

Saudi Arabia's Housing Market: Structural Issues, Financing, and Potential

Highlights

- Widespread home-ownership confers a number of benefits on an economy, including wealth accumulation, collateral for further borrowing, and the encouragement of investment in local communities. In principle it also stimulates financial market innovations, such as securitisation, which allow banks to free up capital for more productive investment.
- Saudi Arabia's residential real estate market is characterised by an imbalance of housing, particularly at the low- and middle-income levels. A comprehensive legal framework should help to increase mortgage financing and reduce pent-up demand.
- A mortgage law aimed at providing such a legal framework is awaiting final approval. The passage of the law would help to solve some of the housing sector's problems. However, some of these, such as buildable land scarcity and affordability, will not be ameliorated overnight. Housing providers have also been affected by restrictions on off-plan sales, which have put a strain on their balance sheets.
- Notwithstanding these constraints, we feel that the passage of the mortgage law would be an important catalyst for the sector. By turning pent-up demand into actual demand, the law would induce additional housing developers into the underserved segments of the market. Other service providers, as well as mortgage market innovation, would likely follow.
- Ultimately, wider home-ownership will support a substantial and sustained increase in private consumption, giving more breadth to the economy, and providing another engine for economic growth and development.

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Table of Contents

Introduction: Housing and Home-Ownership in an Economic Context	3
Box 1: Home-Ownership and Consumption	4
Overview of Saudi Arabia's Real Estate Market	4
Financing	6
The Proposed Mortgage Law and its Potential Benefits	7
Box 2: Why Securitise?	8
Potential Constraints on the Mortgage Law's Effectiveness	9
Conclusion	10

Housing is an important economic good...

...while home-ownership is a catalyst for financial deepening and societal improvements

Demography is an important driver of housing demand

Real estate markets are illiquid and short-run dislocations are common

Introduction: Housing and Home-Ownership in an Economic Context

Saudi Arabia has a shortage of owner-occupied residential housing, particularly at the lower end of the income scale. In this paper we will consider the structural factors that have contributed to this situation, along with the likely impact of the proposed mortgage law. First, we will briefly consider the role of housing and home ownership in an economy.

Housing is a key building block for economic development

The availability of housing increases labour mobility and hence employment potential. Housing construction itself is labour-intensive and has a high multiplier effect given the necessary auxiliary investment in roads, electricity, sewerage, and water. Beyond this, home *ownership* promotes wealth accumulation for lower-income families by enabling them to more-readily build wealth through home equity growth. Home ownership provides the best and most secure collateral against market fluctuations and other borrowing, and yields a positive rate of return in the long run. By creating stakeholders who demand or make additional investments in their communities—in schools, parks and shops, for example—home ownership can also encourage a better quality of life.

Housing markets tend to be illiquid

In principle, real estate is both an investment and consumption good. It can be purchased with the expectation of attaining a return (an investment good), or with the intention of using it (a consumption good), or both. Thus, a renter would consume housing, while an owner-occupier would both invest in and consume it. The dual nature of the good means that it is not uncommon for people to overinvest in real estate—that is, to invest more money in an asset than it is worth on the open market. This phenomenon was evident in the US and some Western European countries in recent years.

The main determinants of the demand for housing are demographic, although other factors such as income, price of housing, cost and availability of credit, are also influential. The core demographic variables are population size and net population growth, though family size, age composition of the family, marriage rates and net migration, all play a role.

Most real estate markets are illiquid, and the process of price adjustment is slow because of the amount of time it takes to finance, design, and construct new supply, and also because of the relatively slow rate of change of demand. As a result of these lags there is a great potential for disequilibrium in the short run.

Rising house prices provide the basis for additional borrowing and consumption

Box 1: Home-Ownership and Consumption

One well-rehearsed argument is that changes in house prices tend to amplify pro-cyclicality in an economy. This is not, as is commonly assumed, through a simple “wealth effect”: housing has a dual role as a real asset and a necessary outlay, and therefore an increase in house prices redistributes wealth within the household sector, rather than boosting net aggregate wealth. Rather, the importance of housing stems from its role as collateral. Specifically, increases in house prices raise the value of the collateral available to households, loosen borrowing constraints, and support spending. As the IMF has pointed out, this effect might be especially strong if income expectations rise at the same time as house prices, giving households an opportunity to borrow against that higher expected income. Regardless of the precise transmission mechanism, the net result—an increase in consumption and an amplification of pro-cyclicality—is assumed to be the same.

However, this is not the end of the story. Home ownership also confers the ability to tap financial markets when times get tough—a process that has been aided by better assessment and pricing of risk and deeper securitisation (see Box 2). Thus, home ownership helps to support incomes and consumption during economic downturns, thereby reducing pro-cyclicality “on the way down”.

The Saudi market is driven by local demand, not foreign investors

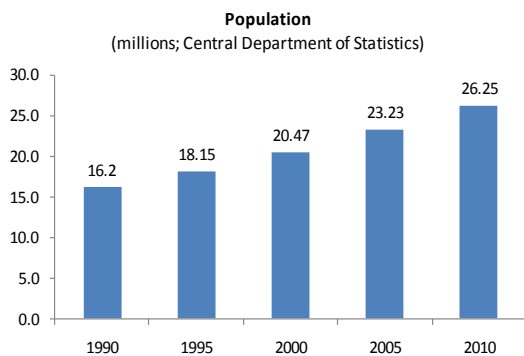
Overview of Saudi Arabia’s Real Estate Market

The Saudi real estate market is by the far the largest in the Gulf region

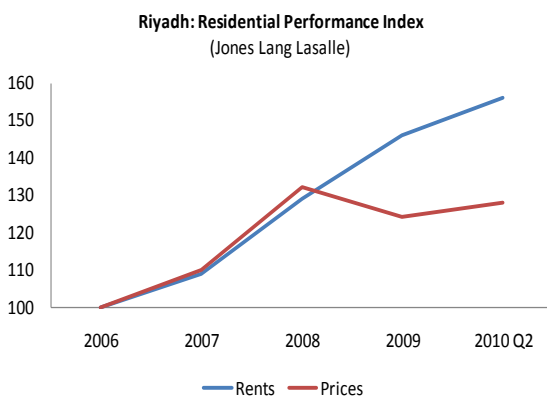
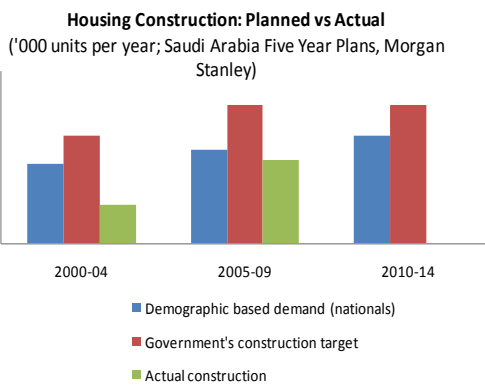
Saudi Arabia’s real estate market is large and fast-growing. It is ten times bigger than any other Gulf market, but remains underdeveloped, with the balance of estimates suggesting that just 30 percent of Saudis own their own home. Freehold ownership is currently legally confined to Saudi nationals, though foreigners can buy leasehold property in designated developments. The key characteristic is that demand is primarily generated by local buyers and not foreign investors.

Despite the country’s size, available land for development is at a premium. **Demand** is being driven by overall population growth of 3.1 percent, and a Saudi national growth rate of 2.2 percent. The growth rate of young Saudi adults—defined as those aged 20-34—is estimated at 2.7 percent. Pent-up demand is considerable given an average family household size estimated at 5.7 (Jones Lang Lasalle—JLL). This in turn reflects the paucity of financing options for most young Saudis, many of whom continue to live with their parents for extended periods.

Migration is another important driver of demand. The high-end rental market (including compounds) tends to be dominated by two groups: high-income expatriates, and religious tourists. Blue collar expatriate workers



Supply has failed to keep pace and the housing shortfall is at least half a million and is likely to exceed 1 million by 2012



drive demand for low-end rental accommodation. According to the 2010 census, the expatriate population is growing at an annual rate of 5.5 percent. Internal migration also plays a role, with urbanisation—propelled by economic growth—increasing the call on urban housing.

Developers have focused on high-end projects

Supply has lagged, with developers tending to focus on high-end rather than lower- or medium-income residential units. Supply rollout has slipped further following the introduction of the Escrow Law in 2009, which prohibits most types of off-plan selling without approval from the Real Estate Commission (see below). In Riyadh, few new projects have been announced over the past year, and many of the earlier-launched Masterplan developments such as Al-Wasl and Ajmakan, have yet to be delivered. For expatriates, there are a number of large compound schemes with 300-plus units in the planning stages, but not yet under construction. Most developers are providing houses priced at more than SR1 million (\$270,000), but demand is strongest within the SR500,000 – SR750,000 range. After all, the average monthly wage for the Saudi public sector (in which the vast majority of nationals are employed) is just SR5,200 (the 2009 median household income for Riyadh was SR6,000).

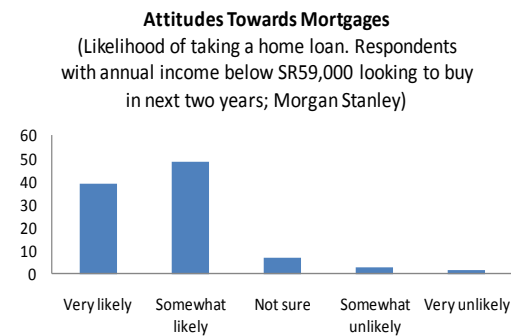
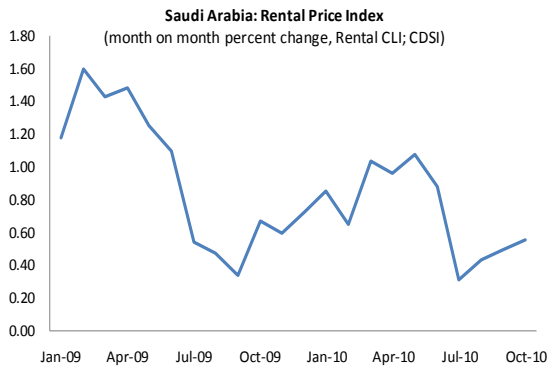
Jones Lang Lasalle sees a shortfall of 1.1 million units by 2012

JLL puts the total stock of residential housing at 3.95 million units at the beginning 2008 (with a total shortfall of 500,000 units). The company projected the total flow of new units in 2008-12 at just 380,000, and with demand expected to increase by 1 million units over the same period, a shortfall of around 1.1 million units is in prospect for 2012. However, this may be an underestimate given that supply has slowed further since JLL made its calculations.

Prices have surged and affordability is a pressing issue

The mismatch between demand and supply has pushed prices upwards. The price of residential land in Riyadh increased by 20 percent per year in 2003-07, with average house prices rising by 16 percent, according to JLL. Residential prices dropped by 22 percent in 2009 according to Colliers International, though JLL says that prices for all types of property in Riyadh were up 12 percent in the first quarter of 2010, year on year; other research suggests that Riyadh apartment prices were up 6 percent in the first half of 2010, while villa prices were 3.9 percent higher (albeit with large variations between different districts). In Jeddah, prices rose 16 percent in the first quarter, year-on-year, and have been partly supported by the flash flood in November 2009 which destroyed a sizeable number of homes. In the Eastern Province the situation is somewhat different, with oversupply leading to a 10 percent fall in prices between mid-2009 and mid-2010, according to CB Richard Ellis.

Higher prices are clearly beneficial to owners of property, and this can have important positive economic consequences (see Box 1). However, in the Saudi context, higher prices both reflect the shortage of supply and further



Banks' reticence stems from the absence of a legal framework

reduce the chances of potential first-time buyers being able to enter the property market.

Rents are increasing at an annual rate of 9 percent

Rents have also increased. Until recently, the rental component of the cost of living index had been trending down gradually on a year-on-year basis. However, it appears to have flattened out at around 9 percent, which is very high by historical and regional norms. The month-on-month rate has also been trending up over the past twelve months. With a weighting of 18 percent in the overall cost of living index, rental price increases are one of the principal drivers of overall inflation. High rental inflation also eats into the real disposable incomes of those who rent, and has the potential to deter foreign direct investment, with potentially serious consequences for economic growth.

Financing

Affordability is closely entwined with the scarcity of mortgage financing

The main reason for the current disequilibrium in the Saudi residential property market is the scarcity of mortgage financing. Currently, Saudi property developers are reluctant to build middle- or low-end residential real estate because, although pent-up demand might be substantial, actual demand—that is individuals able to purchase these types of homes without benefit of a mortgage—is low.

Financing is available, but is generally limited. The Real Estate Development Fund (REDF) provides soft loans to Saudi individuals to build their own homes, but this has proved inadequate given the demand for housing, and the approval process is lengthy. Commercial banks do provide mortgages (on Islamic terms), but lending has been largely confined to those who can provide the large down-payments required (lending for the housing needs of large corporates also takes place). Thus, bank mortgage lending makes up only around 3 percent of GDP in Saudi Arabia¹, compared with approximately 6 percent in Kuwait and 7 percent in the UAE, and well over 50 percent in many developed countries.

There is no outward sign that the mortgage law will be passed imminently

A mortgage law, which deals with default and other issues that have impeded mortgage lending by banks, is still under review. The bill apparently gives lenders the right to foreclose on properties in default, while lenders would gain the added security of reporting debtors through a central authority, rather than through a notary public as is currently the case. The bill is currently with the Shura Council, but consideration of the bill has been delayed. Final approval by the Council seems unlikely in the near term, given a number of issues relating to oversight and enforcement of the law that have yet to be resolved.

¹ Penetration is significantly higher if government-sponsored mortgage lending is included. Morgan Stanley estimates total mortgage penetration at 13 percent on this basis. See *Saudi Mortgages: New legislation? Implications for banks and real estate* (Dec 2010).

The mortgage law would open the way for longer tenors, greater transparency and, potentially, securitisation

The Proposed Mortgage Law and its Potential Benefits

The passage of the law would be an important breakthrough in opening up housing finance to a large section of the Saudi national population—the low- and middle-income earners. The law would also open the way to tackle other constraints in the Saudi housing sector.

By effectively providing collateral the mortgage law would give banks the comfort they need to expand lending

It is important to note that the details of the mortgage bill have not been revealed. However, we assume that at the very least the final law will provide a **remedy in case of default**. By effectively providing collateral, the law should therefore provide lenders (primarily banks) with the comfort to expand mortgage lending significantly. Banks have been geared up to accelerate mortgage lending for a long time and are well capitalised with low loan-to-deposit ratios. A well-functioning credit bureau is in place, and salaries are paid directly into bank accounts.

Recourse to foreclosure should also encourage a significant **increase in the tenor of mortgages**, which in turn will allow more affordable debt-service-to-income ratios. We also assume that the new law will provide a regulatory framework that will improve **transparency** and **build quality** in the residential real estate sector. For example, we expect building standards to be raised since only qualified housing will be eligible for mortgage-backed financing. Greater transparency and standardised processes should also reduce **administration costs** for lenders, which would further encourage lending to the mass market.

Once the mortgage law has had time to operate, potential exists to **liberalise** the market, by allowing in non-bank providers. Competition in Kuwait and the UAE, for example, has led to a wide range of primary mortgage products, and features such as penalty-free refinancing, second mortgages on favourable terms, and fixed interest rate mortgage products. These are important advances: for example, the capacity to borrow against accumulated home equity allows households to tap their housing wealth directly and to borrow more when house prices increase. Similarly, the absence of early repayment penalties frees the borrower to refinance their mortgage debt in the event that interest rates decline.

A mortgage market could also open the door to **securitisation**. Securitisation gained a controversial reputation during the global financial crisis, but that should not obscure its inherent advantages. By allowing banks to deploy their capital more effectively, securitisation encourages credit growth and helps to deepen financial markets. Deeper financial markets enable households and firms to liquefy assets quickly and easily, and, by putting downward pressure on interest rates, encourage long-term capital investments. Securitisation also offers the potential for more accurate price indicators in an otherwise illiquid market (see box).²

² Dar al-Arkn, a Saudi real estate developer, commenced issuance of Islamic mortgage-backed securities in 2008, though the market has not taken off.

Securitisation would allow banks to use their capital more effectively

Securitisation has negative connotations, but it can help to deepen financial markets

The process can go badly wrong

Box 2: Why Securitise?

Securitisation is the process by which individual assets, which on their own might be difficult to sell, or even attach a value to, are aggregated into securities that can be sold in financial markets. The investor then has the right to interest payments generated by the underlying assets. Mortgages are by far the most important source of asset-backed securities.

In developed markets securitisation can take many forms and the motivations driving it can be diverse. For example, a company might excel at one strand of a broader business—such as lending to owners of mobile homes. However, it might not have any particular expertise in other parts of the business, such as managing the assets once they have been created. Selling off the assets through securitisation allows the firm to focus on its core strength, where it can add the most value.

A more basic motivation for securitisation—and the main driver of the process in most markets—is the desire of banks to shift assets off their balance sheets. When a bank extends a loan, the loan’s market value appears as an asset on its balance sheet, and it must then set aside the appropriate amount of capital to cover any decline in the value of that asset. Securitising the asset allows the bank to remove the asset from its balance sheet. This means that it no longer receives interest on the loan, but it makes money from selling the asset and also frees up capital for more productive use, such as financing new investment in the loan origination part of the business.

By allowing banks to use their capital more productively, securitisation encourages credit growth and helps to deepen financial markets, while also putting downward pressure on spreads. Securitisation also helps to generate publicly available prices. Property, for example, is difficult to trade, and because each home is unique, can be difficult to value. Asset-backed securities are usually much easier to trade than the underlying assets themselves. So, if securities backed by commercial mortgages are selling for twice the price than they were a year earlier, this should in principle give a fairly accurate guide to investors, regulators and managers about the value of a lender’s portfolio even when its specific assets have not been securitised. The securitisation process does have important vulnerabilities and these were exposed during the global financial crisis. Though the negative impact of securitisation was multi-layered, in general it is agreed that the multiple repackaging and complexity of the securitised products helped to disguise the risks that were still ultimately associated with the performance of the underlying asset. Just as seriously, the “scramble to securitise” contributed to a deterioration of lending and underwriting standards that was at the root of the crisis.

There are a number of impediments to the effectiveness of the mortgage law

Restrictions on off-plan sales are understandable, but they have also increased the financial burden on developers

The scarcity of buildable land is a major problem

Potential Constraints on the Mortgage Law’s Effectiveness

There are a number of potential constraints on the effectiveness of the mortgage law, were it to be implemented.

The mortgage law will not transform the housing market overnight

It may well be that the mortgage law will not encourage a significant increase in housing credit until it has been properly “tested”. In practice, this would mean the legal authority ruling in favour of a lender in a case where the borrower was in default. It might also require actual **foreclosure** of a property before lenders have sufficient comfort to expand lending significantly.

In addition, the law will only cover property that has the **proper permits**. It is estimated that 30-40 percent of existing residential property in Saudi Arabia lacks proper licensing owing to a failure to obtain official planning approvals. It is therefore possible that this element will be “frozen out” and may become difficult to trade. This is not insurmountable: similar situations in other countries have been resolved through a certification process that allows occupiers to claim title to their property, but it would likely take many years to work through.

Other issues centre on the **legal system** for property. Valuation procedures are not standardised, and the valuation process is further complicated by the tendency to demolish homes on newly-acquired plots and build afresh. Nor is there a central electronic database to register transactions, with the current system of notaries public prone to recording error. The mortgage law is partly designed to remedy this situation, but in the early stages of its rollout, shortcomings in the current system might well weigh on the flow of transactions.

Related to this is the **restriction on off plan sales**. The law prohibiting off plan sales without prior approval from the government was designed to prevent Saudi Arabia from succumbing to the type of property price bubble witnessed in some other Gulf states in 2005-07. This is perfectly understandable and the law has indeed reinforced end-buyers’ confidence. However, the flipside of the law is that developers are obliged to finance and build large-scale projects before offering them for sale. This has put a strain on their balance sheets and has contributed to the slowdown in new projects. Some encouragement is offered by the recent approval of off plan sales at TMG’s Nasamat Al Riyadh project, but it is not clear whether this is a one-off or the beginnings of a more widespread loosening of the Escrow Law.

Buildable land remains scarce

A relatively **static land market** has also impeded real estate development. Land ownership patterns mean that the flow of buildable land to the market has been constricted. The price of land has therefore increased faster than the price of physical property, with the price of a quarter acre plot in a typical Riyadh suburb about SR1.5 million.

The lack of a long-term yield curve makes pricing difficult

Encouragingly, the government has laid out plans to provide about 270 million sq metres of land for the development of housing projects by the public and private sectors under the terms of its latest Five Year Development Plan (2010-14). Yet the release of additional land to the market will be necessary to meet demand and increase the flow of properties available. A tax on land holding, or a legal requirement to develop vacant land within a certain period of purchase constitute potential solutions to this problem, though neither would be easy to implement.

A fully functioning mortgage market might also be hampered by the **lack of a long term yield curve**. The current dearth of long-term bonds makes it difficult to price a 30-year mortgage. Property is illiquid and often volatile, and a predictable, stable yield curve provides an important benchmark for pricing. The US curve can be used as a proxy, though its appropriateness rests partly on the assumption that the Saudi riyal’s fixed peg to the US dollar will not be broken over the long term. Though a reasonable assumption, this is by no means guaranteed.

Most crucial, perhaps, is the issue of **affordability**. Current property prices put most existing accommodation well out of the reach of ordinary Saudis, regardless of the availability of mortgage finance. For example, research by Morgan Stanley suggests that using mortgage finance to purchase a low-end villa in Riyadh would require a salary some 50 percent higher than its survey average. Some think that new developers from the Gulf will enter the lower-to-middle market once mortgage financing releases demand; others believe that the government will need to “kickstart” the market by introducing public-private partnerships that would effectively subsidise developers.

Conclusion

The structural problems highlighted above indicate that the mortgage law will not transform the housing finance landscape overnight. The law should help to transform potential demand into real demand, but it does not—directly at least—address supply constraints.

Nevertheless, we believe that the mortgage law will be the catalyst to increase both demand and supply. If the law releases demand, particularly at the lower- and middle-income level, then we think that new developers will indeed be attracted to the market—helped by the fact that development opportunities elsewhere in the Gulf region have dwindled substantially in recent years. Similarly, as demand is released and new supply is stimulated, so new providers of valuations, insurance and other auxiliary services will enter the market. With greater mass should come better quality and greater consistency. As more mortgages are sold, so the market will deepen. Initially, mortgages could be priced with reference to the US 30 year treasury, but over time the market might develop its own yield curve, particularly if a secondary market develops.

Releasing an adequate supply of land could be the hardest trick, but it is imperative that this is achieved: if the supply of buildable land remains constricted, then the passage of the mortgage law might simply stoke

These problems are serious but not insurmountable

Passage of the mortgage law would provide the catalyst to attract additional developers to the market

Ultimately, home ownership could provide the platform for future economic growth and development

demand without encouraging a commensurate increase in supply, the inevitable result of which would be higher prices.

Widespread home-ownership could provide the spur to economic growth and diversification

Ultimately, the mortgage law could prove to be a catalyst for a number of positive developments in the Kingdom beyond the obvious boon to construction, downstream industries and securitisation noted above. There is enormous untapped economic potential in the middle- and lower-middle classes—potential that could be released by providing them with the means to secure their own property. Home ownership provides security, wealth, and a basis for future borrowing. In short, it could provide the platform for a substantial and sustained increase in private consumption, giving breadth to the Saudi economy and providing the engine of growth for the long term.

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