striking similarities. All designers of housing subsidies have to address the same fundamental questions: what types of modifications should be subsidised, who should get the subsidy, and how much should they get?

In terms of which improvements should be eligible for grant, neither country appears to have designed its scheme in order to maximise positive externalities; in both countries a wide range of improvements was eligible for grant, including those that would benefit only the resident household, rather than society more broadly. England has had particular programmes aimed at improvements with positive externalities such as indoor plumbing (historically) and energy efficiency (now), but these have co-existed with broader schemes based fundamentally on the premise that housing is a merit good. Similarly, in Trinidad, almost any kind of improvement or repair to the home is eligible for grant.

The second question is who should get the subsidy. Here economics has less to say; this is basically a political question. Politicians want to design programmes that are 'fair', but fairness can have many meanings. It could be considered fair to give subsidy to those least able to pay for improvements themselves—which would suggest that 100% grants should be given to the very poorest—or it could be fair to reward those who have demonstrated a degree of financial responsibility. Fairness could mean giving everyone in the country an equal chance to receive a grant, or conversely could mean focusing the money in a few very deprived areas—and so on. Both countries employed 'fair' practices for allocating grant among eligible individuals. In England, those who applied early in the financial year got money, which was distributed until the budget was used up, while in Trinidad grant recipients were chosen randomly from amongst all eligible applications. While such systems are fair in the sense of being unbiased, they do not permit targeting of subsidy for maximum efficiency. In its 2009 analysis of the Warm Front scheme, the National Audit Office echoed this concern, saying that 'the Scheme aims to help all vulnerable groups who might suffer from the cold, which has blunted its effectiveness in focusing on those in the worst cases of fuel poverty' (NAO 2009 p. 6).

Finally, what is the right amount and percentage of grant? Should 100% grants be given to the neediest, or smaller grants to those who can afford to do some – but not all – of the work themselves? In order to have the most beneficial effect on the housing stock, is it better to divide the pot of money into a few large grants or many small ones[2]? The level of grant available under the Trinidadian scheme is enough to enable the recipient to carry out major works such as re-roofing. The grant amounts typically available in the UK are very much smaller in relation to the cost of construction – although incomes are higher and the overall condition of the housing stock is better, so it might be argued that very large grants are no longer appropriate or necessary.

The decisions about these issues depend in part on whether policy-makers' focus is the physical fabric of buildings, or the experience of those who live in them. In terms of presentation at least, the emphasis has shifted. In the middle of the 20th century in England, the focus was on the buildings themselves; the goal was to improve the overall condition of the nation's housing stock, and the fact that some households were removed from their homes was considered a reasonable price to pay. Today, though, the focus is on the household--the Warm Front initiative is promoted as 'tackling fuel poverty' by addressing those households that spend more than 10% of their income on energy costs; there is little reference in the scheme's literature to the condition of the dwelling per se (NAO 2009).

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[2] The Warm Front scheme presents a particularly extreme example of this, having spent some £4.9 million between June 2005 and March 2008 on giving households grants for two low-energy light bulbs (NAO 2009).

# Housing and Urbanisation in Algeria between 1966 and 2008

↪ By Acidi Abdelhak[1], Brakchi Souad[2] and Khanchoul Kamel[3]

## 1. Introduction

After Algerian independence in 1962, the houses abandoned by Europeans made it possible to temporarily fulfil the important demand caused by rural emigration. According to Côte (Côte, M, 1999), upon the departure of the Europeans, approximately 700,000 houses were recovered by the Algerians. During this time, the State was not worried about the problem of housing supply and concentrated its efforts on the creation of economically productive sectors. In addition, the war of liberation had caused damage to the rural areas, in particular to rural housing which had undergone much damage, and consequently had regressed. This present study focus on three major points: firstly to introduce the development of urbanisation in Algeria (Breil, M.J, 1957) between 1966 and 2008. Secondly, to describe the state of housing in the same period and thirdly to show in terms of housing, regional disparities taking into account different indicators.

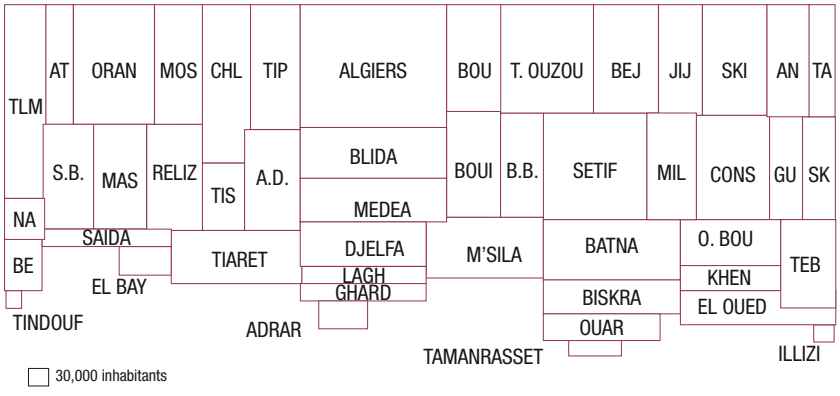
## 2. Study Area and Methodology

Algeria is a country located in North Africa. In terms of land area, it is the largest country on the Mediterranean Sea, the second largest on the African continent after Sudan, and the eleventh largest country in the world. Algeria is bordered by Tunisia in the northeast, Libya in the east, Niger in the southeast, Mali and Mauritania in the southwest, a few kilometres of the Moroccan controlled Western Sahara in the southwest, Morocco in the west and northwest, and the Mediterranean Sea in the north. Its size is almost 2,400,000 km2, and it has an estimated population of about 35,700,000 as of January 2010. The capital of Algeria is Algiers (Bellal, T, 2009).

This study was based primarily on statistical data from the general census of the population and housing of 2008 carried out by the National Office of Statistics and using the preceding censuses (1966, 1977, 1987 and 1998) as comparatives. The method was based on the study and analysis of data using some computer programmes such as: Microsoft Excel, Illustrator and MapInfo. This enabled us to work out several maps by anamorphosis. Anamorphosic maps show regions' areas in relation to their population sizes, and each map shows a housing indicator according to different statistical classes. (Cauvin, C, 1987).

The difficulty raised in the cartography was the duality of scale which exists between the Tell in the north and the Sahara in the south. There are not only physical and human differences, but also a difference in scale. The first covered 400.000 km$^2$ and the second was 2.000.000 km$^2$. Indeed, the demographic and economic weights were concentrated mostly in the northern part (more than 300hab / km2) and decreased in the Saharan area (less than 2hab/km$^2$). In order to highlight the massive character of the northern departments, relative to the Saharan departments (in the south), we took into account the demographic weight of small Tellian departments, and the small population of the Saharan departments. As a result, we preferred to use a map by anamorphosis (see Figure 1): it was a map which represented the departments' areas in relation to their population sizes: the surface of each department is proportional to the size of population of that department.

**Figure 1 Department Areas Taking into Account Population Weight**




*Source:* Office National des Statistiques

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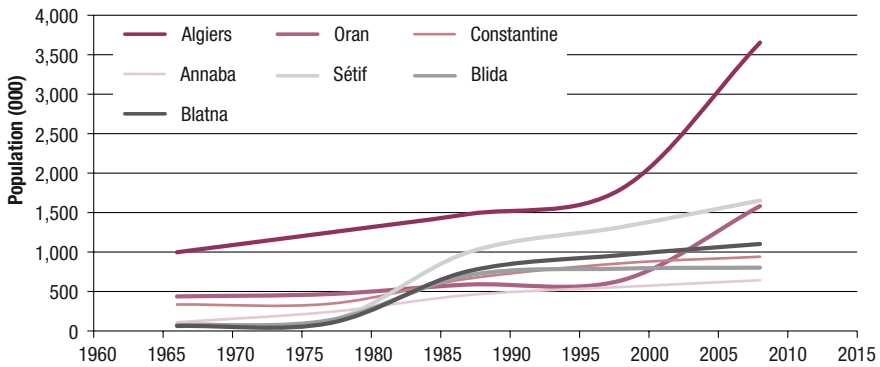
## 3. Urbanisation in Terms of Population

According to Figure 2, urbanisation in terms of population between 1966 and 2008 was characterized by a continuous and regular increase. However this urbanisation is more marked in the metropolitans areas especially: Algiers, Oran and Sétif. As shown in Figure 2, three curves must be explained, those having sharp increases: Algiers, Oran and Sétif metropolitan areas (Lekhel, A, 1995)

**Figure 2** Urbanisation in Major Cities in Algeria



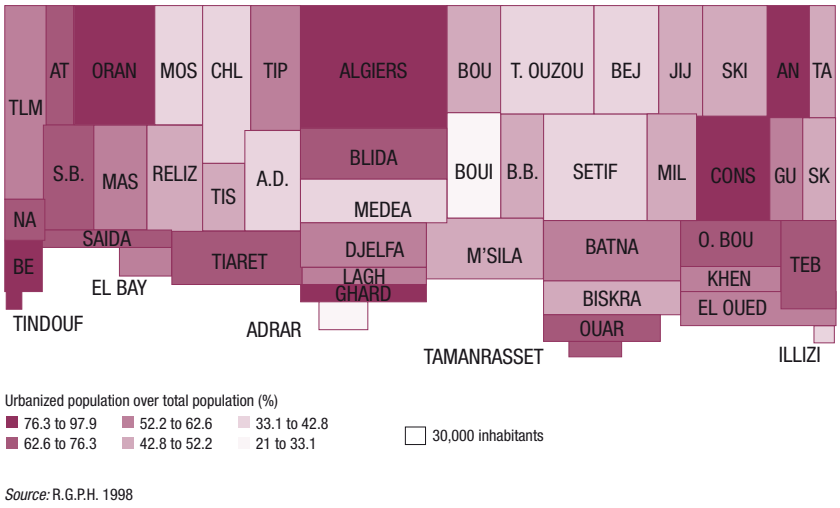

### 3.1. Algiers the Capital of the Country

The sharp increase of population in Algiers, the capital of the country, began in 1998. It can be explained by the new economic policy (foreign investments) adopted by the government that slowed down the intensity of terrorism. Most foreigners prefer to be located in the capital to be near the authorities to avoid any constraints on their investments. This economic change in the country has obviously created a jobs opportunity which has positively influenced a decline in unemployment and an increase in marriages. In addition, inhabitants who gave up their homes during the period of terrorism have re-inhabited their residences.

### 3.2. Oran the Second Major City

Oran, the second major city in the country saw an accelerated population increase especially after 1998, which is explained by foreign investments in the housing sector and the famous big project of the East-West motorway, and its security in comparison with other regions. These factors have helped in the stabilization of its population.

**Figure 3** Relative Urbanised Population Disparities (2008)




*Source:* R.G.P.H. 1998

### 3.3. Sétif the Fourth Major City

The accelerated population growth in Sétif, particularly between 1990 and 2008 was the result of the growth of the new commercial and industrial zone named "El Elma" 30 kilometres from Sétif. The development of these zones has increased consistently the urban dynamic of the department and Sétif has become increasingly gravitational, the rate of unemployment has decreased, and there has been an increase in early marriages.

### 3.4. Urban Population Disparities

The urbanised population is calculated as a percentage in relation to the total population of each department. This rate represents the relationship between the urban population and the total population. In this context, the process of urbanisation shows the degree of development within the areas. Therefore, well organized urbanisation and the balanced network were determinants of development. The average rate of urbanisation passed from 50.5% in 1987 to 57.5% in 1998 and to 86% in 2008. This increase is due partly to the reinforcement of the communication networks in isolated zones and to the insecurity that characterised rural areas.

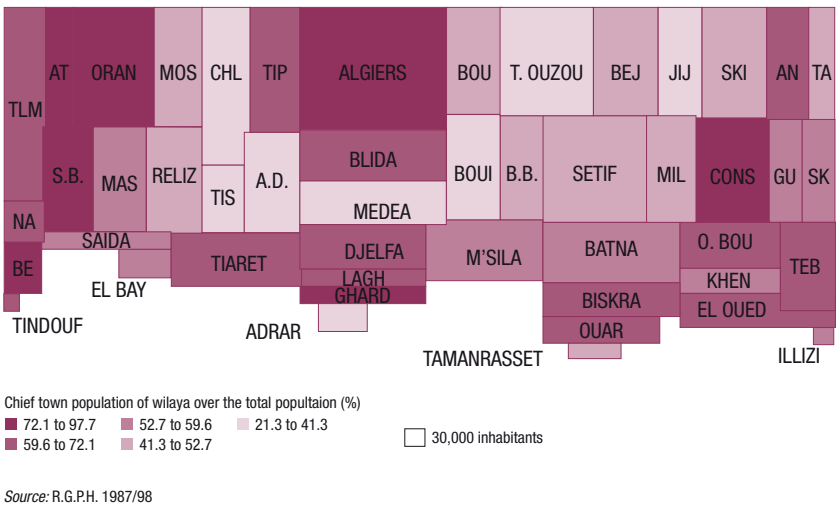
According to Figure 3 the departments with high urbanisation were Ghardaïa, Algiers, Oran, Tindouf, Constantine, Annaba and Béchar with respective rates of 96.7%, 97.8%, 90.1%, 90.9%, 87.1%, 83.9% and 80.5% The important urbanisation in the two saharian departments (Tindouf and Ghardaïa) is explained by their geographical locations: Tindouf has a border location with Morroco, so it is important that it is developed and urbanised. Ghardia has a transit location between the south part of the country and the north part, this location is the main reason for the commercial character of the department. The high rate of urban living in the north is also explained by the area's colonial history which was highly important in this part of the country. French colonists settled in Tell in order to be close to the French metropolis. In the other side, the Tell was a strategic place with more or less the same climate in comparison to European climate.

The Algerian state reinforced this urbanisation by the installation of heavy industry in these departments. Indeed, the developed departments were strongly urbanised and the departments which surrounded them were less urbanised. During the 1980s the state became aware of regional disparities between either different departments, or different regions and parts of the country. To reduce this imbalance, the State reinforced control in the border areas like Béchar and Tindouf.

In addition, the authorities directed the development towards the interior of the country and the Saharan departments. In the Sahara, the growth of the departments like Ouargla, Biskra is explained by their absorption of close core villages and by the demographic dynamism provided by the arrival of frame workers coming from the North of the country. For the Steppes and the Centre, it was due to the settlement of the nomads. On the other hand, the departments Tiziouzou, Médea, Chlef and Sétif had the lowest rates of urbanisation with respectively 35.4%, 39.7%, 41.3%, and 39.3%. These departments had a high rural population (Rousseaux, V, 2000).

In Algeria the department which has a low rate of urbanisation does not mean "a wedged department". For example the low rate of urbanisation in the Kabyle region (Tiziouzou and Béjaia) is explained by socio-cultural characteristics where people stick more to their traditional practices and way of life in spite of a developed school attendance in this area of 83.4% (male and female).

**Figure 4** **Relative Urbanised Population Disparities (2008)**




*Source:* R.G.P.H. 1987/98

Another way to see regional disparities in urbanisation is in the ratio of the concentration of the urban population: calculated as a percentage of population living in the regional capital town of the region to the total population of the department. The national average of the population concentration in the town was 57.4%; thus, more than half of the population was concentrated in the regional capitals. The high density of the population concentration, varying between 72.1% and 97.7%, is found in the main departments which have long established regional capitals, in particular the most urbanised departments such as: Oran, Constantine, Algiers, Ghardaia, Béchar and Tindouf. On the other hand, the most dispersed population was recorded in the underdeveloped interior departments. That was due to the saturation of the head towns and to the development of the scarce zones, because of the programmes of the local equipment (P.L.E.) which aimed to develop the marginalized zones (Figure 4).

According to Figure 4 the most urbanised areas have an urban concentration ratio ranging from 72.1% to 97.7%, and are mainly located in the west region of the country. In the middle region the high urban concentration ratio is well presented in the capital department in the extreme north, and in Ghardaia in the south. However, in the eastern region of Algeria only the Constantine department has a high ratio of urban concentration. This spatial distribution can be explained by the urban and economic development that had focussed mainly around the regional capitals. As a result there has been a massive exodus of the rural population from the secondary urban centres and sparsely populated areas to the regional capitals.

The areas of low population density ranging from twenty one point three percent (21.3%) to forty one point three (41.3%), are found in the rural departments of the Tell and the Saharan departments such as Adrar. For the departments located in the Tell, this can be attributed to the inability of the regional capitals to attract population from the underdeveloped areas. Behaviour and the local traditions are inadequate explanations for the low urban ratio concentration; this is the case of Tizi Ouzou and Jijel which in spite of being coastal departments have a low urban ratio concentration in the regional capitals. The scattered zones of these departments have had an important natural richness (extensive cultivation of olive-trees), considerable traditional activities and a high educational level (ANAT, 2008).

## 4. Housing

### 4.1. Form Aspects

In Algeria, public housing programmes have been undertaken through specific size standards by public corporations, design offices and contractors. During the first years of Housing policy implementation in the 1980s, the range of apartment sizes was from 2 to 6 rooms to meet the households' needs. The apartments were built in multi-storey blocks of 4 to5 floors to avoid elevators. The buildings had a similar design with a common layout regardless of the topography, or the local climate. The traditional forms of living spaces were not taken into account.

A significant building industry was created in order to deliver about 50.000 to 60.000 houses a year in large housing. Prefabricated units were also erected to deliver buildings fast. Cement, steel, moulding elements and wood, mainly imported, were intensively utilized. Vast new urban housing estates have been developed around regional capitals, without common facilities (shops, schools, health centres). The apartments provided for rental purpose were sold by law in order to involve the users in the management and the maintenance charges that were totally supported by the public corporations.

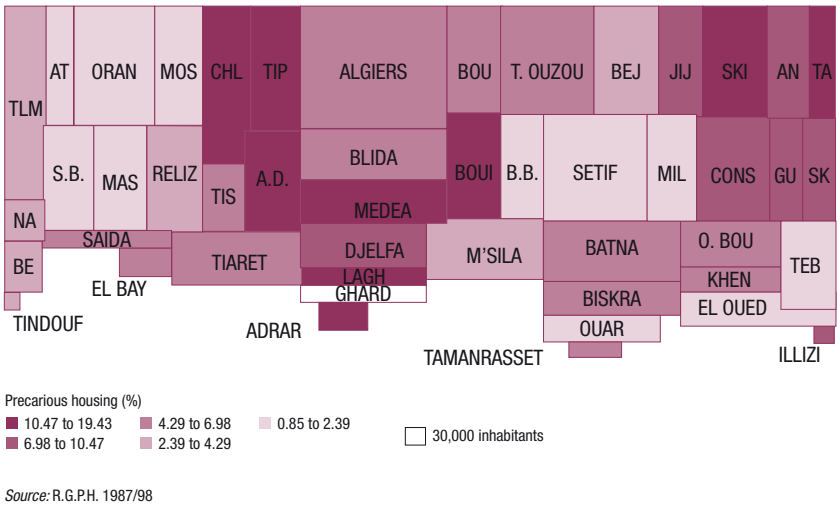
With the beginning of the economic crisis in the mid-80´s due to a reduction in the price of oil, house sizes were reduced. From the 1990s until 2008, a new housing policy meant that State intervention changed with regard to housing design. In the social housing programmes for low-income groups, the size of the apartments became smaller, 1 to 3 rooms, because of shortage of finance. With the direct grant given for the middle-income groups, housing size did not exceed 3 rooms. In this later case, the residents are involved in the design and construction process, while in the social housing developments; the public corporations responsible for development may organize design competitions among architects on a local or national basis. This improvement in the design of the units impacts favourably on the lifestyle of the residents, and means that the local physical and climatic conditions are taken into account in designing the buildings.

## 4.2. Housing Policy

The Algerian government has pursued several housing policies since independence, and they are as follows: From 1966 to 1995 social housing was totally financed by the government with token rent that did not exceed 100 DA and involved all social classes. After 1995, social housing only remained available for low income groups, and direct financial aid is provided by the government to intermediate groups. With a new capital economic system the government is following five policies in term of housing financing:

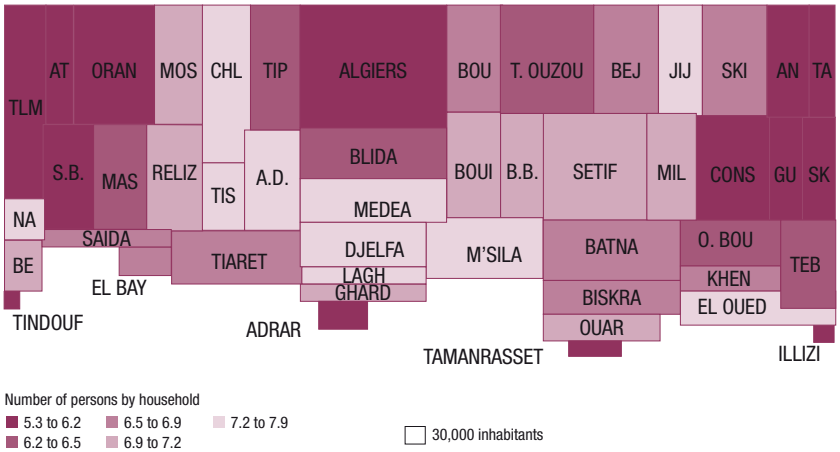
- Rented social housing is totally subsidised by the government, for persons who are earning less than 12000DA (100£), a policy which lasted from 1966 to the end of the 1990s. Post 1998, Algeria has moved from socialism towards capitalism, so housing policy turned to other solutions for funding.
- Participatory social housing concerns persons whose monthly wage is between 12,000-45,000 DA in which thirty percent (30%) of the total cost of housing is subsidised by the government and the cost of housing must not exceed 2,500,000 DA. The remaining cost is shared between the bank with fifty percent of the total cost of housing with a tax of one percent (01%), and the rest of the housing amount is given by the housing owner.
- Rural housing is totally subsidised by the government and concerns persons whose monthly wage is less than 12,000DA.
- Rent to buy concerns persons whose monthly income is between 70,000DA and 45,000 DA. Over a period varying between 25 to 30 years the house buyer rents the house monthly for about 8,000 DA. The advantage of this procedure is that the monthly amount includes the rent and the purchase price.
- Promotional Housing concerns persons whose monthly income is more than seventy thousand Algerian dinars (70,000 DA). This procedure does not have any subsidy from government: The purchaser deposits eight hundred thousand Algerian dinars (800,000DA) and the remaining amount is given by the lending Bank or paid in instalments over several periods by the purchaser (Bellal, T, 2009).

**Figure 5** **Precarious Housing Disparities (2008)**




*Source:* R.G.P.H. 1987/98

**Figure 6** **Regional Disparities in term of Household Sizes (2008)**




*Source:* R.G.P.H. 1987/98

### 4.2.1. Housing Policy Outputs

Among Algerian housing policy outputs, we have the following points (Bellal, T, 2009):

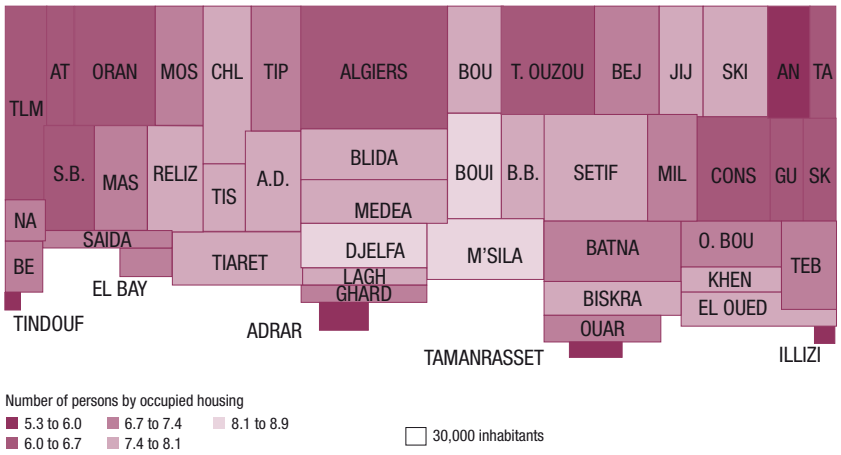
- In the period 1999-2004, 810,000 dwellings were built. Consequently, the occupancy rate per dwelling went down from 7 to 5.5 persons with 1 million dwellings programme, and it is expected to go down to 5 persons in 2011. Fast population growth and sluggish housing delivery led to some housing over-crowding in Algeria.
- Housing supply is more affordable for upper and upper-middle income groups (whose monthly income is more than seventy thousand Algerian dinars), and housing supply is less affordable for low income groups.
- Low income housing demand is left to the informal sector (informal housing not slums)

### 4.2.2. Housing Supply Constraints

Housing demand exceeds housing supply; the problem of housing demand in Algeria still remains unresolved. Several constraints are responsible for this (Bellal, T, 2009):

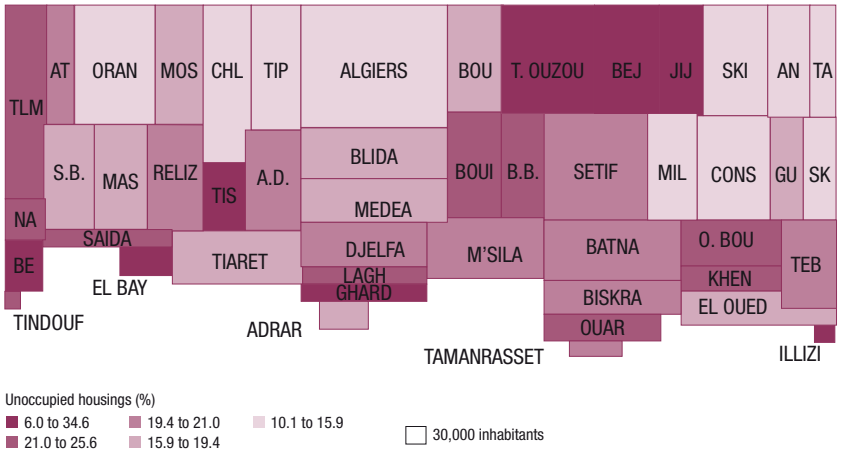
- Delays in housing programs distributions by government
- Delays in housing completions by entrepreneurs
- Banks are not flexible with housing demand since they require a high interest rate (07%) for housing money borrowers.

**Figure 7 Occupancy rates by housing: Regional Disparities (2008)**




*Source:* R.G.P.H. 1987/98

**Figure 8 Percentage of unoccupied housing: Regional Disparities (2008)**




*Source:* R.G.P.H. 1987/98

- The instability of the prices of building materials (scarcity of cement for example because of the great project of the East-West motorway)
- Scarcity of land for construction. This is in contrast to the housing situation before 1990 when land for building was easily available but finance was not.

## 5. Housing Disparities

Squatter housing was very important in the Saharan region such as in the department of Adrar where squatter housing comprised a maximum of 19.43% of the total occupied housing. The rest of the Saharan regions, squatter housing presented usually low values which did not exceed 6% of the total housing, except for the department of Laghouat with a rate of 10.47% (Figure 5)

The housing situation in the West of Algeria is better compared to that of the East. This can be explained by historical factors: high settlement of the French colonists in the West. The capital Algiers had an average squatter housing that varied from 4.29% to 6.98%. Thus, the squatter housing was important either in poor or in rich cities. Nevertheless, the attitude of young people has changed from that of their parents. Now newly married couples prefer to live independently away from their parents, even in unfavourable housing conditions.

The average size of the households in 1966 was 5.9 people. This had increased to 7.1 people and 6.6 people in 1998 and to 6.1 in 2008. After 1987, we noted a decrease in the size of households but it remained high compared to the other countries around the world, in particular in developed societies, where housing was more easily available. The households were dislocated very early and their size was reduced.

In terms of household size, regional disparities are marked in the two extreme poles: in the East and the West regions which showed lower values of the number of persons by household varying between 5.3 and 6.2, such as Tlemcen, Oran, Sidi Bel Abbès in the west, Annaba, Taref, Skikda in the east, Algiers in the central region and Adrar, Illizi and Tindouf departments in the south region.

In addition, the adoption of the spacing birth policy and education development due to the urbanisation increase could be explained by the relatively low rates of literacy. Statistical data shows that, on one hand, the size of households was dependant on the educational level of the population; the departments which had a high rate of school attendance and a low rate of illiteracy had smaller sized households for example Annaba, Tlemcen. On the other hand, the departments with a low rate of school attendance and a high rate of illiteracy had larger households for example El Taref. Moreover, the highest sized households which oscillated between 7.2 and 8 were concentrated in rural areas (Plains and Steppes). This distribution is explained by the unfavourable economic position of the departments (the young people remained longer with their parents and leave the parental home very late), and by cultural factors where the population of these zones preferred founding great families living together in order to affront and to share any constraint.

To better understand the problem of housing and its regional distribution the housing occupancy rate (number of person by one house) is used. According to Figure 7, the majority of country departments had rates of house occupancy rate exceeding the national mean (7.1 persons/ housing).

We have noticed that the regions with high population densities were not those with the highest rates of occupancy (varying from 8.1 to 8.9 persons by housing). These were the least urbanised regions belonging to different geographical zones in plains, mountains and high plateaus. These had the highest rates such as

Djelfa, Bouira and M'Sila. The extreme North-Eastern and North-Western departments as well as the four Tellian metropolitans included less extreme values which varied from 6.04 to 7.42. This does not mean that the housing stock was better in these metropolitan departments; however it is necessary to take account of the cultural factors and their life styles. The industrial development and the advanced urbanisation in these developed departments has had a direct influence on household behaviours.

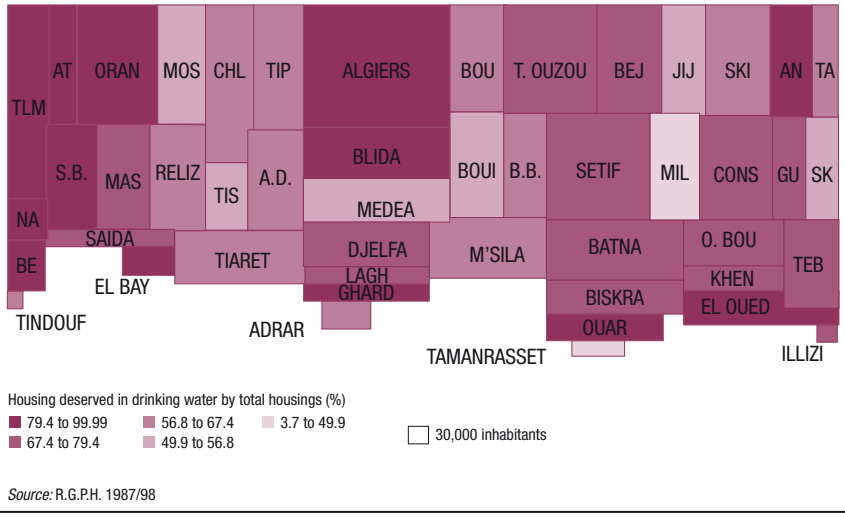
The regions in the southern Sahara were in a better situation to provide adequate housing provision for their inhabitants. However, some geographical areas for example the Mounts of Blessed-Chougran and Ahaggar experienced very high rates of population growth. However, their house occupancy rates were low because housing supply satisfies housing demand without any building delays. (Demain l'Algérie, 2000). The unequal distribution of housing in Algeria can be explained by the national average of the unoccupied residences which was about 18.8% at the time when some Algerian citizens had 2 to 3 houses and others lived in the shantytowns. Unfortunately, this phenomenon is found in all regions, which largely exceeded the 10% rate of the unoccupied houses. The significant demand for rental accommodation in the major cities by external workers that came from other regions decreased because they had occupied unoccupied houses, and this had lead to a decrease of unoccupied houses by 15% (Figure 8).

The majority of empty houses belonged to Algerian citizens living in Europe. We found that in Tizi Ouzou about of 27.6% of houses are empty, an area which recorded the most significant number of emigrants.

Another way in which to understand regional disparities of housing is by looking at the drinking water network (H.W.N.) in comparison with total dwellings. The national average of the housing connected to the water supply network was equal to a national average of 72.3%, 48.4% in rural areas and 86.1% in urban areas. The urbanised regions show a connection rate to a supply of drinking water of 79.4% and 99.9%. The development of an infrastructure for the supply of drinking water made it possible to reach a supply level equal to of the developed countries (BRAKCHI, S, 2006).

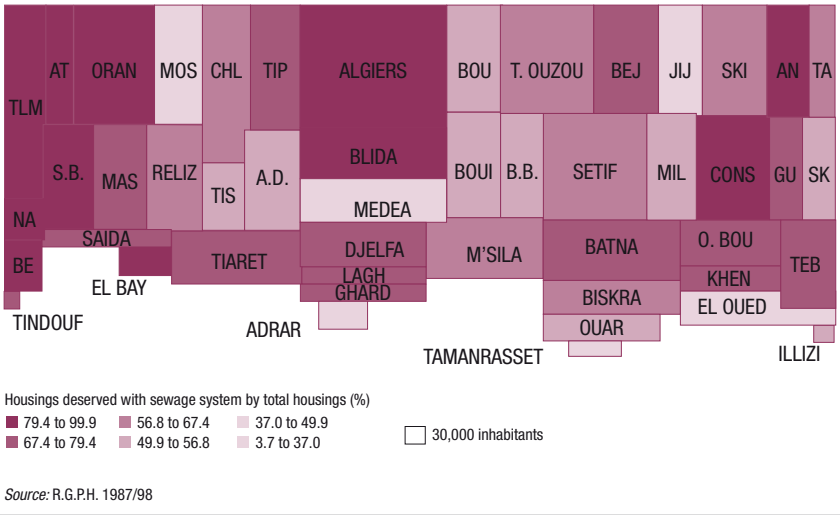
The coefficient of correlation between the ratio of concentration and houses with drinking water is equal to 0.76, the coefficient of correlation between the rate of urbanisation and houses with drinking water supply is lower: r = 0.53 (significance level of 5%) (Brakchi, S, 2006). The high values, varying between 79.4% and 99.9%, were recorded in the West of the country whereas low values, ranging from 67.4% to 79.4%, were found in the East of the country. The rates of drinking water connection further decreased to reach 56.8% in the less developed Tellian regions. The West of the country has the most houses connected to a drinking water supply due to the significant number of well equipped empty houses, and to the important dams left by the Europeans. The Tellian (e.g. Mila) and Saharan (e.g. Tamanrasset) regions recorded the lowest rates of water supply, amounting to 49.3% and 46.2% respectively. The low rate of water supply in Tellian regions was due to the recent administrative delimitation in 1984, and for Saharan regions the low rates were due to the insufficiency in water resources (see Figure 9).

**Figure 9** **Regional Disparities of Housings Deserved in Drinking Water by Total Housing (2008)**




*Source:* R.G.P.H. 1987/98

**Figure 10** **Housings Deserved with Sewage System by total Housing: Regional Disparities (2008)**




*Source:* R.G.P.H. 1987/98

During this decade we noted a reduction of regional differences that were the result of the existence of important programmes to develop the infrastructure of drinking water supply (dams, aquifer wells, transfer, adduction, network, etc…). These programmes belonged to the second five years plan (1985/89) and required a raising of 10.3 Billion DA. This important financial investment in the supply of drinking water permitted the authorities in 1990 to produce for the urban and rural areas (except scattered zones), a total volume of 1.3 Billion m3. These financing projects were exceptional, and remain higher than those observed in Tunisia and Morocco.

The metropolitan regions and the Western part of the country had high values ranging between

79.4% and 99.9%, followed with lower values from 67.4% to 79.4% located mainly in the high East plateaus. These values fell to 49.9% in the high plains of the Centre part, because of the rural character of these departments. The South-eastern Saharan regions showed significant delays in the installation of sewage systems, with achievement rates lower than 37%. These low percentages were due to the difficulty of installation the sewage networks especially in the mountainous areas and the high plateaux, in which the drainage of waste water was mainly directed- toward cesspits as in the regions of El Oued and Adrar. These two regions showed rates of 19.1% and 15.7 %( Figure 10)

The percentage of housing served by a sewage system contrasts with the relationship between the number of houses with electricity and the total number of houses. The average rate of connection to the electrical system was equal to 84.6% with 89% in urban areas and 79.5% in rural areas. The development engaged in each department allowed a global homogenization through the whole country. Thus, 66% of the departments in the East and the West of the country had connection ranging from 79.4% to 89.4%; whereas 30% of the departments that were concentrated in the interior of the country had relatively high values, ranging from 67.4% to 79.4%. The average rate of dwellings connected to the electricity network was higher than both that of connection to a drinking water network and the sewage system, because the electrical power sector profited from several development initiatives. Among the important programmes, we find a vigorous program, with an electrification rhythm of 400 rural areas per year. In 1978, this programme introduced electricity to 96% of dwellings. The remaining 4% of the households had no electrical connection due to their illegal construction.

## 6. Conclusion

Since 1966 urbanisation in Algeria has been affected by a number of natural, historical, political and economic factors. Topography and soil nature has played a great role in determining the pattern of spatial distribution towards the north. This inherited pattern of habitation helped French colonialists to be closer to the European continent to facilitate exports of agricultural products. With the socialist system adopted after 1966, rural areas were marginalised and consequently peasants left for the major cities. After the dark period (1990s), investment in building and commerce became more dynamic and the population of the major' cities has sharply increased as a result.

Despite government efforts the demand for housing between 1966 and 2008 has not been met. In the last couple of decades housing in Algeria has seen improvements in both the design and quality of the houses built. However, the scarcity of land for building especially in major cities, makes the housing problem more severe.

There has been a clear improvement in household living conditions. This development is due to the new construction that has been associated with development operations since the Algerian Independence. Imbalance existed, with small proportions in the size of the households and housing occupancy rates. The metropolitan Tellian and Saharan regions have seen considerable improvement in housing. Connection rates to the various networks (water, sewage and electricity) are also important. However, the interior departments of the country, in particular the area of Chlef and those of the high plains were characterized by the large size of the households and high housing occupancy rates. The latter were usually weakly equipped and did not meet the world standards. In spite of the efforts made by the Algerian government, regional disparities in housing still persist and the heritages were preserved: the statute of "abandoned" space granted to certain areas since almost two centuries, acquired a permanent character. Indeed, while there have been important developments to date, more has to be done in the future to satisfy housing, health, education and employment needs… etc. Some houses are still not electrified, others are without running water. A study of housing using the census data of 2008 will be very useful to improve the spectacular evolution of housing conditions in Algeria.

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## List of cities'abbreviations:

TLM : Tlemcen ; AT : Ain Temouchent ;
MOS : Mostaganem ; CHL : Chlef ; TIP : Tipaza ;
BOU : Boumerdes ; T. OUZOU : Tizi Ouzou ;
BEJ : Bejaia ; JIJ : Jijel ; SKI : Skikda ;
AN : Annaba ; TA : El Tarf ; NA : Naama ;
S.B : Sidi Bel Abbes ; MAS : Mascara ;
RELIZ : Relizane ; TIS : Tissemsilt ;
A.D : Ain Defla ; B.B : Bordj Bouarreridj ;
BOUI : Bouira ; MIL : Mila ;
CONS : Constantine ; GU : Guelma ;
SK : Souk Ahras ; BE : Béchar ; EL BAY : El Bayadh ;
LAGH : Laghouat ; GHARD : Ghardaia ;
OUAR : Ouargla ; O. BOU : Oum el Bouaghi ;
KHEN : Khenchela ; TEB : Tebessa.

# An Insight into the World of Mortgage Fraud in the US and UK

↳ By Beverley Houlbrook[1]

## 1. A Brief Introduction to Mortgage Fraud

### 1.1 Introduction

Mortgage fraud is not a new phenomenon, but is something that becomes more visible as economies enter recessionary periods and house prices tumble. Prior to the current economic crisis, the last time mortgage fraud caused alarm bells to ring to the same extent as they are now was during the recession in the early 1990's. When comparing the two periods, it is apparent that some of the credit and fraud risk issues have not changed in the last two decades. The global mortgage markets however, have changed beyond recognition in the past 20 years, giving rise to more opportunities for professional, innovative fraudsters to exploit and profit from loopholes and system weaknesses.

There are many types of mortgage fraud ranging from the 'soft' fraud types where an applicant is acting in isolation in order to purchase a property, also referred to as **fraud for housing**, through to professional mortgage fraud rings which can be extremely complex, difficult to unravel and wide reaching (in that multiple borrower identities, lending organisations, fictitious properties, over-valued properties and professionals etc. are involved). Losses from this type of fraud – **fraud for profit**, are likely to be significant and result in national, if not global, headlines when the extent of the fraudulent activity is brought to public attention.

### 1.2 Types of Mortgage Fraud: Fraud for Housing

The most common types of mortgage fraud (in terms of volume) are generally income and/or employment related. The over-inflation of salary details, falsification of employment details and the use of false or altered documentation such as bank statements and pay slips to support exaggerated income claims have caused major headaches for mortgage lenders across the globe.

In an environment where house prices are rising, this type of fraud does not usually cause significant losses. If the applicant is able to maintain repayments, they remain in employment and continue to receive pay increases, the consumer is likely to remain in possession of the property and details of the initial fraud may never be uncovered. Even if repayments could not be met and repossession ensued, as long as house prices were increasing, the property could probably be sold at a profit or at worst, a small loss.

However, in an economy where house prices are falling, unemployment is rising and pay increases are no longer a certainty, losses due to this 'softer' type of mortgage fraud can be significant. In this type of market, customers who over-inflate salary details are far more likely to fall into arrears than those who have been honest about their income, simply because they cannot and never could afford their mortgage repayments. Key learning points from property data experts at CoreLogic, indicate that up to 70% of early payment defaulters in America had some element of material misrepresentation in their initial mortgage application.[2]

### 1.3 Types of Mortgage Fraud: Fraud for Profit

In terms of volume, complex mortgage fraud rings are far fewer in number than cases of individual material misrepresentation. However, in terms of value, a well organised mortgage fraud ring can net profits of tens if not hundreds of millions of pounds. The results of being targeted by mortgage fraud rings can have devastating effects on lending organisations, in some cases bringing them to the brink of collapse. Organised mortgage fraud rings may include some or all of the following:

- Straw buyers
- Fictitious applicants (using false identities)
- Over-valued properties
- Back-to-back transactions
- Fictitious properties
- Falsified income and identification documentation
- Mortgage professionals may also be involved, these may include collusive solicitors, accountants, valuers and brokers
- Staff members within the lending organisation
- Falsified applications

Large scale, organised mortgage fraud not only funds the lifestyles of fraudsters, it also hides money laundering activity and funds more sinister types of crime including terrorism, arms dealing, people trafficking and drug trafficking/dealing.

The part played by mortgage professionals is not discussed within this feature, however this is recognised as a significant issue facing lenders. Although the vast majority of mortgage fraud types involving professionals initially emerged in the States, there is one type where the issue arose in the UK first. Solicitor fraud is recognised by most UK lenders as posing a significant

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[2] For further information please contact CoreLogic Solutions

threat. However, until recently this type of fraud, known as Closing Agent Fraud was relatively unheard of in the US.[3] In the UK the FSA is about to issue a report on the adequacy of lenders mortgage fraud systems - the thematic review will be published shortly.[4]

## 1.4 Other Types of Mortgage Fraud

There are a number of other types of mortgage fraud which are prevalent in both the US and UK mortgage industries. One of these types of fraud is 'identity' or 'house theft'. There are a number of different variations of this fraud type but the outcome is generally the same:

- A property is either sold, mortgaged or a further advance is taken out without the knowledge of the true owner of the property
- Funds are advanced and a charge registered
- The true owner only becomes aware of the fraud when default letters arrive, repossession activity begins or new 'owners' try to move in

Those most at risk include: the owners of unencumbered properties; those with small mortgages; buy-to-let (BTL) landlords; company directors; and other high net worth individuals.

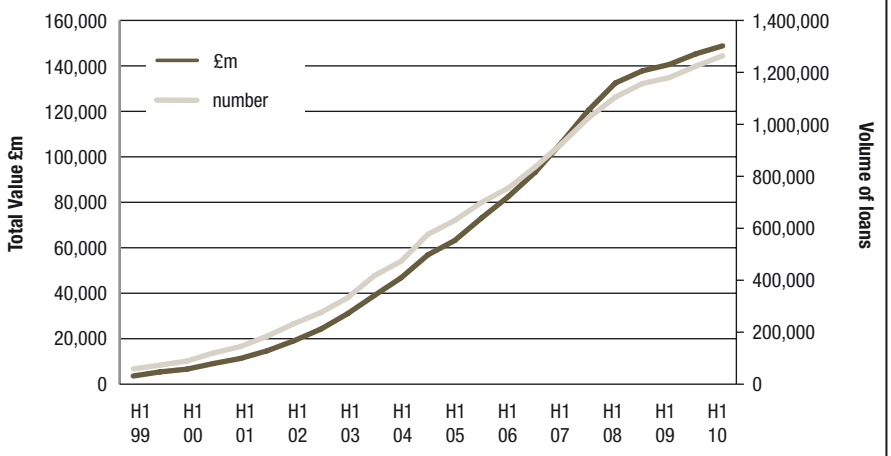
A further common type of mortgage fraud is occupancy fraud, also referred to as 'hidden buy-to-lets'. Some BTL landlords attempt to disguise buy-to-let mortgages as residential loan applications in order to benefit from more beneficial interest rates and the higher LTVs that are generally available for residential mortgage customers.

## 2. Mortgage Risk and Product Comparisons

Although the fundamentals of mortgage application processing are very similar the world over, risk appetite and regulation vary greatly by country and by individual organisation within those countries. It is generally accepted that the mortgage landscape has changed significantly since the last major global recession.

So what's new?

**Figure 1** **Growth of the BTL Market**




**Statistics provided by The Council Of Mortgage Lenders*

### 2.1 Buy-To-Let Mortgages

During the last major UK recession there were only a handful of BTL mortgages. This is a market segment that has seen huge growth over the last 10 years as the cumulative figure highlights.

The number of BTL mortgages at the end of H1 2000 was circa 89,000, with a combined total value of £6.6bn. At the end of H1 2010, there were well over one and a quarter million BTL loans with outstanding balances of almost £149bn. This represents a staggering fourteen-fold increase, with BTLs now representing 10.7% of the UK mortgage market.

### 2.2 Other Non- Conforming Mortgages

Estimates suggest that a further 8% of UK mortgages have been advanced to applicants with either credit impaired histories (3%) or self certified income (5%). Both these areas have seen growth over the last ten years. Applicants with impaired credit histories have been impacted by lender decisions to tighten credit policies. The result has been that some such applicants have resorted to attempting to hide adverse information etc.[5]

The Council of Mortgage Lenders commissioned a piece of analysis that suggested that there were over 8,000 products available to credit impaired applicants in July 2007. This figure fell to 8 products by April 2009.[6]

In relation to self-cert mortgages, these appear to be a phenomenon of the past. As part of the Mortgage Market Review[7], the FSA plans to reduce the number of unaffordable mortgages and the unsustainable growth of riskier products by banning self-certification and requiring income verification for all mortgages. This places more responsibility at the door of lenders and makes them fully accountable for future affordability assessments.

However, growth in this sector has been more prevalent in the USA than in the UK. An estimated 20% of all outstanding advances have historically been made to customers who are considered to be sub-prime.[8]

### 2.3 Products – >100% Loan to Value (LTV) and Negative Amortisation Loans

The other main difference in the mortgage market relates to the products that have been available in more recent times. To a negligible

[3] For more information on how lenders are able to identify suspicious activity by professionals, please visit the website http://corelogicsolutions.co.ukt

[4] For more information on the Thematic Review and MCOB please see fsa.gov.org

[5] Please see website CoreLogic.com for changes to fraud attack over the past 3 years.

[6] See cml.org.uk for further information

[7] See fsa.gov.uk for a full copy of the report

[8] For more information on mortgage trends and losses in the US, see fanniemae.com

extent in the UK and to a much larger extent in the US, products have been made available at more than 100% LTV. Therefore, the excess is in effect unsecured, making lenders dependent on rising house prices. However, this has not been the case, with many borrowers who were already in negative equity now in serious negative equity (due to the compound effect of initial negative equity coupled with falling house prices).

Negative amortisation loans have also had a serious impact on the US mortgage market. A negative amortisation loan is one where repayments of less than the interest only value are repaid to the mortgage. The net impact of this type of lending has been that mortgage balances have continued to increase whilst the value of the underpinning security has fallen.

## 2.4 More Recent Global Trends

Reference has been made to significant changes to global housing markets since the last major recession (circa 1990) and to market developments within the last ten years. However, the global residential mortgage landscape has changed most dramatically over the last four years. The loss experience suffered by different global economies has varied drastically and is to some degree reflective of a number of different factors. These include:

- Rules, regulations and controls surrounding the granting of mortgage finance
- The type of products available to borrowers (including the >100% LTV and negative amortisation loans discussed previously)
- The accepted sales process in the specific territory
- The country specific risk appetite and risk acceptance
- Government schemes to assist borrowers in trouble
- The extent to which house prices have fallen
- Other economic factors such as unemployment

Mortgage fraud losses in the US, UK and Spain in particular have made headline news. Mortgage fraud (to a smaller extent) and other economic factors to a much bigger extent, such as unemployment and liquidity issues have forced major banks on both sides of the Atlantic to re-evaluate their respective positions. Household names such as Lehman Brothers, Bear Sterns and Bradford & Bingley have disappeared completely from the financial services landscape, where as others are now partially government owned or have been purchased by competitors (Halifax/HBOS in the UK and Countrywide and Washington Mutual in America).

In the UK, probably the first major mortgage fraud experience of the latest recession to hit the headlines was Thamesmead (SE28). This raised fears that the housing crisis in the US, which was partially fuelled by large scale mortgage fraud, had arrived in the UK.

## 2.5 The Shifting Balance of Power

For mortgage lenders, strategy and risk appetite is governed to a large extent by profitability and the desire to increase or decrease market share in certain key portfolios. The balance of power between marketing and risk functions swings dependent on mortgage and housing market conditions.

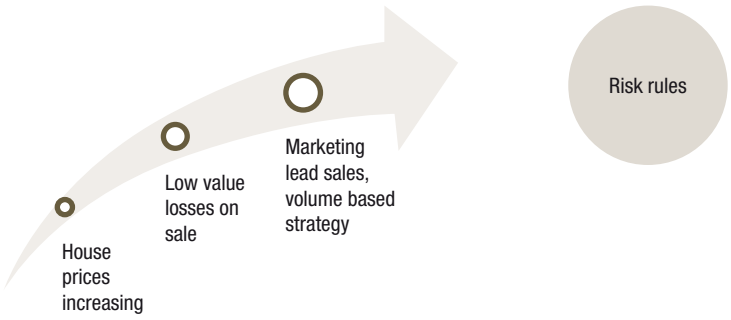
When economic conditions are good, competition between lenders is fierce, margins are squeezed and lenders are eager to increase market share (figure 2).

At the moment, the emphasis is firmly within the risk environment but it is only a matter of time before the pendulum begins to swing towards the opposite direction as confidence in the mortgage market and house prices is restored. The emphasis on risk will remain in the short term whilst borrowers continue to face increasing financial pressures and severe hardship. Firmer regulation will make a difference and help restore confidence in the market, both in the UK and the US.

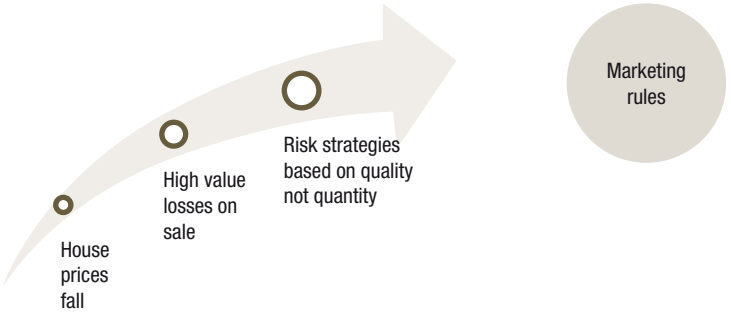
The FSA[9] has advised that the previous regulatory framework was ineffective in constraining high-risk borrowing and lending, so in February 2009[10],

**Figure 2**

When economic conditions are good, competition between lenders is fierce, margins are squeezed and lenders are eager to increase market share:




But when house prices fall and losses start to increase, the balance of power shifts from the marketing manager to the risk manager:




[9] For more information on the Mortgage Market Review, see fsa.gov.org

[10] http://www.cml.org.uk/cml/policy/issues/5105

it formally announced that its Mortgage Market Review would cover all aspects of regulation, including prudential, conduct of business and financial crime. The FSA is also taking a firmer approach when it comes to fraud and irresponsible lending[11], as seen in November 2010 when the director of a small mortgage lender was fined £70,000 for serious failures to lending practices. The company was fined an additional £42,000 and as a result could not conduct new FSA regulated mortgage business. It also had to provide redress for customers who had been adversely affected by its misconduct, many of whom already had impaired credit histories. In fact, this was the first action taken by the FSA against a mortgage lender's senior management for irresponsible lending and unfair practices when dealing with borrowers in arrears.

Similarly, the US has also taken a firmer approach to mortgage fraud and irresponsible lending practices. This was highlighted in June 2010[12] when The Federal Bureau of Investigation cracked down on the issue on a national scale. Nearly 500 people[13] were arrested for offences including encouraging borrowers to falsify income on mortgage applications, misleading homeowners about foreclosure rescue programmes, and inflating house valuations. Many of the borrowers could not afford the loans and once the US housing marketing started to deflate they could not continue to make their payments. The operation emphasises the co-ordinated efforts that the US law enforcement is undertaking to address the problem of mortgage fraud and irresponsible lending, particularly practices that have contributed to the housing meltdown.

## 3. Cross-Border Market Comparisons

### 3.1 The US Experience

As one of the largest and leading world economies, it is generally accepted that the US markets act as a barometer for other world economies and what happens in the States often precedes similar events (although generally to differing degrees) in other financial markets. In particular, there are many similarities between the US and the UK, ranging from religion, language and cultural similarities through to economic trading and political alliances. Therefore it will come as little surprise that when the US economy falls into recession, the UK follows closely behind.

With the onset of the Global Recession, housing markets on both sides of the Atlantic have been heavily impacted by the identification and emergence of mortgage fraud trends and ultimately losses. It is not only the UK economy that is experiencing issues with mortgage fraud though, with other European countries such as Spain also beginning to uncover mortgage fraud.[14]

In terms of banking in general and mortgage finance in particular, there are many similarities between both the products available to mortgage borrowers on either side of the Atlantic and the policies, procedures and systems that have been adopted by lenders. However, as already demonstrated, there are also a number of key differences.

### 3.2 House Prices

House prices on both sides of the Atlantic have fallen significantly in recent years, with some states in the US experiencing house price reductions of more than 50%. Spain has experienced a similar collapse of house prices, especially in tourist areas. The UK in general, has so far not

**Figure 3** **Average House Prices - UK**

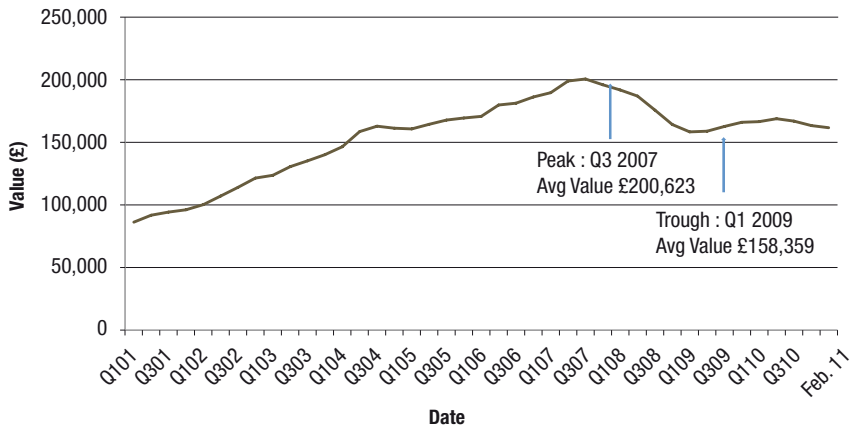
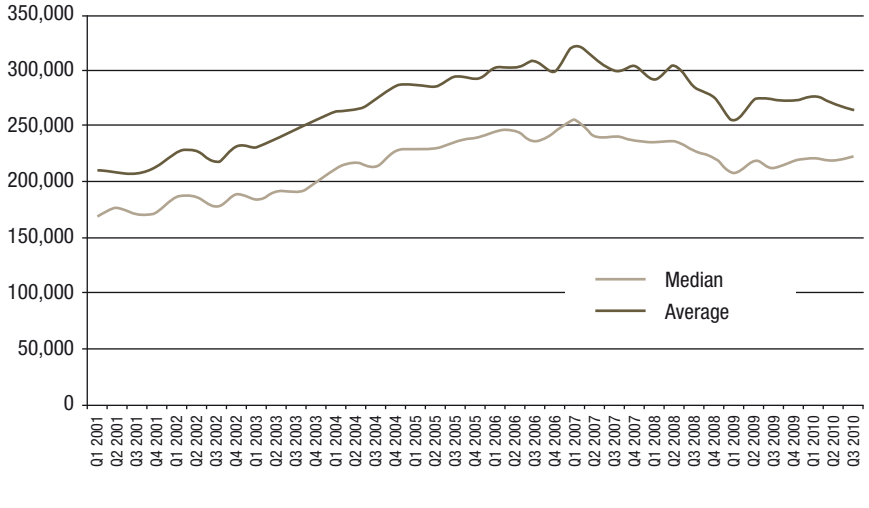



**Figure 4** **United States New Home Prices, $**




[11] http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/159.shtml

[12] For more information see fbi.gov or http://www.ft.com/cms/s/0/da70fbfa-74e0-11df-aed7-00144feabdc0.html#axzz1GHozty67

[13] http://www.fbi.gov/news/stories/2010/june/mortgage-fraud-sweep

[14] See Spanishnews.es re 10m Euro case in Madrid & typicallyspanish.com re 42 people arrested over 2m Euro mortgage fraud in Seville

been as badly affected as certain US states or some areas of Spain. One of the reasons for this could be that in some areas of America and Spain there is an over-supply of housing whereas in the UK there is generally an under-supply (with the exception of city centre flats). However, the following chart based on the Halifax Price Index shows the following picture in relation to UK property prices.

The figure 3 shows:

- In the UK during the last ten years, house prices have more than doubled
- At the height of the market in Q3 2007, the average value of a property in the UK was circa £200k
- Within six quarters, the average price of a home had fallen to just over £158k
- This represents an average fall in value of £42k or 21 percent

In the US, statistics published by the US Census Bureau show a similar trend (figure 4).

The US statistics highlighted above represent new home prices only – from peak to trough the average drop in property price was $70,000 or circa 22 percent. However, this only represents a proportion of the housing market – resale values began declining in late 2005 and the fall in price is more severe at around 26%. In addition, certain states have been more heavily impacted by falling house prices, with Florida, Arizona and Michigan being particularly hard hit.

The falling housing market and the emergence of losses through mortgage fraud started to have an impact on the US economy at least a year before similar events began to emerge in the UK. It was the declaration of provisions raised to cover mortgage fraud and credit losses by some of the major US Banks that forced other nations to examine their own mortgage portfolios for signs of mortgage fraud. So what can other economies that are just now beginning to suffer, learn from the US experience?

### 3.3 Using the Consortium Approach in the Fight Against Mortgage Fraud

In the US, property data and analytics expert, CoreLogic, has developed a solution that works extremely well in helping financial institutions detect and eliminate mortgage fraud. In the first exercise of its kind for mortgage lending, Corelogic has set up a Mortgage Fraud Consortium to share experiences and best practice relating to the detection of mortgage fraud with fellow consortium members. All the consortium member applications are processed through the FraudMarkTM fraud detection suite of products in order to rank them according to the fraud risk associated with each application. This approach works for large and small lenders alike, in that it helps find traditional types of fraud, such as material misrepresentation and valuations fraud, as well as emerging new types of fraud such as short sale fraud.

CoreLogic host regular symposiums for the benefit of its consortium members in order to share the consolidated results between the organisations that use the FraudMarkTM suite of products, and also facilitate best practice and benchmarking exercises and discussions. The consortium analysis represents 65% of all US mortgage originations, 85% of 'servicing' loans and data regularly provided by over 100 lenders with coverage of almost 10 million mortgages.

### 3.4 The CoreLogic Symposium Headline Statistics Indicate that:

- 17% of reported fraud was primarily driven by employees of the lending organisations
- 25% of repossessions showed evidence of material misrepresentation in the original mortgage application
- On sale of a repossessed property where there was evidence of material misrepresentation, on average only half of the original purchase price was realised
- In addition, 70% of early repayment defaults had evidence of material misrepresentation

Material misrepresentation at the application stage, or 'fraud for housing', is considered by many as being 'soft fraud' and therefore potentially less damaging than other types of mortgage fraud. However, findings from the US based on the CoreLogic consortium suggest that this is a big issue that can have a major impact on profits.

The figure 5 shows the principle types of mortgage fraud that have emerged recently in the US:

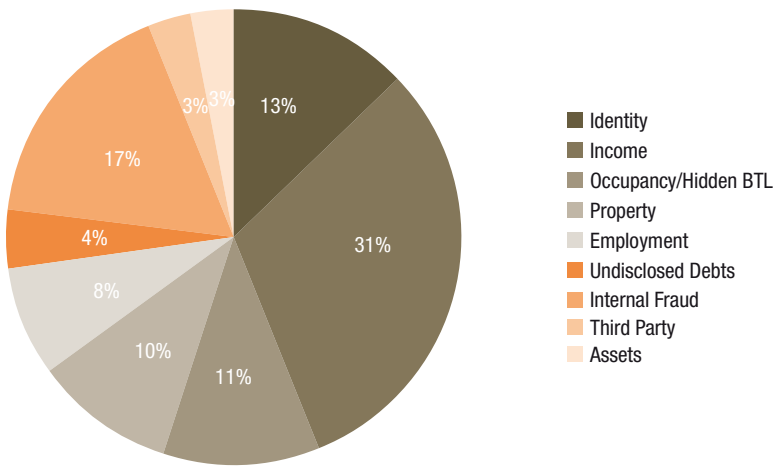
- Income, employment and undisclosed debts are considered to be 'soft fraud', but represent 43% of the total fraud cases identified
- A further 11% of frauds identified were for hidden BTLs (i.e. the customer applied for a residential mortgage although had no intentions of living in the property)

## 4. Key Learning Points and Emerging Trends

Mortgage fraud is a very lucrative business. As trends emerge and strategies are amended to address the risk that has been identified, the innovative fraudster is forced to change his modus operandi.

The change in mortgage fraud trends is very apparent in the US. As solutions and new regulations have been put in place to address income and employment fraud, there has been a definite shift towards occupancy and undisclosed debt fraud. This combined with a reduced risk appetite from mortgage lenders has caused a shift in behaviours. Some of these fraud type shifts are easy to identify:

**Figure 5** **Recent Fraud Filings - US Consortium**

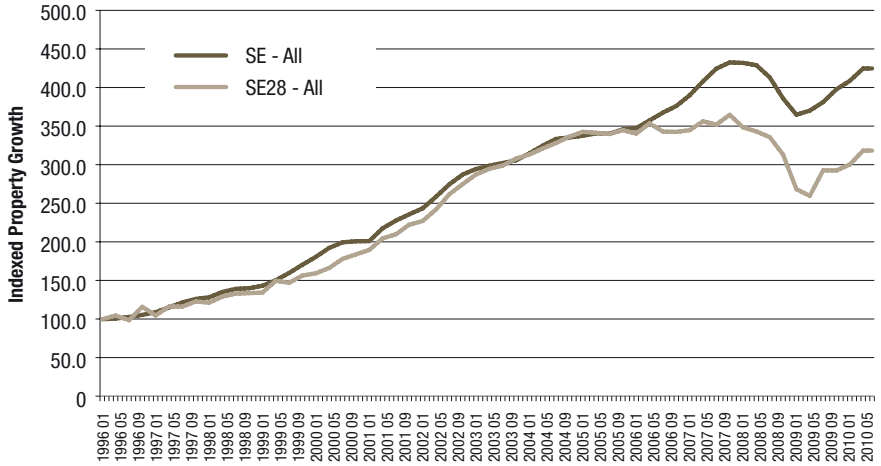


- As lenders tightened credit criteria, sub-prime customers could not remortgage, therefore, resorted to trying to hide adverse information
- As BTL lending was virtually stopped for a time, and LTV criteria reduced, more borrowers resorted to occupancy fraud
- As affordability assessment becomes tougher and income assessment is more thorough, applicants declare their true income but hide credit commitments

Valuable lessons can also be learnt by reviewing historic fraud cases:

As previously mentioned, probably the first major UK mortgage fraud of the latest recession to hit the headlines was Thamesmead (SE28). This raised fears that the housing crisis in the US, which was partially fuelled by large scale mortgage fraud had arrived in the UK. So what happened at Thamesmead?

**Figure 6** **Comparison of Property Growth in SE28 with all SE Postcodes**




## 4.1 Case Study 1 – Thamesmead South-East London (Postcode SE28)

Thamesmead made headline news in mid August 2007 when police confirmed that they had made 11 arrests in connection with an alleged mortgage fraud ring in south-east London.[15]

The fraud revolved around 84 new build flats/apartments that were bought off-plan and resold at over-inflated prices. Four mortgage lenders were reported to have been involved and faced large losses as a result of providing mortgage facilities.

### 4.1.1 How Did The Fraud Work?

Persimmon Homes sold 84 new build flats off-plan to property developers Atrex with a large discount applied.

Atrex paid brokers, accountants & valuers to:

- create false identities
- find mortgage mules (person who is employed to apply for a mortgage using real/fake identities but who has no intention of ever living in the property and who will pass the mortgage funds to the fraudsters)
- provide fraudulent mortgage applications and place with lending organisations

The end result was that the majority of loans were taken out using false identities and/or mortgage mules. Very few (if any) repayments were made to the mortgages, which quickly fell into arrears. When the lenders took possession of the properties in question and tried to sell them, the true extent of the over-valuation fraud came to light.

The losses associated with this mortgage fraud were estimated to be significant and made lenders realise that they needed to analyse their back books for evidence of organised attacks from fraudsters.

### 4.1.2 Were there any warning signs that this was going to happen?

Hindsight is a wonderful thing, and evidence can often be found after the event, but here are a few things that should have set alarm bells ringing.

The Thamesmead development site:

- Is built on reclaimed marshland that is prone to flooding
- Was previously used by the Woolwich Armoury and in the past live ammunition has been found by residents (including children)
- Has a reputation for anti-social behaviour and crime
- Is in an area (SE28) that is renowned for fraud, particularly in the credit card industry

By looking at the CoreLogic ValuePoint automated valuation model (AVM) data, it is apparent that there was evidence of over-valuation issues on purpose built flats in the SE28 area. AVMs provide an objective view of house price trends as they are based on historic property sales information. Use of an address level model such as an AVM removes the judgemental element applied by valuers and provides an accurate view of a property's true value. It is important that all relevant tools are fully utilised in the fight against fraud. The use of AVMs for this purpose adds additional benefit when used in conjunction with other fraud prevention tools.

By isolating SE28 postcodes from all other SE postcodes and indexing property prices, some very interesting trends start to appear (see figure 6).

This shows that from early 2006, SE28 postcodes began to appreciate far less rapidly than other SE postcode areas. By drilling down into the data further, it is possible to compare the distribution by property type (see figures 7 & 8 on next page).

It can be seen that the degree of separation in the semi-detached market is much greater and started far earlier than for the terraced housing market. However, for both property types the value of property in the SE28 postcode district was lower than in surrounding neighbourhoods.

[15] The Times, 19 August 2007, business.timesonline.co.uk

In this case, the most interesting property type segment is flats and apartments (see figure 9).

The market for flats and apartments in the SE28 postcode district shows the exact opposite of the expected natural separation from other SE postcode districts (based on the trend for semi-detached and terraced properties). There could be various reasons for this (such as the number and type of properties being built in the area compared to other areas), but no investigative work has been done to establish the reasoning. What does appear to be apparent is:

- From 2001 onwards, there is separation with flats in the SE28 postcode district being sold for far more money than in other SE postcode districts
- The lines meet and cross in 2007, which is when the first Thamesmead mortgage fraud ring was exposed
- Prices in SE28 fell significantly in 2008-9 and they reached their lowest point in March 2009
- From peak to trough, prices fell by approximately 45%
- Since then, flat and apartment prices have recovered to some extent but are still lower than other SE postcode flats, which are more in line with other property types in the area

***This is what mortgage valuations fraud looks like.***

SE28 is a postcode area that is well known to lending organisations and they are vigilant when vetting and reviewing applications pertaining to this area. After all, a number of them have suffered as a result of organised mortgage fraud in this geographic location. But lenders are not the only victims.

There may be many Thamesmead residents who are now trapped as they bought at the height of the market and many of them are now in negative equity. It is true that there are other borrowers in the UK with negative equity, but probably not to the extent as some of the residents of Thamesmead.

## 4.2 Case Study 2 – Fraud Street, Orlando, Florida USA

There are many good examples of mortgage fraud rings in the States. One such example was identified by the CoreLogic team when investigating trends within the FraudMarkTM data Consortium. The patented FraudMarkTM mortgage fraud solution, compares the characteristics present within both fraudulent and

**Figure 7** Comparison Semi-Detached Properties

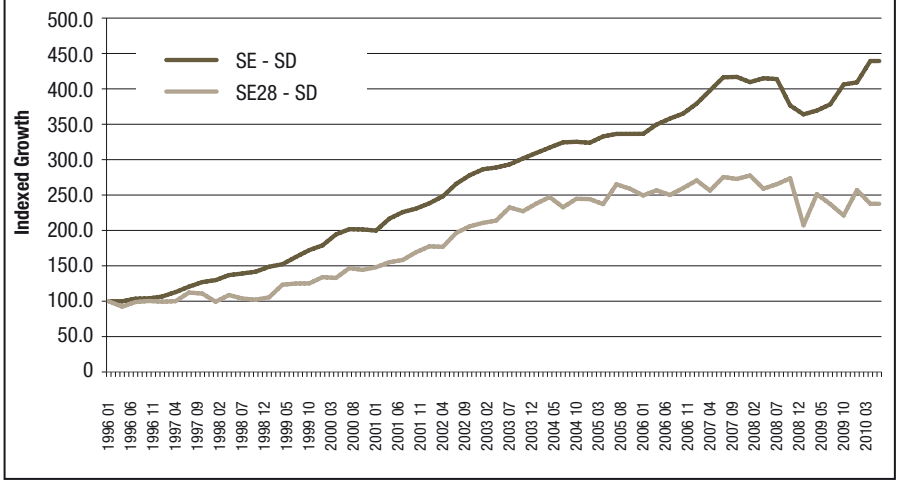



**Figure 8** Comparison Terraced Properties

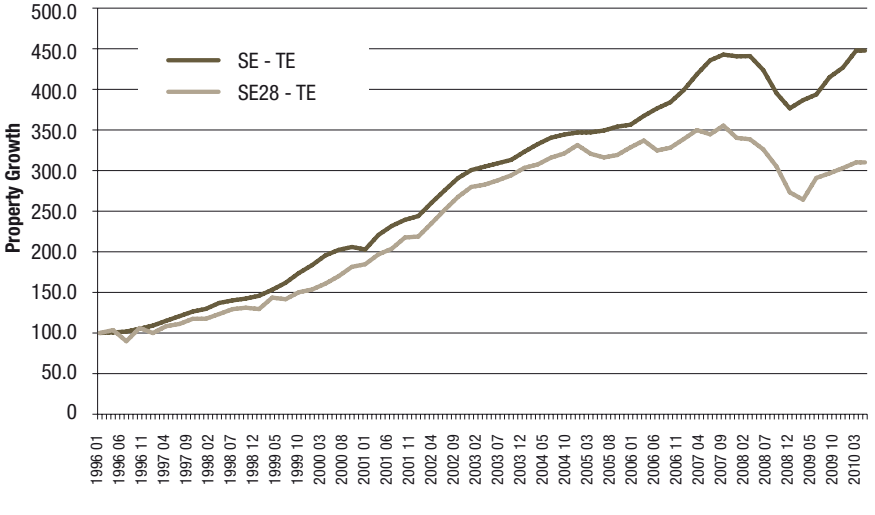
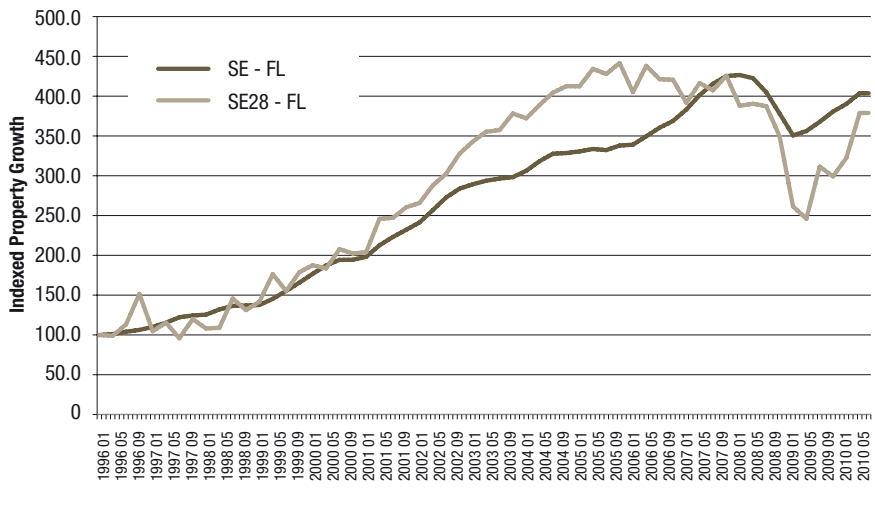



**Figure 9** Comparison of Flat Value Growth - SE28 Versus All SE Postcodes



non-fraudulent applications to identify patterns in data that are indicative of high fraud risk.

Output from the FraudMarkTM suite includes a predictive score on a scale of 1(low risk) to 999(high risk). Risk indicators are also produced to provide guidance regarding the type of fraud that is potentially being perpetrated. Risk indicators are segmented into five risk areas namely, income, occupancy, employment, identity and property value.

The detection tool can be used during the application phase or for portfolio analysis and serves as an ideal complementary solution to other property, credit and compliance review tools

FraudMark™ was used to identify one residential street in Orlando, Florida USA which became affectionately known by Consortium members as 'Fraud Street'.

#### 4.2.1 How Did The Fraud Work?

Over an 18 month period, a total of 28 mortgage loans were taken out for the purchase of condominiums on the street. The same Limited Liability Corporation was involved in the fraudulent activity and was active in the property sales in virtually all cases.

The average purchase price of the properties was $220,000, the average monthly borrower income was $11,000, and the average LTV was 92%. In terms of FraudMarkTM score, it fell within the top 4-5% of all mortgage applications, suggesting that these applications were most likely to have some element of fraud connected to them.

These mortgages were taken out approximately two years ago – so what is the position now?

As a result of these fraudulent mortgage applications, over 50% of the properties are now in foreclosure (have been repossessed by the relevant bank).

Many of the remaining condominiums have been converted from primary residences to rental properties and online property reviews suggest that the buildings suffer from mould problems.

The property listing price is now between $10,000 and $25,000, which is less than 10% of the original purchase price and those residents who are not in foreclosure and bought for the originally advertised price, are unfortunately in a serious negative equity situation.

These two case studies highlight the real issues that mortgage lenders face on a day-to-day basis. They also highlight the plight of innocent property purchasers who are caught in the cross-fire of mortgage fraud. The latter case study relates to a street in Orlando, Florida, which has appeal to overseas investors for holiday homes. This type of fraud also appears to have occurred in Spain where overseas investors saw similar opportunities in the past.

### 4.3 Emerging Mortgage Fraud Trends

As previously mentioned, as lenders improve their systems and close loopholes to prevent fraudsters from exploiting known weaknesses, the fraudster simply changes the focus of the attack. This is definitely still happening with mortgage fraud.

One newly emerging trend is a type of fraud known as short sale fraud in the US, and distressed sale fraud in the UK. Short sale fraud can be defined as the practice of selling a property at a significant undervalue, requesting and receiving some element of debt forgiveness from the original mortgage provider, selling the property to a related party or Limited Liability Corporation and then a back-to-back property sale transaction (or flip) follows at a much higher price. The fraudster is attempting to manipulate both the seller and the mortgagee bank. The seller will readily accept the sale as it gets him out of a financial predicament. The bank is unaware of the true buyer in these scenarios and so accepts the loss position. The fraudster has effectively masked the true sale price and the identity of the real buyer from the mortgagee bank.

Frank McKenna, Vice President of Fraud and Risk Strategy at CoreLogic has been approached by clients in order to try and understand the level of threat and to devise a monitoring solution to highlight risky cases. Some of the cases found as part of the CoreLogic review, were clearly suspicious. A number of transactions were identified where the second purchase transaction occurred within less than a week of the original transaction and for prices double that of the original transaction.

The executive highlights of the industry white paper, which was released by CoreLogic in August 2010, are as follows:

The following are key findings from the study:

- The number of short sales has more than tripled since 2008. Multiple variables indicate short sales will continue to be a significant factor for the industry.
- During 2009 and 2010, over half of all short sales (55.8%) occurred in four states: California, Florida, Texas, and Arizona.
- Approximately 4% of short sales have a subsequent resale within 18 months.
- Investor-driven short sales are not inherently bad, since investors provide the industry with necessary liquidity.
- Short sale transactions are "risky" for lenders when either (1) the second sale amount is vastly higher than the initial short sale, and/or (2) the second sale transaction happens too soon after the first.
- While the exact definition of what constitutes short sale fraud continues to evolve, it clearly exists. Our analysis shows a consistent pattern of lenders incurring more loss than necessary. About one in 53 short sale transactions in our study (1.9%) was part of an egregious flip — and therefore deemed risky.
- We estimate that lenders are currently incurring unnecessary losses in short sale transactions at the rate of $310 million per year.
- Information-sharing groups and consortia are key to lenders mitigating short sale risk and reducing associated costs. Only by leveraging multiple-lender data and experience can individual lenders see negative short sale risk patterns in time to avoid the financial consequences.

With at least £310m of losses identified already in the US, there is also anecdotal evidence from UK lenders that this trend has already started to cross the Atlantic. It is therefore perceived as potentially a major threat for UK mortgage lenders in 2011.

## 5. Market Predictions

Recessions form part of the economic cycle; a cycle that has defined peaks and troughs. With the UK housing market, economists were predicting that the bubble would burst for at least two years before any major deterioration was observed. According to these economists house price falls were inevitable, the only real questions were when the collapse would occur and how much of an impact it would have. With a rising housing market, fraudsters had ample opportunity to exploit and profit from system and process constraints and weaknesses. Valuations frauds are by no means the only or even major cause of the house price collapse experienced, but they do play a contributory role, especially in certain geographical locations.

The way governments are dealing with the issues caused by this global recession and

housing market decline compared to the last recession is very interesting. On this occasion, both the US and UK governments have slashed base rates in order to stabilise the housing markets, help borrowers and help minimise the number of repossessions. During the recession in the early 1990's however, interest rates were extremely high.

### 5.1 Vulnerable Markets

**High LTV Lending** - The most vulnerable markets remain those where risk has been identified in the past. High LTV lending has always been considered as high risk due partially to the nature of borrowers taking high LTV loans and is also because of the customer stake in the property. A large proportion of high LTV lenders are first time buyers. First time buyers are often vulnerable as they have historically struggled to climb onto the housing ladder as they not only have to find a deposit, but also have to stretch the affordability boundaries by taking on mortgage commitments based on higher than average income multiples. For First Time Buyers and other high LTV borrowers, the commitment to make mortgage repayments may be reduced. If their initial stake was comparatively small and they have effectively fallen into negative equity, they often have little to lose and therefore are less likely to continue to make repayments than someone with a bigger stake invested in the property.

**Affordability Stretch** – Customers, who were stretched with regard to affordability at the mortgage origination stage, also remain vulnerable in the current climate, with those who told 'little white lies' on their application forms relating to income and outgoings most at risk of defaulting. This is one example of why it is important to understand the back book portfolio position. Those mortgage holders receiving significantly less income than stated will struggle more than most to keep up repayments and, without early help and guidance, are the ones most likely to result in repossession action being taken against them.

**Buy-To-Let** - BTL propositions remain a relatively new phenomenon, which has seen exponential growth in the last ten years. Lenders specialising in BTL lending previously advocated that BTL customers often performed better than standard residential mortgage customers, which again presents some interesting questions. Due to increased levels of repossessions and fewer potential first time buyers entering the mortgage market, there is more demand for rented accommodation and therefore the professional landlord should be in a fairly strong position. However, the BTL landlord who may only have one or two properties may be in a slightly less comfortable position. If he is struggling to make repayments, has void rental periods, and was relying on the rental income to pay the BTL mortgage, he is most likely to service his residential mortgage before his BTL loan. This may be why UK statistics show that BTL arrears rates (not including Receiver of Rents appointed cases) are the lowest, followed by those of residential mortgages, and with the highest arrears being recorded for all BTLs (including Receiver of Rents cases).

Official BTL lending in the US has seen a very similar growth pattern as the UK. However, anecdotal evidence suggests that a large number of second home loan mortgages taken out in the property boom years of 2004 to 2007 were actually covert BTLs. Occupancy fraud was particularly popular in the US as the residential mortgage LTVs were much higher than BTL as was pricing.

### 5.2 Double Dip Recession

Many believe that the UK market in particular is poised on the edge of a double dip recession. If this is the case and house prices fall further, it is likely that more fraud for housing cases will be exposed. If the number of unemployed increases or pay rises do not keep pace with inflation, those applicants who lied about their income on the initial application could struggle to keep up repayments. The result will be increased losses for lenders on repossession and sale, due to the further deflated value of the underlying security.

There is also likely to be an increase in fraud for profit cases. The 'short sale fraud' phenomenon which has emerged in the states is likely to rise in prominence due to the increased number of home owners who are struggling to make repayments and are also in the negative equity trap. This in itself will not increase the fraud attack in this area. However, it will provide the correct market conditions and opportunity for fraudsters to take advantage and profit from.

## 6. Combating Mortgage Fraud

With so many ways of perpetrating mortgage fraud, lenders are challenged to have systems and controls in place to detect them all. In addition, because previously recognised and reported mortgage frauds were relatively small in number, it has been very difficult for lenders to develop internal models or scorecards to detect mortgage fraud attack. Therefore, the majority of lenders historically opted for a rules based approach to detecting fraud, based on their own experiences. The rules based approach has been successful in the past at detecting some types of mortgage fraud. However, this approach is reactive rather than proactive. Rules can only be built based on past experiences and are therefore unable to detect new and emerging trends and fraud types.

### 6.1 The Next Generation Mortgage Fraud Detection Capabilities

Technology has a huge part to play in the fight against fraud. The widespread or even universal implementation of innovative solutions will help to combat mortgage fraud, but there is no room for complacency. Even when the housing market returns to more normal levels of activity, the threat of mortgage fraud will still be present. As house prices increase, the levels of losses from fraud are likely to decrease. However, the underlying fraudulent transactions will still be present and in evidence. It is imperative that vigilance is maintained, lessons are learned and lenders do not let down their guard. After all, the ultimate aim is to find the fraudster before loan drawdown and stop him in his tracks.

# Islamic Finance and its Application in Housing Projects

↳ By Sarah Gooden

## 1. Introduction

This article is based on a presentation given on 13 October 2010 at the International Social Housing Summit in The Hague with Aad Rozendal and Imran Mubeen from PricewaterhouseCoopers.

Introducing that presentation it was suggested that there were two main reasons why social housing professionals from around the world might be interested in an introduction to Islamic finance. Firstly, in this post credit crunch era when available financing in the form of bank loans is somewhat restricted, financing or investment from other sources will be of particular interest. Investors based in the Gulf states, many of whom wish to invest on an Islamic basis, may represent a potential alternative source of funds. Secondly, a number of governments in Middle Eastern countries including Bahrain and Saudi Arabia have been looking at how they can make affordable housing available to the poorer sections of their populations. This means that there is a potential market in these countries for the provision of a range of services in relation to proposed social housing projects ranging from legal and advisory services to construction and housing management. Both Trowers & Hamlins LLP and PricewaterhouseCoopers have already been involved in advising on prospective projects for the provision of social housing in some of the Gulf States.

## 2. The history and development of Islamic finance

The roots of modern Islamic finance can be traced back to the 1960s when small scale attempts were made, principally in Egypt, to reintroduce Islamic modes of financing into Islamic society and to eliminate interest based transactions.

Before that time the colonial era had seen the Muslim world largely ruled and dominated by western capitalist powers who had brought their own business and financial practices with them. These practices had come to be accepted and regarded as the norm so that the application of Islamic law to commercial and financial areas of life had been largely forgotten.

If we look back to the Middle Ages when the power of Islam was at its height the role of Islamic law in financial matters would have been far more obvious and accepted. Indeed, at this time, the prohibition on lending money at interest, which is found in the Bible as well as in the Qur'an, was still widely accepted within Christian society so the modern gulf between Islamic and non-Islamic systems had not yet developed. Historical research has confirmed that certain Islamic financial documents were widely used in Asia and the Mediterranean up until the 17th -18th centuries[1].

Early attempts in the 1960s, and 1970s to revive Islamic methods of finance met with considerable scepticism and opposition. Growth was initially slow and halting but the first seeds gradually took root and flourished. The opening of the Islamic Development Bank in 1975 and the establishment of the Dar al-Maar al-Islami and Al Baraka groups in 1981 and 1982 respectively were probably key moments in the development of Islamic finance, as they showed that there was considerable financial backing and political will behind the movement.

Since then Islamic finance has grown steadily. Current estimates of the total value of assets managed globally by Islamic financial institutions approximate $1 trillion. This is thought to have grown at between 10 -15% per annum on average over the past ten years. In December 2010 the Financial Times reported that Islamic finance banking assets had risen by 8.9% in 2010 alone[2]. There are thought to be in the region of 400 Islamic financial institutions worldwide with approximately 200 conventional institutions operating Islamic financial services through dedicated Islamic "windows». Islamic financial institutions are now thought to be operating in more than 75 countries. While still tiny in the context of the global financial system these figures are certainly impressive. It seems clear that there is an increasing awareness of Islamic financial services among the world's Muslim population and that demand for these services is steadily growing. Africa, where Islamic finance is little developed is now seen as one of the most important markets with the potential for growth. There is clearly very significant potential for further growth.

In the United Kingdom the Financial Services Authority has now authorised five Islamic banks and tax laws in the UK and a number of European countries have been amended to accommodate Islamic finance products. (In the UK this was done first in relation to Islamic home finance products but has now been extended to cater for commercial transactions too.)

Further afield, in the Middle East Islamic banks have been steadily increasing their share of the retail banking market and the funding for major infrastructure projects and high profile property developments is now often either arranged on a purely Shari'ah compliant basis or at least includes a tranche of Islamic finance. Islamic finance is fully integrated into the Malaysian economy where Islamic and conventional banks operate alongside each other offering alternative products.

[1] Professor Murat Cizakca, Encyclopaedia of Islamic Banking and Insurance Historical Background: Institute of Islamic Banking and Insurance (1995)

[2] Financial Times Special Report: The Future of Islamic Finance (14 December 2010)

With accelerating growth the Islamic financial sector has also developed rapidly in its sophistication and capacity for innovation. One of the most notable trends has been the involvement of conventional banks in this field. Indeed, it could be said that much of the impetus behind the most innovative products has been created by the desire of conventional banks to develop Islamic financial instruments that match the diverse range of products available in the conventional sector.

Islamic finance has weathered the global financial crisis reasonably well. Some Islamic investment banks have been over exposed to real estate and there have been defaults by sukuk issuers caused by the collapse of the Dubai property market. (Sukuk, sometimes misleadingly referred to as Islamic bonds, are Shari'ah compliant investment certificates which represent a share in the ownership of an asset or pool of assets. They are discussed in more detail later in this article.) Levels of sukuk issuance slowed significantly in 2009 but have since revived. The fact that complex derivatives and excessive levels of speculation are not permitted under Shari'ah law is often cited as having protected Islamic institutions from some of the worst effects of the crisis.

## 3. Key principles

Islamic finance is a system of finance conforming to Islamic or Shari'ah law.

The sources of Islamic law are the same for financial matters as they are for all other areas of a Muslim's life. In a very condensed form, these are: the **Qur'an**; the **Sunnah**; and **ijtihad**. These sources when brought together form the **Shari'ah**, the Islamic law[3].

The **Qur'an** forms the primary source of Islamic law[4].

The second fundamental source is the **Sunnah**. The Sunnah is the body of information on the Prophet's life, the commands and advice he gave his followers, the manner in which he lived his daily life and his interpretation by word and action of the message of the Qur'an. The Sunnah often has the role of elaborating upon the principles set down in the Qur'an applying them to everyday life, and providing more detail to the general statements in the Qur'an[5].

The third key source – the **ijtihad** of the scholars – comprises various subsidiary sources and tools used by qualified Muslim jurists interpreting and applying the Qur'an and Sunnah to situations not expressly dealt with in the Qur'an and Sunnah.

The most well-known principle of Islamic finance is the prohibition against **riba**. Whilst this is often translated as "interest" or sometimes "usury", it is actually wider than this and involves any unjust enrichment on money over time without risk. The Qur'anic prohibition against riba is so strong as to leave no doubt as to its position in Islamic finance. At the same time, the Qur'an contains an express encouragement towards trade and this forms the basis upon which much of Islamic finance operates.

Generally speaking, the key principle in Islamic finance is the need to achieve justice. The aim therefore is to avoid injustice to a party in a transaction. Most other principles relevant to Islamic finance are in essence derived from this basic principle.

These include prohibitions against **jahala** (literally ignorance) and **gharar** (speculation/uncertainty). Whilst it is acknowledged that it is impossible to remove all uncertainty from commerce, the intention is that avoidable elements of speculation should be removed and the parties should be clear on the terms upon which they have agreed to do business. These principles mean that gambling, many forms of insurance and many types of derivative contracts are not permitted under Shari'ah law.

There are also prohibitions against unfair advantage (where one party acquires an advantage because of its special knowledge or the other party's lack of market knowledge) and against deriving income from objects or activities that are forbidden for a Muslim (such as alcohol, pork, pornography and indeed interest). This latter prohibition means, for example, that a Shari'ah compliant equity fund would not invest in shares of a company engaged in a prohibited business.

There is no single globally recognised authority on Shari'ah law. Each Islamic bank has its own Shari'ah board, typically made up of three eminent Shari'ah scholars, who are responsible for overseeing compliance with Shari'ah in all the bank's activities. The Shari'ah board is required to approve every product offered by an Islamic bank and every bespoke transaction in which the bank participates. Because there are different schools of law within Islamic jurisprudence and because there is no binding system of precedent, the opinions of scholars can vary, and, as a result, the Shari'ah boards of different institutions may take a different view from each other about certain products and transactions. This lack of standardisation hinders the growth of Islamic finance and its acceptance among the Muslim community. Malaysia has tried to address this problem by giving an enhanced role to the Shari'ah Advisory Council of the Central Bank of Malaysia to act as the sole Shari'ah authority on Islamic finance within Malaysia. All Islamic banks operating in Malaysia are required to comply with the rulings of the Shari'ah Advisory Council. This is very different from the position in other parts of the world where each Islamic bank complies only with the rulings of its own Shari'ah Advisory Board.

(The Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) has also done valuable working in developing Shari'ah standards for different Islamic contracts. These are widely recognised and banking supervisors in a number of Muslim countries either require Islamic banks to comply with them or specify them as standard but they are not universally recognised or applied.)

## 4. Local law

Contracts implementing Islamic finance transactions are not normally expressly governed by Shari'ah law but either by the law of the jurisdiction where the contract is to be used or, for international finance transactions, by English or New York law. Shari'ah law determines the contractual rights and obligations which are to be documented but the contracts themselves are governed by the law of a recognised legal system. Sometimes adapting Islamic structures to work within the local legal framework can present challenges and we have found that some Islamic contracts will work better than others in any particular jurisdiction. Tax law in particular does not normally anticipate the use of Islamic

[3] A helpful textbook on Islamic jurisprudence see Principles of Islamic Jurisprudence by Mohammad Hashim Kamali (Islamic Texts Society 2003)

[4] For a translation of the Qur'an into English see the translation by Tarif Khalidi (Penguin) or by M.A.S. Abdel Haleem (Oxford World's Classics)

[5] The Sunnah is compendious and gathered in many different collections e.g. Sahih Al-Bukhari, Sahih Muslim or The Muwatta of Imam Malik Bin Anas all of which are available in translation

finance transactions, which can mean that the tax treatment will be fundamentally different from that which would apply to an interest based transaction. In some jurisdictions including the UK a number of changes have been made to the tax regime to try to establish equality of tax treatment between Islamic and conventional financing structures. Conventional banks wishing to provide financing on a Shari'ah compliant basis can also encounter regulatory difficulties because the nature of the rights and liabilities and the associated risks can be fundamentally different from those created by conventional debt relationships.

## 5. Islamic finance products

Most Islamic financings are implemented using one of the established types of contract recognised in classical Islamic jurisprudence. These contracts can be divided into two main types:

**1** Profit and loss sharing arrangements; and

**2** Contracts which create a debt arising from the sale or lease of an asset or commodity.

### 5.1 Profit and loss sharing arrangements

The main types of profit and loss sharing arrangements used in Islamic finance are **wakala**, **mudaraba** and **musharaka**.

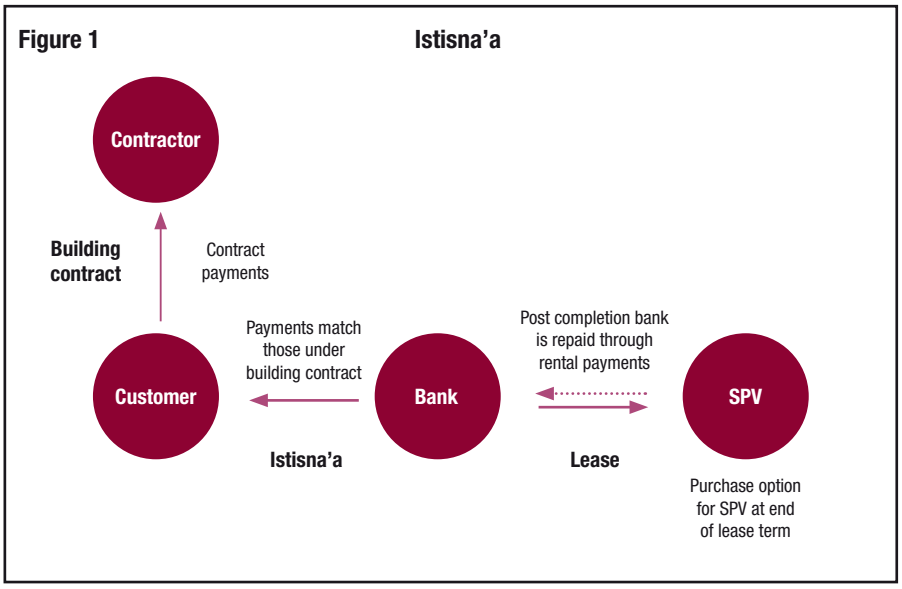
**Wakala** is an agency arrangement under which an agent manages investments on behalf of the investors receiving a fee for its services which may be fixed, variable or performance linked.

**Mudaraba** is similar to a limited partnership. One or more investors contribute funds to an enterprise in agreed proportions. The funds are managed by a manager who is similar to the general partner. The investors are like limited partners and play no part in the management of their investment. The manager receives a fee for his services which may be a fixed sum of money or an agreed percentage of the profits. The manager may also invest his own funds in the enterprise and share in profits and losses on the agreed basis in the same way as other investors.

A **musharaka** agreement is similar to a joint venture. Two or more investors contribute capital, which may be in the form of funds or other assets such as a property. Profits may be shared in whatever proportions the partners agree between themselves.

In a variation known as **diminishing musharaka** one of the partners has either the right or the obligation to buy out another partner's investment in stages over time. In practice the way this usually works is that a financier and customer will jointly acquire a property or other assets. The financier's share will be unitised and the customer will promise to purchase units from the financier at an agreed price and at specified times in the future according to an agreed schedule of payments. Diminishing musharaka is thus a hybrid between a profit and loss sharing arrangement and a contract which creates a debt. It provides a flexible financing arrangement which is widely used as a basis for Islamic home finance products.

**Figure 1** Istisna'a




### 5.2 Sale/asset based contracts

Contracts which fall into this category and are commonly used in the context of real estate include **istisna'a**, **murabaha** and **ijarah**.

**Istisna'a** is a type of sale contract under which the seller agrees to construct or manufacture the thing which is to be sold. In modern Islamic finance istisna'a is most widely used to finance construction and development projects. It takes two common forms. The first is known as a parallel istisna'a, where a bank will enter into two istisna'a agreements relating to the same asset. Under one contract the bank acts as seller and agrees to carry out the construction to agreed specifications. Under the second contract the bank will be the buyer and, in effect, will subcontract construction to a third party. The timing of payments under the two contracts will differ. Under the second contract the bank as buyer will make stage payments to meet the cost of construction as it proceeds while under the first contract payments will be made by the end customer in whatever instalments have been agreed with the bank. In this way the bank finances the construction as it occurs and receives payment from its customer at a later date. In the second type of istisna'a arrangement the bank enters into an istisna'a contract (as buyer) with its customer (as seller), by which the seller agrees to construct the asset for the bank's eventual ownership. The customer may separately enter into a building contract with its building contractor. The bank will make payments under the istisna'a agreement to reflect building costs. The bank will then lease the asset to an associated company of the customer and receive repayment over the course of the subsequent financing term in the form of rental payments under the lease. (See Figure 1)

**Murabaha** is usually described as a 'sale with deferred payment' or a 'cost plus sale'. Murabaha is perhaps the most widely used mode of financing in Islamic finance since it can be used in a variety of different ways to finance specific assets or to provide working capital.

Under a murabaha contract a bank purchases asset or goods at the request of its customer and, immediately on completing the sale sells those goods on to its customer for a price equal to the cost price to the bank plus an agreed profit or mark-up. Title to the goods passes immediately to the customer but payment of the purchase price is wholly or partly deferred. The parties are free to agree on the period for which payment is deferred and on the timing and amount of payments during this period. Sometimes the goods sold are commodities which the purchaser can immediately sell on in the market to generate a cash receipt which

can be used to finance working capital for some other purpose. (See Figure 2)

The bank's cost price and the amount of its profit must be clearly disclosed to the customer. The mark-up is normally either expressed or calculated as a fixed percentage of the cost price equivalent to the prevailing rates of interest at the date of the contract. Murabaha can be controversial because both Shari'ah scholars and the wider Islamic community see the profit being calculated in the same way as interest on a loan and conclude that the transaction is really a disguised loan.

**Ijarah** simply means lease in Arabic. Shari'ah law recognises different types of lease of which the most common are the operating ijarah and **ijarah wa iqtina** or lease with acquisition.

The operating ijarah is a simple operating lease where there is no promise that title to the leased asset will pass to the lessee. The ijarah wa iqtina is a lease together with a promise by the lessee to purchase the asset at the end of the lease term. It is therefore effectively very similar to a conventional finance lease or hire purchase agreement.

The rent payments should be determined in advance for the whole of the lease term and set out in a schedule of payments. However, they may be recalculated periodically provided there is a clear formula for calculation. In practice rents are often set by reference to an interest rate benchmark such as LIBOR because there is no suitable alternative Islamic benchmark which can be used. The use of interest rate benchmarks is sometimes questioned but it is generally accepted that this does not alter the nature of the payments as rental payments and does not undermine the Shari'ah compliant nature of the transaction.

**Figure 2** Murabaha finance

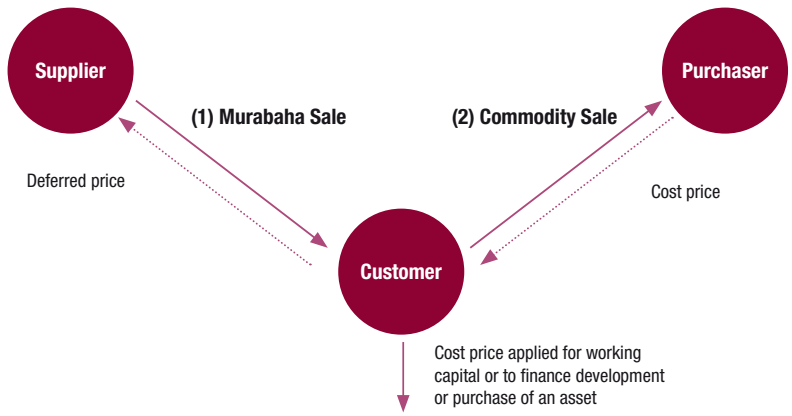
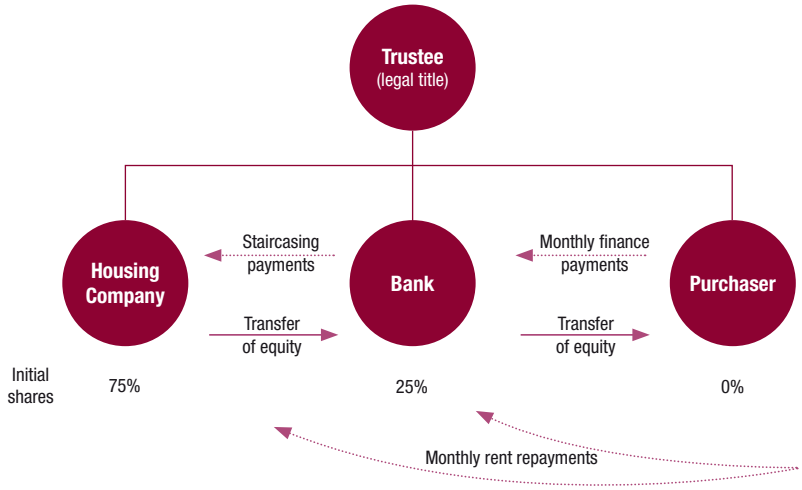



**Figure 3** Shared home ownership trust




## 6. Sukuk

This overview of Islamic finance would not be complete without mentioning sukuk. Sukuk are increasingly being used both as a method of raising finance and also in an effort to create an Islamic capital market, something which is widely seen as a necessary basis for the continued growth and success of the Islamic finance industry.

Sukuk are often referred to as Islamic bonds and compared to conventional asset backed bonds. Sukuk are tradable instruments, often listed on a stock exchange, and may carry either a fixed or variable rate of return to the investor. They are certificates which entitle the holders to a share in the ownership of an asset or pool of assets for a specified period of time and thus entitle the holders to share in any income derived from the underlying assets. However, unlike conventional asset backed bonds, they are not debt instruments secured on the underlying assets but give a direct right of ownership in the assets themselves to the sukuk holders.

AAOIFI has classified more than 14 different types of sukuk, the most commonly used of which to date has been the sukuk al ijarah (although recently sukuk al mudaraba and sukuk al musharaka have become more common). In a sukuk al ijarah the asset or assets owned by the sukuk holders are subject to ijarah arrangements and are therefore producing an income in the form of rental payments. As part owners of the assets the sukuk holders become entitled to share in the rental income for the term of the sukuk. The underlying ijarah arrangements may be ijarah wa iqtina under which the lessee is obliged to purchase the asset at the end of the lease term. In this case the sukuk holders will be entitled to receive their share of the purchase price paid by the lessee. Alternatively, the original owner of the assets may be obliged to repurchase the leased assets from the sukuk holders at the end of the sukuk term although the underlying ijarah arrangements may continue.

Other recognised types of sukuk may represent ownership of assets owned within or subject to

most of the Shari'ah compliant financing contracts described in this article.

## 7. Application to housing

Having looked at the background and conceptual basis for Islamic finance the rest of this article will examine its potential for practical application in relation to housing. The fact that Islamic finance has a strong ethical focus and that so many of its core contracts are asset based makes property and infrastructure projects, particularly those with a social element such as education, health and housing, particularly attractive to Islamic investors and institutions.

The first practical application of Islamic finance to consider is its potential for use in the provision of low cost home ownership. In the UK the use of shared ownership leases and equity mortgages are both well established. Shared ownership leases are fundamentally very similar in their structure to Islamic home finance products utilising Ijarah and diminishing musharaka. However, there are practical barriers to Muslims wishing to take advantage of these products whilst also utilising Shari'ah compliant finance since the models all assume that the purchaser will acquire title to the property utilising mortgage finance to fund his share of the purchase price. Islamic financing products normally require the bank to hold the title and lease the property to the purchaser. Given that the principles behind shared ownership and diminishing musharaka are essentially the same it ought to be possible to reconcile these into a single structure. Trowers & Hamlins LLP has developed a shared ownership trust model which has been successfully used in a shared ownership context and which we believe could readily be adapted to accommodate Islamic finance (see Figure 3). In this model a trustee would hold the legal title to the property on trust for a bank, a social housing provider and a purchaser in shares representing their contributions to the purchase price. The purchaser would have the right to occupy the property and would pay rent to the other parties in proportion to their ownership interests. By making additional payments the purchaser could acquire a larger share in the equity from one or both of the other parties. These payments could be regular scheduled payments or larger "staircasing" payments or a combination of the two.

Turning to finance at the project level rather than an individual dwelling, all of the Islamic finance contracts described earlier in this article have been successfully used as a basis for real estate and development finance for commercial property and other types of infrastructure projects. In principle, their application to fund social housing projects should work in exactly the same way. The main obstacles to this are not in the adaptability or otherwise of Shari'ah compliant structures to social housing but in the rate of return available to investors and the term of the financing available. In the UK huge amounts of private finance have been raised for social rented housing, but typically, this has been at very low margins and for terms of 30 years or even more. However, the provision of finance on these terms has become unsustainable for the banks and in the last two years margins have significantly increased and such financing as is now available is increasingly for terms of no more than five years or with options for pricing to be reviewed at five yearly intervals. It appears that social housing providers in the UK will need to adjust to a financial environment with much higher levels of refinancing risk and higher funding costs. We are still in this period of adjustment but it does not seem unreasonable to think that these new financial pressures may open up greater opportunities for Islamic banks and investors to become involved in the funding of affordable and intermediate housing.

In the past, the majority of finance raised by social housing providers in the UK has come from banks but there has also been some capital markets funding and there has been a renewed interest in this source of finance in the last two years as bank finance has dried up. There have also been a small number of private placements with UK and overseas (largely US) institutional investors, particularly pension funds. Up to now the typical Islamic investor in UK or European real estate has been a Gulf based high net worth individual looking for high levels of return over a three to five year term. In principle, however, there would not appear to be any reason why pension or insurance funds operating on a Shari'ah compliant basis would not need low risk and long term investments in a similar way to their conventional counterparts. Certainly we would think this has potential as a suitable source of finance for affordable housing projects in Middle Eastern countries if not further afield.

The diagrams which follow illustrate how some of the classic Islamic contracts described above might potentially be utilised for housing projects. They do not relate to actual transactions but are put forward simply as suggestions as to how Islamic finance could in theory be applied. They deal only with broad concepts. Implementing Islamic finance always involves dealing with detailed issues and working to balance the competing requirements of Shari'ah compliance, local legal constraints and tax efficiency as well as the commercial obligations of the various parties. This article does not seek to address any of those issues but simply to float some general ideas.

**Figure 4** **Islamic investmen in affordable housing**

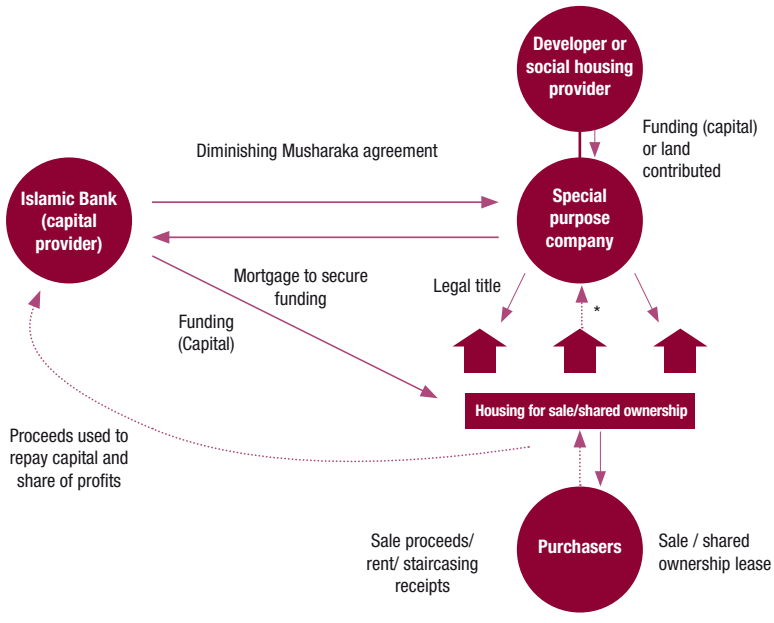


Figure 4 illustrates how a developer or social housing provider might be able to attract Islamic finance into an individual housing project. A special purpose company would be established which would own the title to the land and procure the construction of houses for outright sale or sale on a shared ownership basis. Funding may be provided by the parent company or land may be contributed to it. Government grant or funding may also be available to the project company. Private finance would be provided on an Islamic basis through a musharaka agreement between the project company and an Islamic bank. This is envisaged as a diminishing musharaka under which the project company is advised to utilise its share of the profits derived from sales proceeds and/or rental income to purchase additional portions of the bank's interest in the musharaka. The bank would be granted a mortgage over the land to secure these payment obligations. The protected income over the term of the musharaka would need to be sufficient to enable the project company to buy out the whole of the bank's share, thus effectively repaying the bank's capital.

Figure 5 illustrates a possible structure for a sukuk financing utilising a lease based structure. This envisages that a social housing company would sell rented properties to an SPV which would act as a sukuk issuer and would fund the purchase price from the proceeds of an issue of sukuk to investors. The land would then be leased back to the original owner who would continue to manage the properties and collect rent from the tenants. Rent would in turn be paid by the housing provider to the sukuk issuer under the headlease and this rent would fund the income distribution to sukuk holders. The housing company would have an obligation to buy back the land at the end of the lease term and the sukuk issuer would utilise the proceeds to redeem the sukuk certificates. This type of structure which involves the transfer of land to the sukuk issuer and a transfer back at the end of the lease term is likely to give rise to transfer taxes in many jurisdictions as well as potential tax charges on capital gains. Specific legislation such as has already been introduced in the UK may be required to exempt transfers for the purpose of sukuk issues before this type of structure can be successfully implemented.

Figure 6 illustrates the potential use of a wakala arrangement in the context of a government sponsored project to provide affordable housing for sale. An SPV project company would be established for the purposes of the contract which could be owned by various stakeholders in the project. The project company enters into a project agreement with the government under which it agrees to build, own and operate the social housing for a specified period. The government may contribute capital or land to the project. The project company also raises capital from investors under a wakala agreement by which it is appointed as agent to manage the investments by applying them in the project. The wakala agreement will set out an anticipated rate of return for the investors and it is possible to structure the project company's fee on a performance basis so that this return is effectively, capped. If a higher return can be achieved this can be available for distribution to other stakeholders or reinvested in social housing. The wakala investor could be a single Islamic financial institution, an investment fund or an issuer which has raised the capital from investors through an issue of sukuk.

Social housing finance and Islamic finance are two apparently very separate specialisations which have, over the years, been important parts of my legal practice. There is clearly potential for the two to meet. So far, in the UK at least, the returns available from social housing and the financial objectives of Islamic investors have meant that this meeting has not yet been successfully achieved but it is to be hoped that in due course this will prove possible.

**Figure 5** **Sukuk financing model**

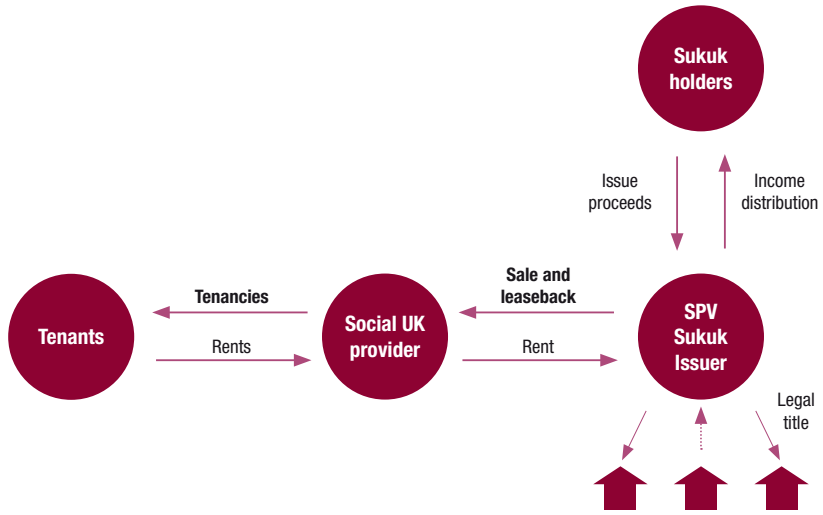
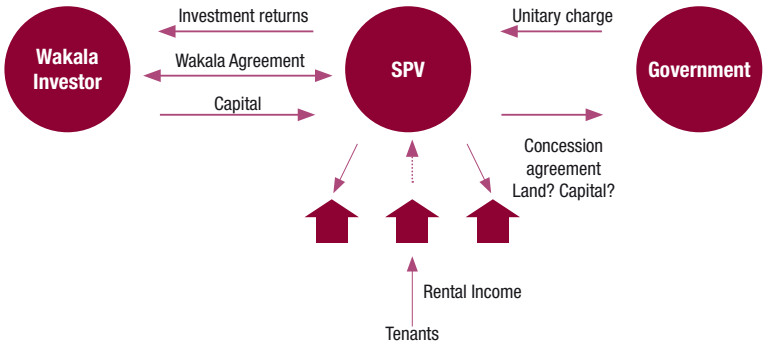



**Figure 6** **Wakala financing model (equity)**



# Book Review

↳ By Andrew Heywood

***The Blackwell Companion to the Economics of Housing*, edited by Susan J. Smith and Beverley A. Searle, Wiley-Blackwell, Chichester (UK), 2010.**

Published in 2010 this volume comprises a set of contributions on the complex interrelationship between private housing and the broader economy. The articles divide into three broad sections; the role of equity withdrawal by households, housing wealth as an insurance and as a means of funding a range of personal support services and a valuable section on the housing market cycle and management of investment and credit risk by households. The contributors are distinguished, and will be well-known to many readers of HFI. If there is an element of "Anglo-Saxon" bias in the choice of writers, it is at least partly explained by the nature of the subject matter.

Most contributions were written towards the end of the last decade. Inevitably therefore much of the data and most of the existing research that informs this work covers the period up to the banking crisis. As we emerge from that crisis it is widely acknowledged that mortgage and housing markets are likely to behave differently from what appeared to be the norm a decade or less ago. By way of example, access to mortgage finance, is likely to remain relatively constrained in markets such as the UK for at least the medium term, and there has been a renewed focus on falling levels of home ownership in a number of markets. It is not clear that previous trends in relation to practices such as equity withdrawal will hold going forward, and this inevitably means that contributors have had to exercise some caution in drawing their conclusions.

Nevertheless, it is unfair to criticise some excellent work on the grounds of its timing and anyone wishing to get up to speed rapidly with recent thinking on the issues covered could not do better than to start here. If an overall criticism can be levelled, it is that a volume titled "Companion to the economics of housing" could have found additional space to focus more fully on the role of housing activity and housing expenditure as an economic driver, and on the relative merits of investing in housing and other asset classes from an economic perspective. Even so, this book represents important spring and summer reading for housing academics and professionals alike.

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