

Building up the housing finance market in KSA

improving the legal infrastructure

Abdulaziz Sulaiman Aleid

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The candidate confirms that the work submitted is my own and that appropriate credit has been given where reference has been made to the work of others.

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Finally, although my name appears as the author of this thesis in reality this would not have been seen through to completion without my parents' prayers and wishes who whatever I have done I would not pay back what they have done for me for the whole of my life.

## **Abstract**

This research project purports to offer a comprehensive analysis of how the legal framework in Saudi Arabia might be improved to further the development and efficacy of the housing finance market. The research aims to achieve the following objectives: enhancing the efficiency of the main participants, lender and borrower, in the housing finance market by providing them with the desired protection; facilitating access to that market; building up a proper regulatory framework for governing the market; and finally, addressing the legal barriers that hinder the provision of cheap liquidity in the market.

Although the Housing Finance Laws (HFLs) 2012 were introduced and enacted with similar objectives in mind, this thesis argues that four issues still present significant obstacles to the development of the housing finance market, albeit some are a result of the provisions of the HFLs themselves. As a consequence, the thesis has sought to address the following questions; what barriers to the development of the housing finance remain unaddressed? How should Saudi law be reformed to provide adequate protection for lender and borrower in the market? Can the Land Fees Law 2016 play a critical role in addressing the current issue of increasing land prices which hinders access to the housing finance market? How can the regulatory framework for regulating the housing finance market in general, and for adopting the macro-prudential policy in particular, be developed to achieve the HFLs' aims? And, finally, how might Saudi laws be reformed to enable the launch of a securitisation market, in order to assist in the development of the housing finance market by providing new means of liquidity?

It is hoped that critical analysis of the above questions will help to facilitate development of the housing finance market and contribute to its further improvement, by addressing potentially workable solutions to the obstacles listed above.

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## List of Abbreviations

BCBS	Basel Committee on Banking Supervision
BCL	Banking Control Law 1966
BDR	Banking Disputes Resolution committee
BLG	Basic Law of Governance
CEDA	Council of Economic and Development Affairs
CRAs	Credit Rating Agencies
CSU	Council of Senior Ulama
DTI	Debt to income
DVT	Development Value Tax
ECB	European Central Bank
FCA	Financial Conduct Authority
FCCL	Finance Companies Control Law
FLL	Finance Lease Law
FPC	Financial Policy Committee
FPC	Financial Policy Committee
FST	Financial Stability Board
FYP	Five Year Plan
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GHA	General Housing Authority
GSEs	Government-sponsored enterprises
HCDA	High Commission for the Development of Riyadh
HFLS	Housing Finance Laws
HKMA	Hong Kong Monetary Authority
HKMC	Hong Kong Mortgage Corporation
IFTs	Islamic finance transactions
IMF	International Monetary Fund
IOSC	International Organisation of Securities Commission
ITL	Income Tax Law
LFSC	Law on the Supervision of Finance Companies
LTT	Land transfer tax
LTV	Loan to value
MBS	Mortgage-backed security
MFNE	Ministry of Finance and National Economy
MIP	Mortgage Insurance Programme
MPWH	Ministry of Public Works and Housing
NCB	National Commercial Bank



PIF	Public Investment Fund
PRA	Prudential Regulation Authority
REDF	Real Estate Development Fund
REFL	Real Estate Finance Law
RERC	Real Estate Refinance Company
RREFL	Regulation of Real Estate Finance Law
SAMA	Saudi Arabian of Monterey Agency
SAR	Saudi Arabian Riyal
SIBOR	Saudi Interbank Offered Rate
SJC	Supreme Judicial Council
SPV	Special Purpose Vehicle
UK	United Kingdom
US	United State of America

## **Chapter One: Introduction**

### **1.1 The aims and objectives of the thesis**

The thesis aims to determine how the Saudi laws on housing finance might best be improved so as to encourage the development of an appropriately structured housing finance market. There are thus four principal objectives of this thesis: enhancing the efficiency of the main participants, lender and borrower, in the housing finance market by providing them with the desired protection; facilitating access to the housing finance market; building up a proper regulatory framework for governing the housing finance market; and finally, addressing the potential legal barriers that hinder the provision of cheap liquidity in the housing finance market.

Although the Housing Finance Laws 2012 were introduced and enacted with similar objectives in mind, this thesis argues that four issues still present significant obstacles to the development of the housing finance market, albeit some are a result of the provisions of the Housing Finance Laws 2012 themselves. The four issues are: first, the lack of protection granted to participants in the housing finance market as a result of the decision of the Supreme Judicial Council (SJC) which deprives lenders and borrowers of the mortgage mechanism by which to secure their interests in financed property. The second issue is the increase in land prices and their negative role in the housing finance market through increasing the cost of borrowing and obstructing potential first homebuyers' access to housing finance. However, the only solution advanced to address this issue was the enactment of the Land Fees Law (LFL) 2016; therefore, the thesis aims to analyse this law and its provisions to see whether or not the law tends to address this issue. The third issue is the high down payment requirement established by article (12) of the Regulation Real Estate Finance Law (RREFL), which has restricted the access of first-time homebuyers to the housing finance market. Finally, legal changes are needed to enable the establishment of a securitisation market and thus to provide cheap liquidity in the housing finance market, as well as to address the liquidity constraint in Saudi caused by the oil prices collapse, which has a negative impact on the market.

The thesis, therefore, seeks to address these issues through realising the broader objectives noted above, and proceeds from the assumption that the modest role played by

the housing finance market in Saudi invites further examination and analysis, in order to best identify appropriate avenues of reform.

In discussing this sensitive issue, the thesis needs to define several fundamental concepts and address some crucial questions, which will shape the discussion:

- What initiatives have been adopted by the Saudi government to develop the housing finance market? And, what barriers to development of that market remain unaddressed?
- What is the Supreme Judicial Council's(SJC) decision, which is believed to be hindering the development of the housing finance market by depriving lenders and borrowers alike of mortgage security? And, do the provisions of the housing finance laws 2012 overturn the SJC's decision? Furthermore, could Islamic finance transactions (IFTs) be considered a solution to the problem created by the SJC's decision? And why? Finally, can we create an alternative solution that might bridge the gap produced by the SJC's decision?
- The only solution advanced to address increased land prices was the enactment of the Land Fees Law 2016; can it lead to either a decrease in the market value of land or an increase in its supply? And what are the legal concerns emerging from the wording of the LFL 2016?
- Does article (12) of the Regulation of Real Estate Finance Law(RREFL), which caps the Loan-to-value (LTV) at 70%, restrict the first homebuyer's potential access to the housing finance market? If so, is this impact consistent with the main aims of enacting the housing finance laws 2012, namely to facilitate access to housing finance? If not, how can the regulatory framework for regulating the housing finance market in general and for adopting the macro-prudential policy, of which the LTV is one element, in particular be developed to avoid the conflict between the general aims of enacting the housing finance laws 2012 and the application of article (12) of RREFL? And how can the adverse impact on the housing finance market of applying the LTV be mitigated?
- Why does Saudi need to launch a securitisation market in the context of the development of the housing finance market? If indeed it does, is there a consequent need to reform the housing finance laws 2012 in order to build up a well-developed securitisation market?

## 1.2 Background

Housing is considered the most important asset and largest expense of households around the world.<sup>1</sup> It is often the greatest financial investment an individual or family will make, and is heavily associated with security, stability and privacy.<sup>2</sup> For most purchasers long-term financing is their only viable option, as few can afford to purchase properties outright.<sup>3</sup> In these circumstances the housing finance market emerges as a necessary facilitator of access to such financing.

The quality of the housing finance market in a given country is often measured by, amongst other things, the rate of homeownership, as underdevelopment of the market often translates into low rates of homeownership.<sup>4</sup> High rates of homeownership in the US, for instance, have been attributed to the development of the residential housing finance market, granting aspiring home buyers access to finance whilst protecting the interests of lenders in the case of borrower default.<sup>5</sup> The need for such a housing finance market, that is to say a regime that appropriately balances the interests of purchasers and lenders, is all the more urgent where public sources of finance cannot meet current levels of demand due to a lack of provision.

In line with this trend, it appears that the Saudi experience is not exceptional, as a large proportion of the population do not own their homes, the homeownership rate being lower than 47%.<sup>6</sup> Although rates of homeownership are not the only indicators of the quality of

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<sup>1</sup> V Warnock and F Warnock, 'Markets and housing finance' (2008) 17 *Journal of Housing economics* 239.

<sup>2</sup> R Opoku and A Alhassan, 'Housing preferences and attribute importance among low-income consumers in Saudi Arabia' (2010) 34 *Habitat International* 219.

<sup>3</sup> B Richard, 'Fannie Mea and the secondary mortgage market' (1971) 66 *Northwestern University Law review* 1.

<sup>4</sup> S Proxenos, 'Homeownership rates: a global perspective' (2002) 17 *Housing finance international* 3.

<sup>5</sup> A Sanders, 'Barriers to homeownership and housing quality: The impact of the international mortgage market' (2005) 14 *Journal of Housing Economics* 147.

<sup>6</sup> Some studies suggest that just 36% of Saudis owned their homes, for more information about this study see: S Alshaik and A Alwazir, 'Saudi housing sector 2012' (*menafn.com*, 2012) <[https://www.menafn.com/updates/research\\_center/Saudi\\_Arabia/Economic/ncb091212.pdf](https://www.menafn.com/updates/research_center/Saudi_Arabia/Economic/ncb091212.pdf)> accessed 25<sup>th</sup> August 2016; while Deputy of crown prince the chairman of the Council for Economic and Development Affairs Stated when he was interviewed by *Alarabia* channel that the home ownership in Saudi is 47%, then the Ministry of Housing confirmed later this percentage, for more information about the interview see: *Alarabia*, 'Mohammed bin Salman and 33 titles of Saudi vision 2013' (*alarabiya.net*, 25<sup>th</sup> April 2016) <<http://www.alarabiya.net/ar/programs/special-interview/2016/04/25/-%D9%85%D8%AD%D9%85%D8%AF-%D8%A8%D9%86-%D8%B3%D9%84%D9%85%D8%A7%D9%86-%D9%81%D9%8A-%D8%A3%D9%88%D9%84->

a housing finance market and its ability to cater to demand for finance lending, they are suggestive of pervasive issues impacting upon both the activities of lenders and the access of prospective homebuyers to the market.<sup>7</sup>

Over the past several years Saudi has witnessed a significant overhaul of its financial system in response to the current housing crisis in the country,<sup>8</sup> which itself was exacerbated by decreased government spending in the housing sector during the period 1985-2007. This lack of investment, coupled with a growing population and the importation of large numbers of foreign workers,<sup>9</sup> has placed excessive pressure on the housing sector, which has been unable to meet the demand for affordable housing. As this crisis has grown in scale the problems it presents have become impossible to ignore, making the need for a financing system all the more pressing.

The Saudi government have made several attempts to resolve this issue through the adoption of various policies and legislation. The most significant of these measures, conducted by both the government and legislative authority in Saudi, has been the enactment of the so-called the housing finance laws 2012. Those laws are; the Finance Lease Law (FLL), the Law on the Supervision of Finance Companies (LSFC), and the Real Estate Finance Law (REFL),<sup>10</sup> which will be the central concern of this thesis and

<http://www.stats.gov.sa/en/%D8%B5%D9%81%D8%AD%D8%A9/statistical-sector> accessed 4 June 2016.  
<http://www.stats.gov.sa/ar/13> accessed 20<sup>th</sup> November 2016. For more information about homeownership rate in Saudi see; V Perry and C Motley, 'Dreams and Taboos: Home Loan Advertising in the United States and Saudi Arabia' (2010) 22 *Journal of International Consumer Marketing* 199 & General authority for statistics, 'Statistic and information sector in Saudi Arabia' (stast.gov.sa, 21<sup>st</sup> July 2016) <<http://www.stats.gov.sa/en/%D8%B5%D9%81%D8%AD%D8%A9/statistical-sector>> accessed 4 June 2016.

<sup>7</sup> S Proxenos, 'Homeownership rates: a global perspective' (2002) 17 *Housing finance international* 3.

<sup>8</sup> Chapter Two will discuss and shed light on the housing crisis in Saudi Arabia and the measures have been conducted by Saudi government to address this issue.

<sup>9</sup> It is estimated, for example, that Saudi population during the 1970s reached 5 million, with the foreign workforce rising to over 1.2 million in 1985. While currently the Saudi population is estimated more than 31 million, the foreign workforce constitutes more than 10 million. For more information, visit the General authority for statistics web; General authority for statistic, 'Pulation by Gender , Age Groups and Nationality (Saudi/Non-Saudi)' (*stats.gov.sa*, August 2016) <<http://www.stats.gov.sa/en/4068>> accessed 12<sup>th</sup> November 2016.

<sup>10</sup> The background to these most recent laws has its origin in 2003, when participants in the 2003 Economic Forum in Riyadh highlighted the difficulties likely to hinder the finance sector and housing finance in Saudi. Afterwards these concerns were submitted to the Saudi government through the *Al-Gassim* law firm, a Saudi firm associated with the Allen & Overy law firm that is expert in Islamic finance, banking, finance, commercial cases, and drafting contracts and bills. Then, *AlQassim* law firm was selected to draft the bills of the housing Finance Laws. Subsequently, the bills received Royal Assent, coming into effect in

signify a major expansion and milestone in the codification of Saudi law. The paragraphs below will provide a brief overview of these laws.

Introducing and establishing a new era in housing finance market, with a securitised market in Saudi Arabia bringing greater depth and maturity to the industry,<sup>11</sup> are key factors in the enactment of the REFL. It also has the broader aim of paving the way for banks and financial institutions to enter into the housing market, and for the dissemination of information within that market. The level of liquidity in the market is targeted by the REFL, as it will be enhanced through the establishment of a securitisation market, which will play a significant role in providing the market with the desired liquidity at low cost. The FLL prescribes the rules on finance leasing and, more specifically, the responsibilities of the lessor and lessee in a *Sharia*'a compliant manner. Here the asset risk is placed on the Lessor during the lease term, but the Lessee is held responsible for the relevant use.

The LSFC provides a framework for companies wishing to conduct financial operations, either in housing finance, production asset finance or small and medium enterprise finance. The law determines, for example, the capital requirements for establishing such companies, and obliges them to engage in finance activities in a manner that does not conflict with principles of Islamic law as defined by the *Sharia* Committee, whose members are themselves appointed by those companies.<sup>12</sup>

The aim of enacting the housing finance laws was mainly to build confidence in the housing finance market, to provide the desired protection for its main participants, to facilitate the housing finance access and to regulate the relationship between the parties to housing finance transactions. Although, in the short term, the housing finance laws will not result in significant increases in lending activity, it is believed that in the long term they will facilitate, to some extent, the development and availability of housing finance in Saudi.

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2012. These laws are unique in that they are the first to control and regulate financial contracts (namely the finance lease contract). Furthermore, it was the first time the Saudi government had enacted law by engaging a law firm to draft proposed legislation. For more information see: The Economist Team, "The recommendations of the first Riyadh Economic Forum. 6-8 October 2003" (*riyadhef.com*, 6 October 2003) < <http://www.riyadhef.com/tabid/55/Default.aspx> > Accessed 12 July 2016.

<sup>11</sup> K Khan, 'Saudi Mortgage Law' (*alrajhi-capital.com*, 1 March 2013) < [http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law\\_Mar%202013\\_Final.pdf](http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf) > accessed 6<sup>th</sup> November 2016.

<sup>12</sup> Discussion of the rules and provisions of the above laws is beyond the scope of this thesis. However, for more information about the housing finance laws see: SAMA, 'Finance laws' (*sama.gov.sa*, July 2012) < <http://www.sama.gov.sa/en-us/laws/pages/financelaws.aspx> > accessed 14<sup>th</sup> July 2016.

In adopting such an aggressive legislative programme the government intended to tackle and resolve numerous legal problems relating to finance in general and to housing finance in particular, given the acute housing shortage. Nevertheless, the deficit in housing finance remained the biggest task facing the government<sup>13</sup> and it could not be addressed solely by the introduction of the aforementioned laws. This is not to say that these laws make no contribution to the resolution of the housing finance crisis, but rather that such a complex and difficult matter warrants further examination and analysis. In this context the goal of this thesis has emerged as the formulation of research that might help in dealing with some of the issues raised.

Although the introduction of the FLL, LSFC and REFL has addressed, to some extent, a wide range of legal issues impacting upon the housing finance market, certain issues do remain and call for further examination and development. This latter point is made in recognition of the fact that the Saudi market is considered an emerging market and, as such, is still undergoing a process of development. Taking these factors into account it is apparent that housing finance is not readily available. This is due to the typically small size of residential lending, which is poorly accessible and depositor-based, whilst lenders remain vulnerable to significant credit, liquidity and interest rate risks. There is therefore a clear need to develop such a market so as to remedy those issues that currently obstruct public access to housing finance. This is especially true in the Saudi context, where the unique culture and religious heritage might play a further role in retarding this process of development.<sup>14</sup>

Accordingly, the principal concern of this research is to improve the legal infrastructure of the housing finance market in Saudi. This necessitates the removal of existing barriers to the procurement of housing finance, which are either left unaddressed by the housing finance laws 2012 or are themselves a product of their implementation.

Finally, it is important to note here that the public housing finance market will be excluded from our consideration; the emphasis is solely on the development of the private

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<sup>13</sup> Oxford business 'An underserved market: Making affordable housing attractive to investors' (*oxfordbusinessgroup.com*, 15 June 2013) < <http://www.oxfordbusinessgroup.com/news/underserved-market-making-affordable-housing-attractive-investors> > Accessed 12<sup>th</sup> November 2016.

<sup>14</sup> There is a study suggest that the housing finance markets in the countries in Middle East and North Africa Countries (MENA) are lack of developments due to the large population of these countries are Muslims an considered under *Shari'ah* law which considers lending through mortgages as repellent, for more inf4roamtion about this study see; A Sanders, 'Barriers to homeownership and housing quality: The impact of the international mortgage market'(2005) 14 *Journal of Housing Economics*147.

housing finance market. Also, it must be noted that the thesis uses the housing finance market as a synonym for the mortgage market. The reason for using this name (the housing finance market) is that the Saudi legislator gave this name to the housing finance laws 2012, instead of calling the measure the mortgage laws. So whenever the mortgage market is mentioned in this research, reference is made, primarily, to the housing finance market and vice versa.

### **1.3 Outline of the thesis**

In order to achieve the objectives stated above, and to address the issues and answer the questions involved, the thesis has been divided into seven chapters, each one discussing and examining a discrete issue. Leaving the introductory chapter to one side the subsequent chapters proceed as follows.

#### **Chapter Two:**

Chapter Two discusses the development of the housing finance market in Saudi, its history, sources, and the challenges it presents. In this chapter two questions provide the central focus of the discussion, namely; what initiatives and proposals have been adopted to develop the housing finance market? And; what barriers to this development remained unaddressed? The aim of these questions is to conduct a review of the initiatives, whether implemented by the government or legislative authority, that have been adopted in response to the underdevelopment of the housing finance market and consequent low rates of homeownership in Saudi. In addition, the chapter aims to identify those barriers to the development of the housing finance market that remained unaddressed.

#### **Chapter Three:**

Chapter 3 purports to analyse the decision of the Supreme Judicial Council (SJC), issued on 26<sup>th</sup> August 1981, which stated that all *Sharia* authorities, including courts and notaries public, should not implement mortgage documentation for loans provided by conventional banks in Saudi because those loans are usurious and thus are not *Sharia*-compliant.<sup>15</sup> It could be argued that the SJC's decision is hindering the development of

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<sup>15</sup> F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 93.



the housing finance market by depriving lenders and borrowers of mortgage security. The chapter will consider whether or not the provisions of the housing finance laws 2012 are able to supersede that decision. This question can be explored through conceptualizing the SJC's decision, in order to determine whether it should be considered from a legal, administrative or judicial standpoint, or some combination thereof. The chapter will then conclude by proposing an alternative solution that may assist in bridging the gap produced by the decision.

#### **Chapter Four:**

This chapter will discuss the Land Fees Law (LFL) 2016 which was enacted to address land prices as presented by the official statement. Although the LFL 2016 was enacted to address land prices in Saudi, it seems the law is incomplete, as there remains an enduring lack of clarity regarding the primary aim of the law. The chapter is designed to discuss whether or not the purpose of the LFL 2016 is consistent with existing research regarding land taxation and its possible impact on land prices.

In order to properly examine and analyse the LFL 2016 two questions must be answered: firstly, whether levying tax on land, imposed by the LFL, tends to precipitate either a decrease in the market value of land or an increase in its supply? And secondly: what are the legal concerns emerging from the wording of the LFL 2016? In fact, there are two such concerns, one pertaining to the lack of fairness and equity, and the other pertaining to the possible overlap between liabilities resulting from the LFL 2016 and obligations stemming from *zakah*, an Islamic instrument which is considered similar to tax. The chapter will discuss these concerns and attempt to answer these questions.

#### **Chapter Five:**

This chapter deals with the capping of the LTV ratio at 70%, as stated by article (12) of the RREFL, and the manner in which this measure has prevented a vast segment of prospective homebuyers from gaining access to the housing finance market. The LTV ratio is usually given as “the ratio of the borrower's loan amount to the collateral value assessed by the case financial institution”.<sup>16</sup> For instance; if a borrower desires to buy a property costing £100,000, and makes a deposit of £15,000 to secure the remaining

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<sup>16</sup> T Lin, L Chia-Chi and C Chun-Hung, ‘Impacts of the borrower's attributes, loan contract contents, and collateral characteristics on mortgage loan default’ (2011) 31 The Service Industries Journal 1385,1392.

£85,000 to finance the purchase, the down payment equals 15% while the LTV will be 85%. Accordingly, it could be argued that article (12) conflicts with the main aim of enacting the housing finance laws 2012, namely to facilitate access to housing finance, a point which raises concern about the regulatory framework that governs the housing finance market. Thus, to avoid such conflict, the chapter seeks to develop the regulatory framework for regulating the housing finance market in general and for adopting the macro-prudential policy, of which the Loan-to-value (LTV) is one element, in particular. Also, the chapter aims to answer this question: how can the adverse impact on the housing finance market of applying the LTV be mitigated?

### **Chapter Six**

Chapter Six focuses on the need to set up a securitisation market in Saudi that would provide a workable and cheap solution to the liquidity shortage in order to develop the housing finance market. Although the chapter identifies a need to launch such a market in Saudi to help address the housing finance deficit, any such move would urgently require legal reform.

The chapter, therefore, seeks to answer two questions which will be central to its discussion. Why does Saudi need to launch a securitisation market in the context of the development of the housing finance market? If indeed it does, is there a consequent need to reform the housing finance laws 2012 so as to build up a well-developed securitisation market?

### **Chapter Seven:**

Building upon the above analysis and discussion, the chapter draws together the threads and reminds the reader why the four aspects of housing finance remain unaddressed and why the research findings of this thesis are likely to address them, and in so doing to realise the main objectives set out at the beginning of this thesis.

## **1.4 Research Significance**

The principal motives behind the adoption of this subject matter are as follows. Firstly, the development of housing finance in Saudi has not been satisfactorily discussed from a legal perspective, as it is more often approached from an economic perspective, which makes this thesis unique in the field. Furthermore, existing research in this area directed

towards the housing sector in Saudi is focused on public housing finance, rather than the private sector.<sup>17</sup> Most studies were conducted during the first era of housing shortages, in the late 1970s and 1990s,<sup>18</sup> while this thesis will mainly focus on developing the housing finance market to achieve many goals that will enable the private sector to flourish.

Secondly, the Saudi government has shown its desire to clear the way for the financial sector, including banks and financial institutions, to play a leading role in the provision of housing finance lending and in mitigating public pressure for reform. However, this can only be achieved if conditions are optimal; this thesis thus seeks to assist in creating a healthy environment through addressing those obstacles to the further development of this sector. In particular, in the wake of the collapse of oil prices, the Saudi government adopted the so-called Saudi Vision 2030,<sup>19</sup> which explicitly signals the government's intention to pave the way for the private sector to perform many functions formerly the preserve of government.

Thirdly, this research presents a comprehensive study analysing and discussing the possible factors that contribute in hindering the development of the housing finance market, and attempts to propose solutions compliant with the general principles of both the Saudi legal system and Islamic law, drawing inspiration from the successful experiences of other jurisdictions.

Fourthly, this research is significant for those countries possessing a dual banking system, comprised of both conventional and Islamic banking, as this thesis advances a new collateral security structure that is "compliant" with the general principles of Islamic Law while granting the desired protection to all market participants, as is seen in Chapter Three.

Finally, the thesis should be of interest to the Saudi government, as it highlights defects arising from prior attempts to address housing shortages, which unfortunately did not

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<sup>17</sup> R Aldakheel, 'Residents' satisfaction with public housing: the case of Buraidah public housing development in Saudi Arabia' (PhD thesis, University of Michigan 1995); S Al-Tasan, 'An Evaluation of Housing Finance in Saudi Arabia: The Real Estate Development Fund's Policies and Alternative Options' (PhD thesis, University of Durham 1998) & S Al-Hathloul and E Narayanan, 'Housing stock management issues in the Kingdom of Saudi Arabia' (1992) 7 *Housing Studies* 268.

<sup>18</sup> Chapter Two sheds lights on the first era of housing shortage occurred in Saudi during the period 1970s and 1980s.

<sup>19</sup> For further information about Saudi Vision2030 visit: Saudi Vision, 'A Developed Digital Infrastructure' ([vision2030.gov.sa](http://vision2030.gov.sa), April 2016) < <http://vision2030.gov.sa/en> > accessed 20<sup>th</sup> November 2016.

meet with success. The proposal suggested in chapter Five may be of particular assistance in this respect.

## 1.5 Methodology

It is crucial to note that Saudi Arabia, not being a common-law jurisdiction, has no referable case law from which to infer the likely outcomes of future cases, or to explicate the judicial reasoning in such decisions. The principle of *stare decisis* does not form part of the Saudi legal system; therefore, courts are not bound by previous cases.<sup>20</sup> Instead, Islamic law, legislations, regulations, royal decrees and royal orders, represent the main sources of the legal system in Saudi.<sup>21</sup>

This thesis adopts several methods – doctrinal, theoretical, and contextual – to achieve the above aims and to answer the above questions. The doctrinal method<sup>22</sup> used by the thesis will involve an examination of the existing legislations, regulations and statutes related to the housing finance market. The principal focus will be on the housing finance laws of 2012, the Land Fees Law 2016, and other relevant Saudi laws and regulations affecting the development of the housing finance market. All are reviewed in order both to enrich the content of the thesis and to establish a strong foundation on which to propose possible avenues of reform.

Also, the thesis uses the theoretical method<sup>23</sup> to investigate how the theories of taxation, security and securitisation could be complemented with the philosophy of Islamic law and the Saudi legal system.

In addition, the methodology in some parts of the thesis can be considered as contextual, as the thesis examines the law within its social and economic context. The aim is therefore to place the legal infrastructure necessary for reform of the housing finance market in its

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<sup>20</sup> M McMillen, 'Rahn Concepts in Saudi Arabia: Formalization and a Registration and Prioritization System' (*papers.ssrn.com*, 31 August 2010) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1670104](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670104)> accessed 20<sup>th</sup> November 2016 & A Baamir and I Bantekas, 'Saudi law as lex arbitri: Evaluation of Saudi arbitration law and judicial practice' (2009) 25 *Arbitration International* 239.

<sup>21</sup> F Al-Fadhel, 'Legislative Drafting and Law-Making Practices and Procedures under Saudi Arabian Law: A Brief Overview' (2012) 1 *IJDLR* 95.

<sup>22</sup> For further information about doctrinal methodology see: T Hutchinson and N Duncan, 'Defining and describing what we do: Doctrinal legal research' (2012) 17 *Deakin L. Rev* 83.

<sup>23</sup> M Dubber, 'Critical Analysis of Law: Interdisciplinary, Contextuality, and the Future of Legal Studies' (*individual.utoronto.ca*, June 2012) <<http://individual.utoronto.ca/dubber/CAL.pdf>> accessed 25<sup>th</sup> November 2016.

proper social, economic and policy-making context to provide a comprehensive study that, it is hoped, will contribute to its further development.<sup>24</sup>

As the thesis is a doctrinal study, it draws from all available sources, including electronic resources and archiving services, such as Westlaw, LexisNexis, Hein Online and Google Scholar, together with libraries and academic collections in the UK, such as the British Library, Cambridge University Library, Oxford University Library, and Leeds University Library, etc.

It is necessary to use the descriptive method in some parts of the thesis, especially Chapter Two, to establish the essential concept of the development of housing finance in Saudi. This method provides the background of the legislative authority and government in Saudi that is needed to understand the development of the housing finance market and the barriers hindering this development. The thesis further uses the critical analysis method in its remaining sections, as these sections deal with controversial issues surrounding the development of housing finance, thus indicating a path towards addressing the barriers hindering this development.

In fact, the combination of these methods is deemed the most suitable approach with which to achieve the research objectives. As has been argued, conducting a critical study without a basis in analytical data would lead to baseless results, while conducting an analytical study without a critique is pointless.<sup>25</sup>

Although the research will only focus on the situation within Saudi Arabia, it attempts to draw on other jurisdictions' experiences and thus learn some lessons. The choice of this approach is derived from the belief that Saudi's lack of experience in this field makes it necessary to learn from those jurisdictions that have wide experience in it. For example, in Chapter Five, the thesis draws on the UK's experience of procedures implemented before the adoption of the macro-prudential policy, including the LTV, which reveals both adequate preparation and strong cooperation between financial authorities. In addition, the thesis attempts to benefit from Hong Kong's experience, stretching back to

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<sup>24</sup> For further information about the contextual approach that used by law studies see for example: D Nelken, *Beyond law in context* (Ashgate Publishing limited 2009) 29; R Folsom and N Roberts, 'The Warwick Story: Being Led Down the Contextual Path of the Law' 30 *J. Legal Educ.* 166 & R Nazzini, 'Administrative enforcement, judicial review and fundamental rights in EU competition law: A comparative contextual-functional perspective' (2012) 49 *Common Market Law Review* 971.

<sup>25</sup> M Dubber, 'Critical Analysis of Law: Interdisciplinary, Contextuality, and the Future of Legal Studies' (*individual.utoronto.ca*, June 2012) <<http://individual.utoronto.ca/dubber/CAL.pdf>> accessed 25th November 2016.

the 1990s, of addressing the adverse impact of the LTV by creating a mechanism for mitigating it.

In addition, the thesis seeks, in Chapter Six, to draw on the wide experience of the US in developing its own housing finance market and increasing the homeownership rate through establishing and developing the securitisation market. There were clear indicators by the Saudi legislator that the housing finance laws 2012 were inspired by the American experience of establishing a legal basis for the securitisation market. Those indicators were recently confirmed by the Saudi government when it declared its intention to establish a partnership between the Public Investment Fund (PIF), which is owned by the Saudi government, and the Boston Consulting Group, to help design a government-owned entity similar to America's Fannie Mae and Freddie Mac, with the purpose of developing a housing finance market.<sup>26</sup>

The research has, however, met with certain difficulties and obstacles. First of all, the topic of housing finance market in the Saudi context has not been widely studied.<sup>27</sup> Similarly, and partly as a consequence, there are a lack of resources related to certain aspects of the thesis, such as housing finance and legal studies in the Saudi context. In addition, as noted above, judicial precedents are not reported or published in Saudi, resulting in a dearth of case law.

It is worth mentioning that the barriers selected for consideration in this research are not the only challenges that the development of the housing finance market faces in Saudi. Legal challenges can be found in every aspect of this field, for example in the lack of regulations and in dispute settlement, among other issues. However, the constraints of a doctoral research project forced the researcher to limit the scope of this thesis to those barriers considered major hindrances to the development of the housing finance market because of their importance, and the researcher hopes that the study will encourage further academic research into and discussion of any topic arising from and pertaining to these issues.

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<sup>26</sup>Z Fattah, S Bianchi and D Almashabi, 'Saudi Arabia Said to Plan Fannie Mae-Style Mortgage Company' *Bloomberg* (New York City, 18<sup>th</sup> November 2015) <<http://www.bloomberg.com/news/articles/2015-11-18/saudi-arabia-said-to-plan-fannie-mae-style-mortgage-company>> accessed 12<sup>th</sup> November 2016.

<sup>27</sup> For example the following researches covered the housing finance in Saudi filed: R Aldakheel, 'Residents' satisfaction with public housing: the case of Buraidah public housing development in Saudi Arabia' (PhD thesis, University of Michigan 1995); S Al-Tasan, 'An Evaluation of Housing Finance in Saudi Arabia: The Real Estate Development Fund's Policies and Alternative Options' (PhD thesis, University of Durham 1998); S Al-Hathloul and E Narayanan, 'Housing stock management issues in the Kingdom of Saudi Arabia' (1992) 7 *Housing Studies* 268.

Finally, it must be noted that the data and findings of this thesis show the position of the topic from October 2012, when the thesis began, until November 2016, when the research was concluded.

## **Chapter Two: The development of the housing finance market in Saudi Arabia – history, origins and challenges**

### **2.1 Introduction**

This chapter will answer two questions: (1) what have been the initiatives adopted by the Saudi government in developing the housing finance market, and (2) what barriers to developing that housing finance market remain unaddressed?

The aim of these questions is to conduct a review of the initiatives, whether governmental or legislative, that have been adopted to address the lack of development in the housing finance market and the knock-on effect of reduced home ownership in Saudi Arabia and to determine those aspects believed to hamper efforts to develop the housing finance market for further analysis. The objectives of this chapter are: to highlight the main initiatives adopted by the government and legislative authority to develop the housing finance market; and to prove that, despite significant governmental and legislative initiatives to develop that market, there are four aspects that remain unaddressed and need further examination and study.

The chapter, therefore, has been divided into the following sections: (2.1) introduction; (2.2) an exposition highlighting the historical background of the development of the housing finance market in Saudi Arabia with focusing on the first phase of the housing crisis, followed by a discussion in (2.2.1) of factors contributing to the second, current, housing crisis in Saudi Arabia. This section in turn can be classified into (i) the decline in governmental contributions to the Saudi housing sector; and (ii) changes in demographics and demands in Saudi Arabia. Section three (2.3) will discuss the housing finance shortage crisis in KSA and sources of housing finance in the country. The fourth section (2.4) reviews governmental intervention and legislative initiatives to develop the housing finance market in KSA. Section five (2.5) identifies the barriers to development of the housing finance market, which are: (i) lack of protection for lenders as potentially undermining the development of a housing finance market; (ii) increased land prices and their negative role in housing finance; (iii) capping of the Loan to Value (LTV) at low levels, with the lack of cooperation in the housing finance market as a potential source of unpredictable results; and finally (iv) challenges in developing the housing finance market through securitisation of the market to remedy the liquidity shortage. The final



section of this chapter (2.6) is the conclusion, which summarises and analyses the key matters addressed throughout the chapter.

## **2.2 Historical background to the development of the housing finance market in Saudi Arabia**

The development of a housing finance market in Saudi Arabia began in the 1970s when the Kingdom experienced rapid economic expansion as a result of the oil price boom during that same decade, which continued well into the mid-1980s: government expenditure was \$14 billion during the period 1970-1975, increasing to 1985-90 to \$322 billion.<sup>1</sup> This economic boom was felt in the Saudi economy - the real estate and construction sectors saw a period of rapid growth. However, the consequent decline in employment in rural areas forced many Saudi citizens to move to larger cities in search of employment. The urban housing infrastructure in Saudi Arabia during this period was not prepared to accommodate such a significant increase in people; the limited number of dwellings caused an acute housing shortage,<sup>2</sup> which led to an increase in real estate prices, which in turn increased the cost of living for citizens and made it difficult for middle and lower income citizens to access the housing ladder.<sup>3</sup> This first phase may be considered to be the first housing crisis in Saudi Arabia (the second and on-going housing crisis, which will be examined later on, began in the late 1990s).

In responding to the significant demand for housing, the Saudi government has adopted policies designed to develop the housing finance market and to improve housing infrastructure, comprised of three steps: firstly, a consideration of the government's aims and objectives in addressing the housing issue; secondly, the establishment of a government agency to supervise and regulate the housing market; and finally, creating a

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<sup>1</sup> S Al-Hathloul and E Narayanan, 'Housing stock management issues in the Kingdom of Saudi Arabia' (1992) 7 *Housing Studies* 268 & A Al-Meer, 'Organizational commitment: A comparison of Westerners, Asians, and Saudis' (1989) 19 *International Studies of Management & Organization* 74.

<sup>2</sup> S Al-Tasan, 'An Evaluation of Housing Finance in Saudi Arabia: The Real Estate Development Fund's Policies and Alternative Options' (PhD thesis, University of Durham 1998).

<sup>3</sup> T Fadaak, 'Urban housing policy evaluation in the Kingdom of Saudi Arabia' (PhD thesis, Portland State University 1984).

government agency to act as financier in providing Saudi citizens with interest-free loans.<sup>4</sup>

The first policy is represented in the so-called Five Year Plan ('FYP'),<sup>5</sup> the function of which being to primarily develop an economic and social development policy for Saudi society<sup>6</sup>. The FYP aimed among many aims and goals to raise the living standards of Saudi citizens and provide them with a welfare system. General housing objectives and a required numbers of dwellings / housing units were incorporated in the FYP.<sup>7</sup> It was believed that the FYP eased the Saudi government's task of determining the budget required to finance housing projects in order to reduce the housing shortage. This objective was to be achieved by allocating the required budget to fund such projects, developing human resources to supervise the projects and regulating the aspects of this sector in order to ensure they would be compatible with the overall objectives of the FYP. Under pressure to increase housing stock, the Saudi government sought to establish an entity functioning as both supervisor and regulator in the housing sector and implementing the government's housing policies and programmes. This step was the second policy adopted by the Saudi government, which in May 1975 established the General Housing Department. Given its own ambitious plans to address the housing crisis, the government decided to transform the Department to become the Ministry of Public Works and Housing ('MPWH'), which was tasked with the duty of implementing the government's policies and goals set out in the FYP.<sup>8</sup>

The creation of the MPWH was significant not only because of its role as both supervisor and regulator for the housing sector, but also for its efforts in contributing towards the construction of many housing projects around the Kingdom. Two massive projects known as 'Rush Housing' were spearheaded by the MPWH (and which had the long-term

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<sup>4</sup> Y Eshmawi, 'Policy and development: the impact of growth on urban housing in Saudi Arabia-towards a solution for the low-income' (PhD thesis Massachusetts Institute of Technology 1983).

<sup>5</sup> The first plan was prepared and submitted to King Faisal in August 1970; for more information see; M Nehme, 'Saudi development plans between capitalist and Islamic values'(1994)30 Middle Eastern Studies 632.

<sup>6</sup> R Looney, 'Socio-economic tradeoffs in Saudi Arabia's third five year plan (1980-1985)'(1986) 20 Socio-Economic Planning Sciences 181.

<sup>7</sup> Aldakheel R, 'Residents' satisfaction with public housing: the case of Buraidah public housing development in Saudi Arabia' (PhD thesis, University of Michigan 1995).

<sup>8</sup> F Farsy, *Modernity and tradition: the Saudi equation* (Routledge 1990) 15.

objective of being sold to residents),<sup>9</sup> one of which comprised of 4,752 units based on the three main cities in Saudi Arabia,<sup>10</sup> and the other 14,686 apartments and 9,854 villas, which was spread out across various cities across the Kingdom.

The third and final policy adopted by the Saudi government was to establish a government-owned body that would act as a specialised financing institution. The Ministry of Finance and National Economy ('MFNE') thus established the Real Estate Development Fund ('REDF'), which had the aim of funding the construction of affordable homes, with long-term free-interest loans, for Saudi citizens.<sup>11</sup> The REDF started its operations with a modest authorised capital SR 250 million (approximately \$66,650,000),<sup>12</sup> which of course could not be expected to make a huge difference to the housing finance market. The Saudi government soon realised that the REDF would not be able to make as large a contribution to the housing finance market as originally anticipated, and in response the Saudi government took initiatives to increase capital by 1995 to SR 74 billion (approximately \$195,000,000,00).<sup>13</sup>

The REDF's target demographic was Saudi nationals in low and middle income brackets where eligible applicants<sup>14</sup> could be granted up to 70 per cent of the estimated cost of the property, up to a maximum of SR 300,000 (approximately \$80,000), with a once in a lifetime loan facility. Eligibility was to be determined by the borrower's age, marital status, gender and home ownership status besides granting loan provided to own land to build upon based on the REDF's law.<sup>15</sup>

The above initiatives, coupled with oil wealth caused by the boom in oil prices during the 1970s and early 1980s, therefore helped kick-start the housing finance market, produce new and affordable housing and helped the Saudi government overcome the housing

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<sup>9</sup> A Al-Mayouf and A Al-Khayyal, 'Provision of Public Housing in Saudi Arabia: Past, Current and Future Trends' (2011) 23 Arch. & Planning journal 59.

<sup>10</sup> F Mubarak, 'Cultural adaptation to housing needs: a case study, Riyadh, Saudi Arabia' (IAHS Conference Proceedings, 1999).

<sup>11</sup> S Al-Tasan, 'An Evaluation of Housing Finance in Saudi Arabia: The Real Estate Development Fund's Policies and Alternative Options' (PhD thesis, University of Durham 1998).

<sup>12</sup> For more information on the REDF's history see: A Al-Saati, 'Residents' satisfaction in subsidized housing: an evaluation study of the Real Estate Development Fund Program in Saudi Arabia' (PhD thesis, University of Michigan 1987).

<sup>13</sup> R Al Mallakh, *Saudi Arabia: Rush to Development* (Routledge 2015) 170.

<sup>14</sup> S Al-Hathloul and M Mughal, 'Urban growth management-the Saudi experience' (2004) 28 Habitat International 609.

<sup>15</sup> The REDF law was enacted by the Royal decree (M/23) 1974.

crisis caused by urban migration and urbanisation.<sup>16</sup> This was reflected in the second and third years of the FYP,<sup>17</sup> indicating that the early achievements within the housing sector (both in respect of construction and ownership) were thanks to the government as opposed to the private sector, which contributed nothing at all. The high rate vacancy in housing units in the wake of third FYP has led to the excess overall housing supply and in turn a significant decrease in real estate value.<sup>18</sup> Despite the government's success in resolving the first era of the housing shortage, a second housing shortage occurred in Saudi Arabia in the late 1990s and continued up to the present, representing a significant challenge for the government and public alike. What are the reasons for this second housing shortage?

### **2.2.1 Contributory factors towards the second, current, housing crisis in Saudi Arabia**

#### **i. The decline of governmental contribution towards the Saudi housing sector**

After the 1990s, the Saudi government's contribution towards the housing sector declined and the number of housing units built by the REDF decreased, dropping below FYP predictions. The decrease in the number of housing units built with REDF assistance can be attributed to a freeze in government subsidies towards the REDF. The last government attempt to increase authorised capital of the REDF was in 1995, when the government increased it from over SAR 74 billion, as mentioned above. Due to the absence of any significant increase in authorised capital, the construction of housing inevitably stagnated. The government's decision to freeze or reduce its input in the housing sector was particularly noticeable during the reign of King Fahd, former king of Saudi Arabia between 1982 and 2005, who issued a royal order to abolish the MPWH and transfer its undertakings to the Ministry of Municipal and Rural Affairs ('MMRA'). This unprecedented move was due to austerity policies that were partly aimed at reducing or

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<sup>16</sup> F Mubarak, 'Cultural adaptation to housing needs: a case study, Riyadh, Saudi Arabia' (IAHS Conference Proceedings, 1999).

<sup>17</sup> A Al-Meer, 'Organizational commitment: A comparison of Westerners, Asians, and Saudis' (1989) *International Studies of Management & Organization* 74.

<sup>18</sup> S Al-Hathloul and E Narayanan, 'Housing stock management issues in the Kingdom of Saudi Arabia' (1992) *Housing Studies* 268.

altogether stopping the injection of capital into the housing sector, although abolishing the regulatory and supervisory body was questionable.<sup>19</sup>

In regards to the REDF, the decline in governmental subsidies naturally caused its operations to dwindle and reflect the decline in the housing finance market. For example, during the 1970s, a total of 47,063 loans were provided, compared to 23,340 during the 1990s.

The austerity measures imposed by the Saudi government may be attributed to either of two factors: the first being the significant cutback in Saudi Arabia's financial surplus caused by falling oil prices in the mid-1980s,<sup>20</sup> which led to an economic depression and forced the government to change its priorities, which was then followed by the economic consequences of the First Gulf War,<sup>21</sup> which is estimated to have cost the region \$676 billion<sup>22</sup> and the Saudi economy a post-war debt of SAR 664 billion.<sup>23</sup> The second possibility is the belief that the excess housing supply rendered housing stocks sufficient, causing the Saudi government to focus its efforts, investment and resources elsewhere. The Saudi government thus played an indirect role in the housing sector during the fourth and fifth plans due to the over-supply.

The government's strategy was evident in the fourth plan when the housing sector witnessed a high rate in the number of vacant housing units, reflecting the policy adopted by the government. However, the demand for new housing grew rapidly from 1988 onwards,<sup>24</sup> due to population growth owed in part to the increased number of foreign workers.

## **ii. Changes in demographics and demands in Saudi Arabia**

Saudi Arabia is considered to be the most densely populated country in the Gulf Cooperation Council ('GCC'), with its population increasing from just under 4 million in

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<sup>19</sup>F Mubarak, 'Cultural adaptation to housing needs: a case study, Riyadh, Saudi Arabia' (IAHS Conference Proceedings, 1999).

<sup>20</sup>R Barsky and K Lutz, 'Oil and the Macroeconomy since the 1970s' (2004) 18 *The Journal of Economic Perspectives* 115.

<sup>21</sup>F Halliday, 'The Gulf War and its aftermath: first reflections' (1991) *International Affairs* 223.

<sup>22</sup>Y Ibrahim, 'Gulf War Is Said to Have Cost the Region \$676 Billion in 1990-91' *The New York Times* (New York City, 25<sup>th</sup> April 1993) <<http://www.nytimes.com/1993/04/25/world/gulf-war-is-said-to-have-cost-the-region-676-billion-in-1990-91.html>> accessed 12<sup>th</sup> November 2016.

<sup>23</sup>S AbuShahin, 'Could the general debt heading a crisis' *Makkah* (25 December 2014) <<http://makkahnewspaper.com/article/3334/Makkah/-->> accessed 13<sup>th</sup> November 2016.

<sup>24</sup>S Tuncalp and A Al-Ibrahim, 'Housing finance in Saudi Arabia' (1990) 14 *Habitat International* 111.

1960<sup>25</sup> to over 31 million in 2016.<sup>26</sup> The significant growth in occurred most prominently during the period 1970-1994 when official censuses were conducted by the government and the population sizes were found to be over 7 million and 16.95 million respectively- a 141 per cent increase.<sup>27</sup> By comparison with the global population, the Saudi population rate grew by 2.9 per cent between 2003 and 2009, whereas the global population grew by 1.3 per cent.<sup>28</sup> It is expected that the population growth of Saudi Arabia will continue but at a slower pace,<sup>29</sup> and is expected to reach 38.5 million by 2030.<sup>30</sup>

This demographic change<sup>31</sup> has had a negative impact on the housing sector by putting great pressure on a sector that was already unprepared to accommodate so many additional people – an increase in population naturally leads to a rise in the demand for housing, especially in the main large cities, Riyadh, Dammam and Jeddah, which acquired the vast majority of the population for many reasons, as will be shown later.<sup>32</sup> However, Saudi Arabia was experiencing an increased shortage in housing stock, a sharp decrease in home ownership due to population growth and a decline in governmental contribution towards the housing sector.

The demographic change in Saudi Arabia has coincided with a new pattern of lifestyle changes adopted by Saudis for various purposes, and generating a new demand for

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<sup>25</sup> M Nehme, 'Saudi development plans between capitalist and Islamic values'(1994) 30 Middle Eastern Studies 632.

<sup>26</sup>General authority for statistics, 'Statistical Sector' (*stats.gov.sa*, 21 July 2016)<<http://www.stats.gov.sa/en/%D8%B5%D9%81%D8%AD%D8%A9/statistical-sector>> accessed 13<sup>th</sup> November 2016.

<sup>27</sup> A Al-Mayouf and A Al-Khayyal, 'Provision of Public Housing in Saudi Arabia: Past, Current and Future Trends'(2011) 23 Arch. & Planning journal 59.

<sup>28</sup> A Alfouzan, 'Analyzing the Factors that Lead to Housing and Construction Cost Escalation: A Case Study Focused on Riyadh, Saudi Arabia' (Master's Thesis, Western Kentucky University 2013).

<sup>29</sup> A Alghamdi, 'The Housing Cycle Theory with Regard to Housing Development in Saudi Arabia'(1995) 59 JKAU: Eng. Sci. 1.

<sup>30</sup> According to official statistics from General authority for statistics, for further information see: General authority for statistics, 'Statistic and information sector in Saudi Arabia' (*stast.gov.sa*, 21<sup>st</sup> July 2016)<<http://www.stats.gov.sa/en/%D8%B5%D9%81%D8%AD%D8%A9/statistical-sector>> accessed 14<sup>th</sup> November 2016.

<sup>31</sup> For further discussion and examination about the demographic change see; M Ramady, *The Saudi Arabian economy: Policies, achievements, and challenges*( Second edition, Springer Science & Business Media 2010) 352.

<sup>32</sup> The population in the largest cities in 1992, for example, Riyadh, Jeddah and Dammam constitutes 59,3% of the whole population in Saudi, for more information see; General authority of statistics, 'The General Population and Housing Census' (*cdsi.gov.sa*, 19<sup>th</sup> May 2016)< <http://www.stats.gov.sa/en/indicators/1>> accessed 24<sup>th</sup> November 2016.

housing. For instance, in the 1980s and 1990s there were seven universities<sup>33</sup> in the main large cities in KSA: Riyadh, Jeddah, Dammam, Abha, Makkah and Madinah, which led many young Saudis who wished to pursue higher education to leave their families to study at those universities. This move of course put great pressure on the housing sector in these cities, particularly as some of these students, who were married, took their wives and children with them; of course a big family requires spacious accommodation. In addition, many young professionals are leaving their parents in search of better paid jobs in the big Saudi cities which offer more opportunities than small cities; and such a move also requires the establishment of a new household, creating fresh demand for housing in these cities.<sup>34</sup> Both trends have created a new source of housing demand, putting more pressure on a sector that is not prepared to meet additional demand.

The above has been accompanied by another factor, namely an increase in wages, which has exacerbated the situation.<sup>35</sup> For example, between 1975 and 1980 the average income per capita of a Saudi working male increased from SAR 18,002 (\$4,800) to SAR 30,754 (\$8,200).<sup>36</sup> More recently, the average per capita income increased from SAR 40,705 (\$10,853) in 2004 to SAR 94,275 (\$25,136) in 2012.<sup>37</sup> It can be argued that the increase in average incomes should have helped people own homes or at least enable them to obtain home purchase loans from public or private financial institutions. However, there is a link between the increase in average income and house prices.<sup>38</sup> As studies have revealed, in many countries around the world, increases in average incomes only increase house prices.<sup>39</sup> Thus rather than allowing Saudi citizens purchase homes, increased salaries have increased property prices and in turn led to difficulty in buying houses in the Kingdom.

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<sup>33</sup> For further information about the higher education in Saudi and its development see; M Alamri, 'Higher education in Saudi Arabia' (2011) 11 *Journal of Higher Education Theory and Practice* 88.

<sup>34</sup> S Tuncalp and A Al-Ibrahim, 'Housing finance in Saudi Arabia' (1990)14 *Habitat International* 111.

<sup>35</sup> A Alghamdi, 'The Housing Cycle Theory with Regard to Housing Development in Saudi Arabia'(1995)59 *JKAU: Eng. Sci.* 1.

<sup>36</sup> S Tuncalp and A Al-Ibrahim, 'Housing finance in Saudi Arabia' (1990)14 *Habitat International* 111.

<sup>37</sup> World Bank, 'GDP per capita (current US\$)'(*data.worldbank.org*, August 2015)<<http://data.worldbank.org/indicator/NY.GDP.PCAP.CD/countries/SA?display=graph>> accessed 20<sup>th</sup> November 2016.

<sup>38</sup> A Reichert, 'The impact of interest rates, income, and employment upon regional housing prices' (1990) *The Journal of Real Estate Finance and Economics* 373.

<sup>39</sup> D Hongyan, Y Ma and Y An, 'The impact of land policy on the relation between housing and land prices: Evidence from China'(2011) 51 *The Quarterly Review of Economics and Finance* 19.

The consequence of such growth population is represented in the acute shortage in housing, and the inability of the public sector (embodied in REDF) to cater for the huge demand for housing finance. For example, the number of REDF loan applications during the period 1975-1994 was 598,850 whereas the number of REDF loan applications submitted during the period 2011-2015 and whilst remaining on the waiting list as more than 1.7 million.<sup>40</sup> The long waiting list is a reflection of the absence of a housing finance market able to improve and develop itself in order to cater a huge demand for housing finance. This raises the question: is the REDF the only housing finance provider and, if so, does the Saudi market require other such market players? Furthermore, to what extent has such a modest role played by housing finance providers contributed towards the housing shortage in the Kingdom?

### **2.3 The housing shortage crisis in Saudi Arabia, and sources of housing finance in Saudi Arabia**

Broadly speaking, in Saudi Arabia wealthy families have the ability to help their children either by providing a home as a gift or financially assisting them in purchasing a helping them purchase a home. Middle and working class families, however, find purchasing a property more difficult due to heavy reliance upon savings and lending. It follows, however, that if middle and working class families have to save up for the entire purchase of a property then most of them would be excluded from homeownership.<sup>41</sup> The second option for people is to therefore resort to lenders in order to gain the desired housing finance and thereby enable them to purchase a property. However, has the housing finance market been able to cater for such demand?

Housing finance in Saudi Arabia is available in the public and private sectors. As mentioned above, the public sector is represented by the REDF, considered to be the main housing finance provider in the Kingdom.<sup>42</sup> Since 1974, when it was established by the

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<sup>40</sup> K Khan, 'Saudi Mortgage Law' (*alrajhi-capital.com*, 1 March 2013) <[http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law\\_Mar%202013\\_Final.pdf](http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf)> accessed 25<sup>th</sup> November 2016.

<sup>41</sup>J Gelfand, 'Mortgage credit and lower-middle income housing demand'(1970)46 *Land Economics* 163.

<sup>42</sup> O Nassier, 'Contribution and achievements of a national development organization in meeting the planning goals: the Saudi Real Estate Development Fund' ( PhD thesis, University of La Verne 1992).



government, the REDF has provided interest-free loans for the lower and middle income buyers, with repayment periods typically around 25 years, comprised of monthly instalments equivalent to SAR 1,667 (\$445).<sup>43</sup> The REDF typically provides loans equivalent to SAR 500,000 (\$133,330); however, it does not disburse the loan in a lump sum but in four instalments.<sup>44</sup> The purpose of the REDF loan is to help Saudi citizens build their own private homes<sup>45</sup> or to purchase a ready-built home instead.<sup>46</sup> Therefore, these loans become the preferred option for Saudis for funding property purchases. However, due to the limited capital within the REDF and the decline in government subsidies, excess demand has been created for REDF loans, leading to longer waiting times of between 15 and 20 years.<sup>47</sup> Providing free-interest loans could therefore be considered a negative factor in changing the borrowing culture of Saudi Arabia and impacting on the competition principles with the banking sector.

The World Bank, in its annual report about the financial sector in Saudi Arabia, has reiterated this issue, stating that despite the REDF being the main provider of housing finance, with a portfolio of SAR 78 billion (\$20.8 billion), it is unable to cater for the huge demand, with waiting times of up to 18 years, adding that ‘the demand for housing will continue and increase, reflecting the young growing population’.<sup>48</sup> Consequently, more than 1.7 million applicants are still waiting to obtain loans from the fund despite governmental intervention in injecting SAR 43 billion (\$11.5 billion) into the fund, followed by further SAR 14.8 billion (\$3.9 billion) in 2011.<sup>49</sup>

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<sup>43</sup> K Khan, ‘Saudi Mortgage Law’ (*alrajhi-capital.com*, 1 March 2013) < [http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law\\_Mar%202013\\_Final.pdf](http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf)> accessed 6 November 2016.

<sup>44</sup> REDF, ‘The instalments and their dates’ For more information see < [http://www.redf.gov.sa/ar/LoanProcedures/Pages/Private\\_Loans\\_Procedures2.aspx](http://www.redf.gov.sa/ar/LoanProcedures/Pages/Private_Loans_Procedures2.aspx)> accessed 13<sup>th</sup> November 2016.

<sup>45</sup> S Tuncalp and A Al-Ibrahim, ‘Housing finance in Saudi Arabia’ (1990)14 *Habitat International* 111.

<sup>46</sup> The REDF has recently adopted a policy enabling the desired applicant of purchasing a housing provided to some conditions stated by the REDF, for more information about these policies and conditions see: REDF, ‘The fast housing finance loan’ (*redf.gov.sa*, April 2015)<<http://www.redf.gov.sa/ar/Pages/default.aspx>> accessed 12<sup>th</sup> November 2016.

<sup>47</sup> A Aloweid, ‘Residents Opinions toward their Dwellings Built with the Support of the Real Estate Development Fund’ (2012) 6 *Journal of King Abdulaziz University: Environmental Design Sciences* 63.

<sup>48</sup> The World bank, ‘SAUDI ARABIA’ (*worldbank.org*, May 2012)<[http://lnweb90.worldbank.org/FPS/fsapcountrydb.nsf/\(attachmentwebFSA\)/KSA\\_FSAP\\_Update\\_FSA\\_P.pdf/\\$FILE/KSA\\_FSAP\\_Update\\_FSA\\_P.pdf](http://lnweb90.worldbank.org/FPS/fsapcountrydb.nsf/(attachmentwebFSA)/KSA_FSAP_Update_FSA_P.pdf/$FILE/KSA_FSAP_Update_FSA_P.pdf)> accessed 12<sup>th</sup> August 2016.

<sup>49</sup> The above government interventions to boost the REDF’s capital was approved by the royal order no(A/18) dated 24 February 2011.

Long waiting lists is not the only issue, however: REDF loans are also deemed to be insufficient in enabling the borrower to buy a home. The cost of dwellings and houses has been increased over recent years. For example, between 2002 and 2006 house prices increased by 13.7 per cent annually,<sup>50</sup> a total of 68.5 per cent over four years. These increases made the loan provided by the REDF insufficient to buy a home. According to a report published by the *Alrajhi* bank in 2013, an apartment 190 square-metre cost SAR 788,500 (\$210,269)<sup>51</sup>, against an REDF loan of SAR 500,000 Riyal (\$133,333). The inadequacy of the REDF loans therefore posed a problem within the Kingdom.

The second source of housing finance loans is the banking sector, which was officially established in October 1952; its establishment coinciding with the creation of the Saudi Arabian Monetary Agency ('SAMA'), which acts as a central bank.<sup>52</sup> The banking sector consists of eight domestic banks and twelve foreign banks authorised to operate in Saudi Arabia.<sup>53</sup> Both the domestic and the international banks contribute to the Saudi housing finance market, but their role is less prominent than it is thought to be. For example, the SAMBA bank, a domestic bank operating in Saudi Arabia, issued a report entitled 'Saudi Arabia's Housing market structural issue, financing and potential', which highlighted the fact that bank mortgage lending in Saudi Arabia was at very low levels compared with that in neighbouring countries and developed countries alike. The report added that, whilst banks accounted for 6 per cent of Gross domestic product (GDP) in Kuwait, 7 per cent in the United Arab Emirates and over fifty per cent in many other developed countries, they contributed just 3 per cent of GDP in Saudi Arabia.<sup>54</sup> The idea that the role of the banking sector is modest was supported by another international report, namely that of Standard & Poor's, which indicated that as of 2012, the banking sector in Saudi Arabia had contributed to the housing finance market only 5.1 per cent of total banking system

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<sup>50</sup> R Opoku and A Alhassan, 'Housing preferences and attribute importance among low-income consumers in Saudi Arabia' (2010) 34 *Habitat International* 219.

<sup>51</sup> K Khan, 'Saudi Mortgage Law' (*alrajhi-capital.com*, 1 March 2013) < [http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law\\_Mar%202013\\_Final.pdf](http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf)> accessed 6 November 2016.

<sup>52</sup> J Al-Suhamaimi, 'Consolidation, competition, foreign presence and systemic stability in the Saudi banking industry' (2011) Bank for International Settlements Information, Press & Library Services 1.

<sup>53</sup> Saudi Arabian Monetary Agency (SAMA), 'Licensed entities' (*sama.gov.sa*) < <http://www.sama.gov.sa/ar-sa/Finance/Pages/FinancingLicencedEntities.aspx>> accessed 24<sup>th</sup> September 2016.

<sup>54</sup> SAMBA, 'Saudi Arabia's Housing market structural issue, financing and potential' (*samba.com*, December 2010) < [http://www.samba.com.sa/GblDocs/saudi\\_arabia\\_housing\\_market\\_eng.pdf](http://www.samba.com.sa/GblDocs/saudi_arabia_housing_market_eng.pdf)> accessed 21 October 2016.

loans.<sup>55</sup> This compares with the double-digit penetration figures of residential mortgages as a percentage of GDP generally seen in most other G-20 countries, such as about 40% in France or roughly 50% in Germany according to the International Monetary Fund (IMF).<sup>56</sup>

Of course, the consequences of such a modest role played by public and private sectors in the housing finance market is significant due to the homeownership rate, which is often used as a measure of the quality of a country's housing finance market,<sup>57</sup> decreasing sharply below 47 per cent – this is not commensurate with a country that has vast oil reserves and is considered one of the largest oil exporters in the world.<sup>58</sup>

Indeed, the lack of performance of public and private sectors in the housing finance market exacerbated the housing shortage, and made satisfying great housing needs in Saudi Arabia difficult by the government alone. According to estimates of the Ninth FYP, issued in 2007, 1.25 million housing units would be required to meet current demand, whereas the Saudi government's target was to build 950,000 housing units, signifying a deficit of 300,000 housing units.<sup>59</sup> Other studies suggest that demand for housing is expected to rise from 195,000 units in 2011 to 264,000 units in 2020,<sup>60</sup> whereas in 2010 *Al Shoaibi*, head of the Saudi *Shura* Council's Economic Affairs and Energy Committee, has stated that the country would need between 18 million and 20 million homes over the

<sup>55</sup> Standard & Poor's Ratings Services, 'Draft: How will Saudi Arabia's new mortgage law affect domestic banks?' (*trendsmena.com*, 18 February 2013) < <http://trendsmena.com/wp-content/uploads/2013/06/How-Will-Saudi-Arabias-New-Mortgage-law-affect-domestic-banks1.pdf> > accessed 12th November 2016.

<sup>56</sup> Standard & Poor's Ratings Services, 'Draft: How will Saudi Arabia's new mortgage law affect domestic banks?' (*trendsmena.com*, 18 February 2013) < <http://trendsmena.com/wp-content/uploads/2013/06/How-Will-Saudi-Arabias-New-Mortgage-law-affect-domestic-banks1.pdf> > accessed 12th November 2016.

<sup>57</sup> E Roche, 'Loans around the world' (1997)14 *Secondary Mortgage Markets: A Freddie Mac Quarterly* 1.  
<sup>58</sup> *Alarabia*, 'Mohammed bin Salman and 33 titles of Saudi vision2030' (*alarabiya.net*, 25th April 2016) < <http://www.alarabiya.net/ar/programs/special-interview/2016/04/25/-%D9%85%D8%AD%D9%85%D8%AF-%D8%A8%D9%86-%D8%B3%D9%84%D9%85%D8%A7%D9%86-%D9%81%D9%8A-%D8%A3%D9%88%D9%84-%D9%85%D9%82%D8%A7%D8%A8%D9%84%D8%A9-%D8%B9%D9%84%D9%89-%D8%A7%D9%84%D8%B9%D8%B1%D8%A8%D9%8A%D8%A9.html> > accessed 25th November 2016.

<sup>59</sup> K Khan, 'Saudi Mortgage Law' (*alrajhi-capital.com*, 1 March 2013) < [http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law\\_Mar%202013\\_Final.pdf](http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf) > accessed 6th November 2016.

<sup>60</sup> S Alshaik and A Alwazir, 'Saudi housing sector 2012' (*menafn.com*, 2012) < [https://www.menafn.com/updates/research\\_center/Saudi\\_Arabia/Economic/ncb091212.pdf](https://www.menafn.com/updates/research_center/Saudi_Arabia/Economic/ncb091212.pdf) > accessed 25th August 2016.

next ten years.<sup>61</sup> The Saudi government has consequently had to respond to the acute shortage, and has intervened again in developing the housing finance market.

## **2.4 Governmental intervention and legislative initiatives in developing the housing finance market in Saudi Arabia**

Responding to the acute housing shortage in Saudi Arabia, various initiatives were taken. These were targeted at developing a housing finance market for two reasons: to increase the homeownership rate, and to facilitate access to housing finance market. Initiatives have taken the form of government initiatives and legislative initiatives.

Government intervention began in 2007 when the Saudi government<sup>62</sup> established the General Housing Authority ('GHA') to supervise and regulate the housing sector through, for example, designing the country's future housing policies, conducting research and studies relating to the housing sector, and setting up housing projects to increase the rate of homeownership.<sup>63</sup> Nevertheless, the Saudi government realised that the issue of housing exceeded the capacity of GHA, and so a ministry was required.

In 2011, King Abdullah, the former king of KSA 2005-2015, issued a number of royal orders relating to the housing sector. The first order involved changing the GHA to become the Ministry of Housing and granting the required powers to enable it to exercise its function of meeting the expectations of the government and public alike. The second royal order was to allocate SAR 250 billion (\$66,649,800,000) to build around 500,000 new homes.<sup>64</sup>

Aside from the above initiatives, it is widely believed that the REDF's policies played a crucial role in undermining the effectiveness of the Saudi real estate finance market. Therefore, the government's initiatives involved subjecting REDF policies to scrutiny, and finding a strong indication of a need to reform the conditions for owning land due to a pre-requisite of REDF loans being conditional upon owning land or having obtained a

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<sup>61</sup> Z Fattah, 'Lack of Mortgages Frustrates Young Saudi Homebuyers' *Bloomberg* (New York city, 18 October 2010) <<http://www.bloomberg.com/news/2010-10-18/lack-of-mortgages-frustrates-young-saudi-homebuyers-as-elders-debate-law.html>> Accessed 13<sup>th</sup> November 2016.

<sup>62</sup> The General Housing Authority regulation was approved by the Council of Ministers Resolution no 275 dated 28/8/1428 (10/09/2007).

<sup>63</sup> A Al-Mayouf and A Al-Khayyal, 'Provision of Public Housing in Saudi Arabia: Past, Current and Future Trends' (2011) 23 *Arch. & Planning journal* 59.

<sup>64</sup> Royal order no(A/12) dated 25<sup>th</sup> March 2011.

site upon which a property is to be built.<sup>65</sup> This reform aimed to improve the effectiveness of the REDF whilst making securing a loan from the REDF easier. The government did eventually abolish the condition of having a plot ready, and began permitting citizens to submit applications without needing to already have a plot. However, this move opened the floodgates to 1.7 million applicants, who joined more than 500,000 existing applicants on the waiting list.<sup>66</sup> This unexpected number of applicants exceeded the capacity of the REDF and was not the result the government was seeking.

The government intervened again later on, but this time in order to address the consequences of the increased waiting list, by seeking to increase the capacity of the REDF and injecting SAR 43 billion (\$11,465 billion), followed by another SAR 14.8 billion (\$3,946 billion) in 2011.<sup>67</sup> Nevertheless, the Saudi government needs to think carefully before adopting future policies in respect of housing. In particular, it is evident that citizens have been fundamentally let down by government intervention, which has only resulted in making matters more difficult for prospective home buyers.

Government initiatives consequently led to the construction of just 50,000 housing units between 2011 and 2016, when in actual fact the housing sector required 120,000 new units to be built every year to meet demand.<sup>68</sup> There clearly must not be a repetition of this crisis in the future, particularly in light of the government's limited capacity for carrying out such a huge task. It would be incredibly naïve to do nothing on the other hand, as this would repeat past failures whilst bringing about a different result. It is evident that the successful initiatives within the housing sector during the 1970s and 1980s cannot be repeated by government efforts alone, and so other parties must be involved in assisting the government.

Accordingly, it could be argued that the government recognised implicitly its inability alone to satisfy the enormous housing needs of citizens and therefore required involving other parties, such as the banking sector and financial institutions. This trend was

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<sup>65</sup> O Nassier, 'Contribution and achievements of a national development organization in meeting the planning goals: the Saudi Real Estate Development Fund' (PhD thesis, University of La Verne 1992).

<sup>66</sup> J Almaliky, 'Alsura Council: 500 Thousands applicants on the waiting list of the REFL' *Almadinah* (AlMadinah, 24<sup>th</sup> Decemb4er 2013) <<http://www.al-madina.com/node/500137>> accessed 28<sup>th</sup> November 2016.

<sup>67</sup> Royal order no(A/18) dated 24 February 2011.

<sup>68</sup> In June 2016, the Saudi Housing Ministry announced its intention to make 50,000 units available for eligible applicants. However, as indicated in detail in Chapter Three, studies show that Saudi Arabia needs to build 120,000 units every year to meet housing demand.

highlighted explicitly by the Housing Ministry, when it revealed its intention to become a regulator and observer rather than a financier or provider of housing finance. In particular, the Housing Ministry realised that the waiting list of applicants for REDF loans had reached more than 1.7 million applicants,<sup>69</sup> which made realistic fulfilment of the government's obligations to the housing sector questionable.

However, the housing finance market does not represent a healthy environment for the banking sector, which seeks warranties and protection for their interests. The modest role played by the banking sector in the housing finance market may be a reflection of the belief that this sector needs reform and develop in order to attract investment from the banking sector.

Establishing a housing finance market is not an easy task either, as it requires the adoption of new policies and the enactment of legislation to establish a well-developed market, especially in light of the many potential hurdles it may face during its establishment and development. This is primarily due to two factors: firstly, many Saudis are highly averse to borrowing because they rely on the interest-free loans provided by the REDF, despite the potential to have to wait twenty years for a loan. Typical home purchases are completed only when an individual has either saved enough to make a cash-only purchase, or is able to resort to borrowing from family members. Thus, there is a need for the Saudi financial culture to undergo a significant transformation from traditional and conservative methods to new and modern forms. Secondly, establishing a new financial market requires an increase in confidence, which cannot be achieved if potential participants do not feel that their interests are protected.

In response to the need for reform of the housing finance market and increasing its effectiveness, legislative authorities<sup>70</sup> have launched a number of initiatives aimed at developing the real estate finance market. There are three initiatives can be ordered as follows:

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<sup>69</sup>K Khan, 'Saudi Mortgage Law' (*alrajhi-capital.com*, 1 March 2013) < [http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law\\_Mar%202013\\_Final.pdf](http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf)> accessed 6 November 2016.

<sup>70</sup> The legislative authority under Saudi legal system representing in; the Council of Ministers and *AlShura* Council, for further information about this authority and its function and powers see; F Al-Fadhel, 'Legislative Drafting and Law-Making Practices and Procedures under Saudi Arabian Law: A Brief Overview'(2012)1 IJDLR 95.

First, there is strong sentiment that Article 10<sup>71</sup> of the Banking Control Law,<sup>72</sup> which prevents banks from owning real estate for either trade or financial purposes, minimises the role of banking sector in the housing finance market.<sup>73</sup> Retaining the title of real estate being financed is considered to some extent good protection for lenders' interests, whilst banks, who are considered the biggest players in the housing finance sector due to their massive portfolios, are prohibited from such protection. More than thirty years have passed since Article 10 was enacted, and there have been no major amendments despite calls to take further steps to deal with such legal obstacles.<sup>74</sup> Due to the importance of granting banks and financial institutions the desired protection to extend their operations whilst at the same time increasing their effectiveness, Article 10 was amended in 2012,<sup>75</sup> and now permits banks to own real estate solely for the purpose of housing finance.<sup>76</sup>

Second, housing finance laws that were enacted in 2012<sup>77</sup> can be considered as revolutionary in the development of the housing finance market. In 2003, the participants at the Economic Forum in Riyadh highlighted the difficulties likely to hinder the finance sector in general, and in particular the real estate finance market in the Kingdom.<sup>78</sup> After these concerns were submitted to the Saudi government, the *Al-Gassim* law firm<sup>79</sup> was

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<sup>71</sup> The Banking Control Law was issued by Royal Decree (38) dated 22-2-1386 (22 June 1977); article 10 states that: "No bank shall undertake this transaction; to acquire or lease real estate except in so far as may be necessary for the purpose of conducting its banking business, housing of its employees or for their recreation or in satisfaction of debts due to the Bank".

<sup>72</sup> Banking Control Law was approved by the Royal Decree no (M/5) dated 22 June 1966.

<sup>73</sup>R Wilson, 'The development of Islamic finance in the gulf cooperation council states' in D Held and K Ulrichsen (ed), *The Transformation of the Gulf: Politics, Economics and the Global Order* (Routledge 2013).

<sup>74</sup> For example, there are numbers of article discuss and examine article 10 and its negative impact on the effectiveness of the banks operate in Saudi, for more information see; M Kahn, 'Secured Lending in Saudi Arabia' (1984) 3 Int'l Fin. L. Rev27.

<sup>75</sup> By the Royal decree no(M/23) dated 18<sup>th</sup> July 2012.

<sup>76</sup> The above permission was stated in article 2 of the real estate finance law, which was enacted by the Royal Decree no (M/22 )dated 27/7/2012 that exempted banks the current legal restriction stated in article 10 of the Banking Control law.

<sup>77</sup> A study and debate leading to the above laws lasted nearly a decade, revealing just how important these laws are both to the Saudi government and to Saudi citizens. They have been awaited for a long time by lawyers, specialists and public, many of whom have been optimistic about them, believing that the new laws will transform tenants into homeowners.

<sup>78</sup>The economist Team, 'The recommendations of the first Riyadh Economic Forum.6-8 October2003'(Riyadh.com, 6 October 2003) <<http://www.riyadhef.com/tabid/55/Default.aspx>>\_Accessed 12<sup>th</sup> November 2016.

<sup>79</sup> *AlGasim* is a Saudi law firm associated with the law firm Allen & Overy. It has particular expertise in Islamic finance, banking, finance, commercial cases, and drafting contracts and bills. For further information, see: the lawyer, 'Allen & Overy considers future in Saudi as local firm deal ends'

selected to draft housing finance bills. Subsequently, the bills received royal decree, and were enacted in 2012. These laws were unique in that they were the first to control and regulate financial contracts (namely the finance lease contract). Furthermore, it was the first time the Saudi government had enacted law by engaging a law firm to draft proposed legislation. In enacting these laws, the government aimed to tackle and resolve many legal problems relating to finance in general, housing finance and the housing shortage.

The housing Finance Laws 2012 included the Finance Lease Law ('FLL'), the Law on the Supervision of Finance Companies ('LSFC') and the Real Estate Finance Law ('REFL')<sup>80</sup>, which will be the central focus of this thesis. When these came into effect, they signified a major expansion and milestone in the codification of Saudi law.

The above laws introduced and established a new era in housing finance, with a securitised market in Saudi Arabia bringing greater depth and maturity to the industry,<sup>81</sup> and have been the key factors in the enactment of the REFL. They also aimed to pave the way for entry into the housing finance market by banks and financial institutions, and for the dissemination of information within the market. The level of liquidity in the market has been given good attention by the REFL, as it has been enhanced and increased through the establishment of a securitising market, which will play a significant role in providing the market with the desired liquidity at a low cost. With regard to a borrower's creditworthiness, banks are obliged to check before granting credit through an authorised credit bureau.

The FLL prescribes the rules on finance leasing and specifically, for example, the responsibilities of the lessor and lessee in a *Sharia*'a compliant manner. Here, the asset risk is placed on the lessor during the lease term, but the lessee is held responsible for its relevant use.

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(*thelawyer.com*, June 2012) <<http://www.thelawyer.com/allen-and-overly-considers-future-in-saudi-as-local-firm-deal-ends/1013000.article>> accessed 5<sup>th</sup> October 2016.

<sup>80</sup>These most recent laws date back to 2003, when participants in the Economic Forum in Riyadh highlighted the factors likely to hinder the finance sector and housing finance in Saudi Arabia. These concerns were then submitted to the Saudi government through the Saudi *Al-Gasim* law firm. Its expertise is in Islamic finance, banking, finance, commercial cases, and drafting contracts and bills. It was selected to draft the bills of the Housing finance laws. Subsequently, the bills received royal assent, coming into effect in 2012. These laws are unique in that they are the first to control and regulate financial contracts (namely the finance lease contract). Furthermore, it was the first time the Saudi government had enacted law by engaging a law firm to draft proposed legislation. For more information see The Economist Team, 'The recommendations of the first Riyadh Economic Forum. 6-8 October 2003' (*riyadhef.com*, 6 October 2003) <<http://www.riyadhef.com/tabid/55/Default.aspx>> Accessed 10<sup>th</sup> November 2016.

<sup>81</sup> K Khan, 'Saudi Mortgage Law' (*alrajhi-capital.com*, 1 March 2013) <[http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law\\_Mar%202013\\_Final.pdf](http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf)> accessed 15<sup>th</sup> August 2016.



The LSFC provides a framework for companies seeking to conduct financial operations, either in housing finance, production asset finance or small and medium size enterprise finance. The law determines, for example, the capital requirement for establishing such companies, and obliges them to engage in finance activities in a manner that does not conflict with principles of Islamic law as defined by the *Sharia* Committee, whose members are appointed by those companies.

Third, the development of housing finance laws was not limited to the finance aspects or simply to grant desired protection for lenders. It is more comprehensive than this: therefore, whilst enacting the above laws, another aspect of the housing finance market was developed through establishing a quasi-judiciary committee to hear disputes arising following the implementation the housing finance laws.<sup>82</sup> It could be argued that the aim of this initiative was to establish a comprehensive legal framework for the housing finance market which would include dealing with three primary aspects regarding the market: supervision, regulation and dispute resolution. It can also be added that the aim may be to accelerate litigation through establishing a committee whose members are experts in the housing finance laws.

As mentioned above, the aim of above initiatives has been mainly to develop a housing finance market through boosting confidence in the market, granting protection for its main participants, and regulating the relationship between parties to housing finance transactions. Some decision makers have announced following the enactment of the 2012 housing finance laws that such laws would provide specific methods of financing housing in Saudi Arabia, giving lenders additional guarantees and other inducements to invest in this sector.<sup>83</sup> The Minister of Finance has also stated that the laws would give the housing finance market further guarantees in order to balance rights in a finance agreement, provide appropriate methods of financing housing projects in the country and reduce the borrowing cost for prospective homebuyers.<sup>84</sup> Besides the government members' announcements, optimistic voices were heard in the *Shura* Council in Saudi. The

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<sup>82</sup>Royal order no(A/27) dated 30<sup>th</sup> November 2015 to establish a quasi-judiciary committee to hear disputes arising following the implementation the REFLs.

<sup>83</sup> Alwatan, 'The Finance Minister: The Finance Laws Save the rights of all the Parties' *Alwatan* (Abha, 3 July 2012) <[http://www.alwatan.com.sa/local/News\\_Detail.aspx?ArticleID=105366&CategoryID=5](http://www.alwatan.com.sa/local/News_Detail.aspx?ArticleID=105366&CategoryID=5)> Accessed 12<sup>th</sup> November 2016.

<sup>84</sup> Alwatan, 'The Finance Minister: The Finance Laws Save the rights of all the Parties' *Alwatan* (Abha, 3 July 2012) <[http://www.alwatan.com.sa/local/News\\_Detail.aspx?ArticleID=105366&CategoryID=5](http://www.alwatan.com.sa/local/News_Detail.aspx?ArticleID=105366&CategoryID=5)> Accessed 12<sup>th</sup> November 2016.

secretary of *the Shura* Council, for example, stated that the bills outlining the new laws would provide a new means of real estate finance in Saudi Arabia, which would facilitate the setting up of new finance companies alongside the banks that currently provide this service.<sup>85</sup> The early announcements reveal how optimistic decision-makers were about the potential for housing finance laws to develop the housing finance market, which in turn would be reflected in addressing the housing crisis.

The above initiatives are only part of the story because the housing shortage and the acute deficit in housing finance outweighed the government's intervention despite the latter's magnitude. This is not to say that the initiatives did not contribute towards resolving the housing finance crisis, but rather this complex and difficult matter needed further examination and analysis. It is clear that the development of the housing finance market depends on a mixture of legal, economic and political factors. The success in dealing with all of these factors may probably lead to achieving the development of a housing finance market, which in turn would lead to an increase the operations of housing finance and the homeownership rate. Therefore, any factor hindering achieving these aims may be considered a potential barrier needing to be addressed.

The growth and efficiency of a market economy is dependent upon increased access by individuals and businesses to trade within that market at a reasonable rate. The growth of wealth of an individual is particularly dependent upon the availability of affordable housing finance. The housing finance market can therefore easily be affected by legal, economic and political changes.

## **2.5 Barriers to developing the housing finance market**

The development of housing finance market is grounded in the belief that a well-developed housing finance market promotes homeownership, which in turn promotes economic and political stability.<sup>86</sup> The development of such a market aims to meet the following targets in order to increase the rate of home ownership: addressing any barrier preventing the main participants in such a market from extending their operations,

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<sup>85</sup>A Falah, 'Shura Council discusses the different opinion with the Minister Council about the finance laws' *Alwatan* (Abha, 6 March 2011)<

[http://www.alwatan.com.sa/Local/News\\_Detail.aspx?ArticleID=44330](http://www.alwatan.com.sa/Local/News_Detail.aspx?ArticleID=44330)> Accessed 12<sup>th</sup> November 2016.

<sup>86</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R, 2007)4.

providing the desired protection for the main participants in the market, reducing borrowing costs, and finally finding an alternative source for liquidity but at a low cost. Accordingly, the following require further examination and investigation where development of the Saudi housing finance market is concerned:

**i. Not protecting lenders as a potential cause for undermining the development of a housing finance market**

A well-functioning housing finance system requires adequate legislation in order to provide stakeholders, whether borrowers or lenders, with comfort, confidence and protection.<sup>87</sup> This section, however, will place emphasis on lenders, asking why their role in the housing finance is considered modest, and will attempt to find a solution that may enhance that role. There are two issues might hinder lenders in the housing finance market, and reduce their role. The Supreme Judicial Council's decision and the uncertain legal framework relate to foreclosure, as will be explained below. It is noteworthy that foreclosure here refers to the delay and expense inherent in foreclosure laws and regulations and their negative impacts on the housing finance market.<sup>88</sup> Also, it refers to the ambiguous laws meant to deal with the process of foreclosure, which make lenders and financiers reluctant to expand their operations in the market due to the uncertainty created by these laws, as will also be explained in detail later. Accordingly, the reference to foreclosure here is not meant in the strict legal sense of extinguishment of the borrower's equity in the property: a remedy which of course the Saudi courts do not grant.<sup>89</sup>

Generally speaking, Saudi people and companies, as well as all foreign partnerships and companies operating in Saudi Arabia, are entitled to acquire legal ownership of real estate in the country.<sup>90</sup> In Saudi Arabia, original title deeds, as well as all mortgage documents

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<sup>87</sup> Deloitte, 'Saudi mortgage laws; A Formula for a well-functioning market?' (*deloitte.com*, August 2012) <[https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/realestate/me\\_real\\_estate\\_mortgage\\_whitepaper\\_072013.pdf](https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/realestate/me_real_estate_mortgage_whitepaper_072013.pdf)> accessed 10<sup>th</sup> November 2016.

<sup>88</sup> M Jacoby, 'The value (s) of foreclosure law reform' (2010) *Pepperdine Law Review* 101.

<sup>89</sup> Also the courts in the UK do not grant this remedy but instead order a sale of the mortgaged property, for further information see: S Wechsler, 'Through the looking glass: foreclosure by sale as De Facto Strict Foreclosure-An empirical study of mortgage foreclosure and subsequent resale' (1984) 70 *Cornell L. Rev* 850.

<sup>90</sup> S Khan, 'Secured Lending in Saudi Arabia' (1984) 27 *Int'l Fin. L. Rev* 74.

concerning real estate, are issued by the *Sharia* courts or by notaries public, both of which are under the authority of the Supreme Judicial Council (SJC).<sup>91</sup>

In many jurisdictions, real estate is considered the main source of security for lenders,<sup>92</sup> and the predominant guarantee for loans is therefore mortgaged real estate. Accordingly, lenders urge their customers to mortgage property in the lender's favour<sup>93</sup> because mortgaged real estate provides stronger security for lenders.<sup>94</sup> However, conventional banks in Saudi Arabia are not allowed to register mortgages because the SJC believes that all loans provided by these banks are usurious, and are thus not *Sharia*-compliant. This prohibition dates back to an SJC decision of 26 August 1981, according to which all *Sharia* authorities, including courts and notaries public, should not implement mortgage documentation for such loans. The decision remains in force and has remained unchanged, so much so that the financing of real estate by commercial banks in Saudi Arabia has been hindered. It is worth noting, however, that although the above-mentioned decision was issued with reference to conventional banks, Islamic banks and conventional banks, which set up transactions to comply with Islamic law, are not exempt, and they therefore, too, are affected by that decision.

The banks, however, have created two methods to circumvent the SJC's decision, in order to enable them to register mortgages with either *Sharia* courts or notaries public. For instance, the first method is that some banks ask the borrower to mortgage the property being financed in favour of an employee of the bank. A public notary cannot refuse to register that property.<sup>95</sup> The second is for the borrower to give the original deeds to the bank in order to pledge his property to the bank, thus satisfying the bank that he will not sell it or transfer it to a third party.<sup>96</sup>

Although these and other alternative methods may seem acceptable to some extent, they involve risks. With the first method, for example, the bank employee may exercise his

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<sup>91</sup> The above commitment is based on two laws: the judicial law which was approved by the Royal Decree No. (M/78) dated 19 September 2008, and the Regulation of Notaries Public which was issued by ministerial resolution No. (3740) dated 5 July 2004.

<sup>92</sup> See for example: K Gray and S Gray, *Elements of land law* (5th edition, Oxford 2009)695 & C Lympelopoulos, I Chaniotakis and M Soureli, 'The importance of service quality in bank selection for mortgage loans' (2006) 16 *Managing Service Quality: An International Journal* 365.

<sup>93</sup> J Berkowitz and R Hynes, 'Bankruptcy Exemptions and the Market for Mortgage Loans' (1999) 42 *The Journal of Law and Economics* 809.

<sup>94</sup> W Gnichtel, 'Lease Financing in Saudi Arabia' (1984) 3 *International Finance Law Review* 34.

<sup>95</sup> F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (8<sup>th</sup>, Brill 2000)108.

<sup>96</sup> I Khan, 'Secured Lending in Saudi Arabia' (1984) 27 *Int'l Fin. L. Rev* 74.

right as a mortgagee against the mortgagor. In this case, the bank can take no action against him because the financed asset is mortgaged in favour of the employee. With the second alternative method, there is a legal defect in the judicial system that mitigates the protection provided by this method, since the *Sharia* courts in Saudi lack a system for registering documents electronically.<sup>97</sup> Therefore, sometimes a borrower in bad faith will exploit the absence of electronic registration by applying to the *Sharia* courts, arguing that he is the owner of the property, has lost the original deed to it, and desires to obtain a duplicate deed from the *Sharia* courts. Usually the *Sharai* courts would not refuse to issue such a deed as long as the property belongs to the person, who would then exercise his rights over the property by selling it or transferring it to a third party. This risk of course mitigates the protection provided by this method and undermines its effectiveness.<sup>98</sup>

Thus whilst drafting the 2012 housing finance Laws,<sup>99</sup> the *Al-Qassim* law firm referred to this problem throughout the draft as a major issue that needed to be resolved.<sup>100</sup> The law firm suggested that the earlier SJC decision, which was the root of the problem, should be overturned either by the SJC itself or by a royal decree at the time the housing finance laws 2012 were approved. However, the housing finance laws have not overturned the SJC's decision, nor has the royal decree. The problem still therefore exists, and Saudi banks still suffer from the SJC's decision.

The second issue that hinders the lenders in the housing finance market is the uncertain legal framework relating to foreclosure. Many Saudi banks have indicated that the absence of a clear legal framework governing foreclosure has impeded home financing by banks.<sup>101</sup> *AlRajhi* Bank, for example, pointed out that financing options in the Kingdom are limited because the uncertain legal framework relating to foreclosure has

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<sup>97</sup> M McMillen, 'Rahn Concepts in Saudi Arabia: Formalization and a Registration and Prioritization System' (*papers.ssrn.com*, 31 August 2010) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1670104](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670104)> accessed 11<sup>th</sup> November 2016.

<sup>98</sup> F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (8<sup>th</sup>, Brill 2000) 108.

<sup>99</sup> In July 2012 four laws were enacted: the Real Estate Finance law, the Finance lease law, the Finance Companies Control Law and Mortgage law.

<sup>100</sup> The *Al Qassim* Law Firm submitted all documents and bills to the Riyadh Chamber of Commerce and Industry in July 2007, who in turn referred these documents to the government.

<sup>101</sup> Two of the biggest banks operating in Saudi, the SAMBA and *AlRajhi* banks, issued two reports on the housing market in Saudi Arabia, both of which agreed that foreclosure is considered a hurdle for the banks' transactions in housing finance.

led to constraints on lending.<sup>102</sup> The SAMBA bank has given the same reason for concern.<sup>103</sup> However, these banks do not make it clear why the issue has hindered their activities.

The lengthy procedures for enforcement of foreclosure might account for the banks' complaints about the Saudi legal system. In the event of a borrower defaulting, for example, a mortgagee cannot enforce the provisions of the mortgage agreement, whether by selling the property or by collecting rent on it, without consent from a competent court. The mortgagee, therefore, has to apply to the court for consent to enforce the provisions of the mortgage agreement. Following this, a petition is presented to the *Emiraha* to enforce the wording of the petition. However, the *Emiraha* may refer the case back to the court if it has objections.<sup>104</sup> Such procedures are considered problematic by lenders in Saudi Arabia, who desire little more than a comprehensive legal framework to clarify their duties and obligations. Some writers have suggested another difficulty, namely that 'there is very limited precedent of actual enforcement of security, and as such the topic remains uncertain'.<sup>105</sup>

With these considerations in mind, the new housing finance laws enacted in July 2012 include a law called the 'Execution Law', which contains provisions that may offer a solution to the ambiguity surrounding foreclosure on property. Some specialists have stated, in the wake of the enactment of the new laws, that the Execution Law 'will assist in the recovery of an asset for and on behalf of the financier upon a borrower's default'<sup>106</sup>. Another specialist, summarising the concept underlying that law, stated that 'such law provides for judges to hear enforcement disputes and insolvency action'.<sup>107</sup> This law has been eagerly awaited for some time because it creates so-called 'execution judges', who are empowered to enforce judicial judgments and to hear enforcement disputes. It also establishes so-called enforcement instruments, which can be brought before an execution

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<sup>102</sup> I Khan, 'Secured Lending in Saudi Arabia'(1984) 27 Int'l Fin. L. Rev 74.

<sup>103</sup>SAMBA, 'Saudi Arabia's Housing market structural issue, financing and potential' (*samba.com*, December 2010)<[http://www.samba.com.sa/GblDocs/saudi\\_arabia\\_housing\\_market\\_eng.pdf](http://www.samba.com.sa/GblDocs/saudi_arabia_housing_market_eng.pdf)> accessed 25<sup>th</sup> November 2016.

<sup>104</sup>I Khan, 'Secured Lending in Saudi Arabia'(1984) 27 Int'l Fin. L. Rev 74.

<sup>105</sup> H Cort and R Rayfield, 'The Road to Structured Security'(2008) 27 Int'l Fin. L. Rev 74.

<sup>106</sup> King & Spalding, 'Kingdom of Saudi Arabia – New Mortgage, Real Estate and Financing Laws' (*kslaw.com*, 2013) < [http://www.kslaw.com/library/publication/measure\\_Winter2013.pdf](http://www.kslaw.com/library/publication/measure_Winter2013.pdf) > accessed 12th November 2016.

<sup>107</sup> Deloitte, 'Saudi mortgage laws; A Formula for a well-functioning market?' (*deloitte.com*, August 2012)<[http://www.deloitte.com/assets/DcomMiddleEast/Local%20Assets/Documents/Industries/Real%20Estate/me\\_real\\_estate\\_mortgage\\_whitepaper\\_072013.PDF](http://www.deloitte.com/assets/DcomMiddleEast/Local%20Assets/Documents/Industries/Real%20Estate/me_real_estate_mortgage_whitepaper_072013.PDF)> accessed 15th November 2014.

judge.<sup>108</sup> It is fair, therefore, to assert that such a law may resolve the issue in question. However, it has not been tested, and much time must pass before it can be evaluated.

In fact there is an example which shows that, despite the enactment of the Housing Finance Laws 2012, the SJC's decision still stands and has not been overturned by these laws. As mentioned above, the REDF<sup>109</sup> provides loans of a maximum of SAR 500,000 (\$133,300); however, some applicants, who are considered financially able, may want to buy properties costing more than SAR 500,000, but the REDF cannot provide loans above the maximum. Accordingly, it has changed some of its policies by coming to agreements with national banks to finance property purchases of above SAR 500,000. The banks, however, seek to secure their loans by mortgaging in their own favour the property or asset being bought by the applicant. The banks, when creating this condition, believed that the government, as represented in the REDF, might have the authority to force the courts to reverse the SJC's decision and grant them the desired protection provided by a mortgage. Unsurprisingly, the courts have refused to allow mortgaged real estate in favour of banks<sup>110</sup> and that of course contributes to the SJC decision. Consequently, earlier agreements have not been enforced despite having been concluded in the wake of the enactment of the new housing finance laws 2012.

For all the above considerations, Chapter Three will be allocated to analysis of the SJC's decision and to finding out how to create a mechanism that offers the desired protection for both borrowers and lenders in order to develop the housing finance market without upsetting the decision of the SJC.

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<sup>108</sup> Execution law identified enforcement instruments as the following:

- Judgements and court orders (provided final, unless the judge's order is for immediate enforcement);
- Arbitral awards appended with an enforcement order under the new Arbitration Law;
- Reconciliation papers issued by the competent authorities or endorsed by the court (i.e. settlement orders); commercial papers officially certified 29 contracts and documents;
- Foreign judgements and arbitral awards and officially certified foreign contracts and documents;
- Ordinary papers, the content of which is admitted to be wholly or partly due; and
- Other contracts and instruments designated as such by law. For further information see: Clifford Chance, 'Saudi Arabian mortgage, finance and court reform' (*cliffordchance.com*, September 2012) <[http://www.cliffordchance.com/briefings/2012/09/saudi\\_arabian\\_mortgagefinanceandcourtreform.html](http://www.cliffordchance.com/briefings/2012/09/saudi_arabian_mortgagefinanceandcourtreform.html)> accessed 15<sup>th</sup> November 2016.

<sup>109</sup> The REDF is a government agency and provides interest-free loans of up to SAR 500,000 (\$133,300) for Saudi nationals, for further information see: REDF, 'The fast housing finance loan' (*redf.gov.sa*, April 2015) <<http://www.redf.gov.sa/ar/Pages/default.aspx>> accessed 12<sup>th</sup> November 2016.

<sup>110</sup> M Al-Abdulaah, 'Real Estate Fund holds Justice and the banks responsible for disabling additional loan' *Okaz* (Jeddah, 12 December 2013) <<http://www.okaz.com.sa/new/Issues/20131212/Con20131212661281.htm>> accessed 12<sup>th</sup> October 2016.

## ii. Increased land prices and their negative role in the housing finance market

Broadly speaking, land prices are considered the main components of housing costs and demand: housing costs are inseparable from land prices, and the interaction between them is very strong, because as long as the price of land increases, so too will house prices.<sup>111</sup> It is difficult to treat housing as a single good due to there being bundled components within housing as a whole, and their value constitutes the overall value. It has long been recognised that the value of housing is controlled by changes in the prices of these heterogeneous components.<sup>112</sup> However, ‘it is important to recognize that the values of these bundled components do not necessarily move in conjunction with one another: Overall changes in home values will in fact reflect a weighted average of the changes in the value of each individual component.’<sup>113</sup> The most significant component in the change in housing value is land value, as this is considered to be the main component of housing prices.<sup>114</sup>

The interaction between the housing prices and land prices may explain the strong relation between them, as a rise in land prices would in turn increase the overall cost of housing.<sup>115</sup> Thus, understanding the relationship and interaction between housing and land prices is very important, in order to reveal the extent to which land prices can impact upon housing costs. The *Ricardian* rent theory, for example, states that ‘the demand for land is derived from the demand for housing in a particular city’.<sup>116</sup> Accordingly, ‘if the land market is efficient, the land prices are primarily determined by property prices’.<sup>117</sup>

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<sup>111</sup> R Bostic, S Longhofer and C Redfearn, ‘Land leverage: decomposing home price dynamics’ (2007) 35 *Real Estate Economics* 183.

<sup>112</sup> M Davis and M Palumbo, ‘The price of residential land in large US cities’ (2008) 63 *Journal of Urban Economics* 352.

<sup>113</sup> R Bostic, L Stanley and R Christian, ‘Land leverage: decomposing home price dynamics’ (2007) 35 *Real Estate Economics* 183, 186.

<sup>114</sup> M Potepan, ‘Explaining inter metropolitan variation in housing prices, rents and land prices’ (1996) 24 *Real Estate Economics* 219.

<sup>115</sup> D Hongyan, Y Ma and Y An, ‘The impact of land policy on the relation between housing and land prices: Evidence from China’ (2011) 51 *The Quarterly Review of Economics and Finance* 19.

<sup>116</sup> D Ricardo, *Principles of political economy and taxation* (Dover Publications Inc 2004) 95.

<sup>117</sup> D Hongyan, Y Ma and Y An, ‘The impact of land policy on the relation between housing and land prices: Evidence from China’ (2011) 51 *The Quarterly Review of Economics and Finance* 19.



The Saudi housing finance market has been significantly impacted by land prices, since their value constitutes nearly 50 per cent of the total cost of housing.<sup>118</sup> Such a phenomenon has been recognised by international and national organisations, and has been considered a barrier to the development of a housing finance market, which consequently needs intervention to resolve it. For example, the World Bank has pointed to insufficient land availability as a key constraint upon housing finance in Saudi Arabia, which in turn has led rapidly increasing prices in major cities.<sup>119</sup> The National Commercial Bank ('NCB') has considered that land prices should not exceed more than 30 per cent of the total cost housing,<sup>120</sup> in the main regions; Makkah, Riyadh and the Eastern Province, housing developers are unable to meet the demand for affordable housing.<sup>121</sup> These reports, in fact, have reinforced the *Ricardian* rent theory, which linked between land prices and property prices as being barriers to the development of the housing finance market. However, what is interesting is that the reports have alluded to the belief that the impact of this factor is not limited to hindering the development of housing finance but to hindering the deliverability of affordable housing. Housing developers are unable to meet the demand for affordable housing since the increase in land prices has led to overvaluation of house prices.<sup>122</sup>

Prospective first home owners have not been spared the impact of increased land prices due to difficulty in obtaining housing finance. As the Saudi Deputy Housing Minister has made clear, delays in the Ministry's plans to provide housing and/or housing finance products was attributed to the increase land prices.<sup>123</sup> To demonstrate the rate of increase

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<sup>118</sup>S Alshaik and A Alwazir, 'Saudi housing sector 2012' (*menafn.com*,2012) <[https://www.menafn.com/updates/research\\_center/Saudi\\_Arabia/Economic/ncb091212.pdf](https://www.menafn.com/updates/research_center/Saudi_Arabia/Economic/ncb091212.pdf)>accessed 25<sup>th</sup> November 2016.

<sup>119</sup>The world bank and the IMF, 'Saudi Arabia'(document.worldbank, May 2012)<<http://documents.worldbank.org/curated/en/242781468303631157/pdf/665050REVISED00se0Only090B0x369278B.pdf>> accessed 12<sup>th</sup> November 2016.

<sup>120</sup> For more information about how much supposed the land's value constitutes from the whole property's cost see; M Neutze, 'The price of land for urban development'(1970) 46 Economic Record 313.

<sup>121</sup>S Alshaik and A Alwazir, 'Saudi housing sector 2012' (*menafn.com*,2012) <[https://www.menafn.com/updates/research\\_center/Saudi\\_Arabia/Economic/ncb091212.pdf](https://www.menafn.com/updates/research_center/Saudi_Arabia/Economic/ncb091212.pdf)>accessed 25<sup>th</sup> November 2016.

<sup>122</sup>S Alshaik and A Alwazir, 'Saudi housing sector 2012' (*menafn.com*,2012) <[https://www.menafn.com/updates/research\\_center/Saudi\\_Arabia/Economic/ncb091212.pdf](https://www.menafn.com/updates/research_center/Saudi_Arabia/Economic/ncb091212.pdf)>accessed 25<sup>th</sup> November 2016.

<sup>123</sup>B Badwelan, 'Allocated funds for those who cannot afford to get loan to build their houses' *AlMadinah*(ALMadinah,18January2015)<<http://www.al-madina.com/node/582752/%D8%A7%D9%84%D8%B2%D9%85%D9%8A%D8%B9-%D8%B1%D8>

in land prices, according to the *Alrajhi Capital*, land prices have been increasing at around 15 per cent per year, implying a 90 per cent increase in six years.<sup>124</sup>

Such a significant phenomenon should not be ignored if this market is to be developed. It would be ill-advised to do nothing, but simply to introduce several initiatives without taking into account the potential of the role played by increased land prices in undermining those initiatives. The increase in land prices may be attributed to urbanisation,<sup>125</sup> land shortage,<sup>126</sup> and speculation/monopolisation. The following section will shed some light on these causes.

Urbanisation resulted in an acute housing shortage in the Kingdom in the 1970s because they affected both land prices and the housing sector by increasing their value, in turn lead to difficulty in owning a home during that period.<sup>127</sup>

In the 1970s and 1980s, for example, Saudi Arabia experienced significant urbanisation in the wake of increase oil prices.<sup>128</sup> Such urbanisation covered entire regions in Saudi Arabia. The level of urbanisation increased fourfold from just 15 per cent in 1950 to 72 per cent in 1986.<sup>129</sup> This largescale urbanisation was accompanied by increasing land prices, which went on to boost housing costs and, at the same time, the difficulty of owning a home.<sup>130</sup> However, Saudi nowadays is not witnessing urbanisation,<sup>131</sup> as the

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B5%D8%AF-%D8%A7%D9%84%D8%A3%D9%85%D9%88%D8%A7%D9%84-%D9%84%D9%85%D8%AD%D8%AF%D8%AF%D9%8A-%D8%AE%D9%8A%D8%A7%D8%B1-%D8%A7%D9%84%D9%82%D8%B1%D9%88%D8%B6-%D9%84%D8%A8%D9%86%D8%A7%D8%A1-%D8%A7%D9%84%D9%85%D8%B3%D8%A7%D9%83%D9%86.html ≥ accessed 25 August 2016.

<sup>124</sup>K Khan, 'Saudi Mortgage Law' (*alrajhi-capital.com*, 1 March 2013) < [http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law\\_Mar%202013\\_Final.pdf](http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf)> accessed 6th November 2016.

<sup>125</sup>For further information about how urbanization affects land prices see: A Plantinga, R Lubowski and R Stavins, 'The effects of potential land development on agricultural land prices' (2002) 52 *Journal of Urban Economics* 561 & D McMillen and J McDonald, 'Urban land value functions with endogenous zoning' (1991) 29 *Journal of Urban Economics* 14.

<sup>126</sup>For more information about the impact of land shortage on land and housing Prices see: E Lambin and P Meyfroidt, 'Global land use change, economic globalization, and the looming land scarcity' (2011) 108 *Proceedings of the National Academy of Sciences* 3465 & G Bramley, 'Land-use planning and the housing market in Britain: the impact on housebuilding and house prices' (1993) 25 *Environment and Planning* 1021.

<sup>127</sup>S Al-Hathloul and E Narayanan, 'Housing stock management issues in the Kingdom of Saudi Arabia' (1992) 7 *Housing Studies* 268.

<sup>128</sup>S Tuncalp and A Al-Ibrahim, 'Housing finance in Saudi Arabia' (1990) 14 *Habitat International* 111.

<sup>129</sup>S Al Hathloul and N Edadan, 'The distribution and growth of urban settlements in Saudi Arabia' (1991) 23 *GeoJournal* 269.

<sup>130</sup>S Tuncalp and A Al-Ibrahim, 'Housing finance in Saudi Arabia' (1990) 14 *Habitat International* 111.

<sup>131</sup>According to Cambridge dictionary urbanisation is: "the process by which more and more people leave the countryside to live in cities".

vast majority of Saudis already live in urban areas such as cities, while few people still live in the countryside;<sup>132</sup> hence we exclude this possible cause from consideration.

Nevertheless, from 2005 up to 2014, Saudi Arabia has witnessed heavy government expenditure on infrastructure, made possible by increased revenue from higher oil prices. Estimates suggest that in 2013 the Kingdom planned to spend \$514 billion to build industrial cities and airports,<sup>133</sup> in addition to the construction of twenty universities, airports, hospitals and rail links since 2005. In addition, the government adopted three projects in the years 2012, 2013 and 2014 to set up a metro system in three cities- Riyadh, Makkah and Dammam,<sup>134</sup> at a cost of SAR 84 billion (\$22,3991 billion), SAR 62 billion (\$16,5327 billion) and SAR 80 billion (\$21,3325 billion) respectively.<sup>135</sup>

The second potential cause to increase land prices is land shortage. In considering this factor, it is necessary to examine some of the figures associated with the Kingdom's geography and the extent of undeveloped land, to see whether or not there is a land deficit. Saudi Arabia is the second largest state in the Arab world, with a total area of 2,150,000 square kilometres.<sup>136</sup> This vast territory is split into 13 regions, the biggest of which are *Makkah*, *Riyadh*, and *the Eastern province*. Alongside these figures is Saudi Arabia's population of over 31 million, or 15 people per square kilometre.<sup>137</sup> Therefore, theoretically, there is no deficit in land in Saudi Arabia, and such a potential deficit will be excluded from this analysis. However, land shortage may be related to another factor, which is the third cause.

The last potential cause comprises monopolisation and speculation, which need greater clarification and discussion. Broadly speaking, wealthy Saudis prefer long-term

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<sup>132</sup> M Kadi, 'Soil Pollution Hazardous to Environment: A case study on the chemical composition and correlation to automobile traffic of the roadside soil of Jeddah city, Saudi Arabia'(2009) 168 *Journal of hazardous materials* 1280.

<sup>133</sup> Saudi fiscal budget 2013/2014 has adopted significant projects aiming to improve the infrastructure including , but not limited; instructor 20 universities and set up a metro system in three cities.

<sup>134</sup> For more information about Riyadh metro project, for example, which cost more than SR 80 billion, visit; Riyadh Metro Project, 'BACS Riyadh Metro Project'(bacsmp, July 2015) <<http://www.bacsmp.com/>> accessed 25<sup>th</sup> November 2016.

<sup>135</sup>The above projects were approved by the the minsters resolution no(235) dated 23 April 2012.

<sup>136</sup> Saudi Geological Survey, 'General Information about The Kingdom of Saudi Arabia' (*sgs.org.sa*, July 2005) <<http://www.sgs.org.sa/Arabic/Pages/default.aspx>> accessed 13<sup>th</sup> November 2016.

<sup>137</sup> General authority for statistic, 'Pulation by Gender, Age Groups and Nationality (Saudi/Non-Saudi)' (*stats.gov.sa*, August 2016) <<http://www.stats.gov.sa/en/4068>> accessed 11<sup>th</sup> November 2016.

investment in undeveloped land, known in the country as ‘white land’<sup>138</sup> because it is more convenient to invest in land that does not require heavy expenditure upon it, given that its value would increase anyway.<sup>139</sup>

White land constitutes a large area of total urban growth boundaries in Saudi cities. The High Commission for the Development of *Arriyadh* (HCDA)<sup>140</sup> has indicated that undeveloped land in the capital of the Kingdom (Riyadh) represents 78 per cent of total vacant land in the city.<sup>141</sup> This vacant white land is targeted by wealthy Saudis and influential people who invest in these assets but neither develop nor sell them unless the value doubles. This practice of holding undeveloped land without developing or selling has been criticised by both the public and observers: the latter regard such a practice as monopolisation because it results in artificial increases in land prices.

Many specialists and *Shura* Council members have debated and discussed this subject in order to find a means to cause land prices to reduce. They believe that neither the market nor the government can force landowners to sell their land or reduce land values without legislation granting them these powers. As a result, the Housing Minister has announced that reducing land prices is a priority for the government,<sup>142</sup> and the government in turn has drafted a land taxation bill with the aim of reducing land prices. These measures have been welcomed by the public who, of course, would like to see a drop in land prices to provide access to the housing finance market, since this factor increases the cost of lending money with which to buy a home.

However, enactment of the land taxation bill is complicated by a general debate as to whether or not taxation is contrary to Islamic law. The Council of Ministers, which, next

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<sup>138</sup> Z Fattah, ‘Saudi Arabia’s affordable housing shortage’ (*businessweek*, 28 March 2013) <<http://www.businessweek.com/articles/2013-03-28/saudi-arabias-affordable-housing-shortage>> accessed 12<sup>th</sup> November 2016.

<sup>139</sup> K Khan, ‘Saudi Mortgage Law’ (*alrajhi-capital.com*, 1 March 2013) <[http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law\\_Mar%202013\\_Final.pdf](http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf)> accessed 12<sup>th</sup> November 2016.

<sup>140</sup> The High Commission for the Development of *Arriyadh* was established for developing the city in all economic, social, cultural, architectural and environmental aspects. The Commission is also responsible for drawing up policies and procedures aimed at raising the efficiency of services and facilities connected with improving the living standards and the welfare of citizens.

<sup>141</sup> Argaam, ‘High Commission for the Development of *Arriyadh*: undeveloped lands represent 78% of the total area of the capital’ (*Argaam*, 6 June 2012) <<http://www.argaam.com/article/articledetail/275558/>> accessed 12<sup>th</sup> November 2016.

<sup>142</sup> S Altulani, ‘Housing Minister; We will levy tax on lands and the government policy is to reduce lands cost’ *Alyaum* (Dammam, 26 April 2014) <<http://www.alyaum.com/article/3080287>> accessed 15<sup>th</sup> November 2016.

to the *Shura* Council, is considered the body of legislative authority in Saudi,<sup>143</sup> after studying the bill referred it to the Council of Senior *Ulama* (CSU), an official institution consisting of twenty religious scholars appointed by the King,<sup>144</sup> to seek religious opinion on it. The CSU discussed and examined the bill and issued an order dated 25<sup>th</sup> August 2004, which confirmed that the government should not levy tax on land because tax does not comply with Islamic teachings; there are many reasons behind the increase in land prices and levying tax on land would not be the only solution; and, therefore, the government would be able to resolve this issue without levying taxes.<sup>145</sup>

The CSU's decision did not provide any justification, however, which leaves open the possibility for anybody to create a justification for their own respective matters. Nevertheless, the CSU's decision has not been welcomed by all. *Al-Salem*, for example, comments that the CSU's decision deserves praise but is not exempt from criticism as it could not convince the public, and furthermore, the CSU in its decision did not suggest an alternative solution to the problem.<sup>146</sup>

Although referring the bill to the CSU creates ambiguities, as the latter is not part of the law-making process within the Saudi legal system, the legislative authority in the Kingdom did not approve enactment of the land taxation bill, a decision which might be attributed to the CSU's decision, mentioned above. However, again in 2016, the Saudi legislative authority surprised both the markets and its main participants when it enacted the Land Fees Law (LFL) 2016, having altered the conceptual basis of the LFL from land taxation to land fees. The question arises here as to whether or not the LFL 2016 is able to address land prices and in turn contribute in the development of the housing finance market. This question leads us to another: whether the LFL 2016 will achieve the aim expressed in the official statement on its enactment, which is to precipitate either a decrease in the market value of land or an increase in its supply. Also, the wording of the LFL 2016 raises some concerns, requiring further examination, in regard to lack of

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<sup>143</sup> Both Council of Ministers and the *Shura* Council play crucial role in law making in Saudi Arabia, however, discussion their merits and role is beyond the scope of this thesis, therefore, for more information see; F Al-Fadhel, 'Legislative Drafting and Law-Making Practices and Procedures under Saudi Arabian Law: A Brief Overview'(2012)1 IJDLR 95.

<sup>144</sup> F Al-Fadhel, 'Legislative Drafting and Law-Making Practices and Procedures under Saudi Arabian Law: A Brief Overview'(2012)1 IJDLR 95.

<sup>145</sup> M Aloni, 'Lands and real estate include in Zakat bill' *Aleqtadiyah* (Riyadh, 13th October 2013) <[http://www.aleqt.com/2013/10/13/article\\_792667.html](http://www.aleqt.com/2013/10/13/article_792667.html)> accessed 1<sup>st</sup> June 2014.

<sup>146</sup> O Aldubabian, 'CSU supports increasing land prices' *al-Hayat* (London, 16<sup>th</sup> September 2016) <<http://www.alhayat.com/m/story/4632026>> accessed 20<sup>th</sup> November 2016.

fairness. For all these considerations, Chapter Four will analyse and examine these issues in greater detail.

**iii. Capping Loan to Value (LTV) at low levels: absence of cooperation in the housing finance market as a potential cause for unpredictable results.**

As has been seen at the beginning of this chapter, the enactment of the housing finance laws 2012 was synchronised with huge promises that they would enhance the mechanism of housing finance and make access to the financial market much easier. Those promises were accompanied by the belief that the laws would facilitate accessing the housing finance market and increase housing finance at a faster pace. Housing finance, however, faced constraints in its operations, as imposed by article 12 of the Regulation of the Real Estate Finance Law 2012 (RREFL). which capped the loan-to-value (LTV) at a low level (70 per cent). It is already apparent that the new housing finance laws, including the REFL, have not provided the development of such market with the boost that was widely anticipated before their implementation. Therefore, the hope and promises that came with enactment were dispelled by the implementation of the laws, which made accessing to the housing finance market much more difficult for Saudi families.

Generally speaking, macro-prudential policies, of which LTV is one, along with other tools such as debt-to-income (DTI)<sup>147</sup> play a significant role in the financial market in general and in housing finance marker in particular, due to their impact on reducing systemic risk and financial instability.<sup>148</sup>The importance of designing and employing macro-prudential tools by financial institutions and banks is derived from the belief that such tools may limit the exposure and vulnerability of the banking sector to volatiles in property prices. Nevertheless, there are a number of advantages to using the LTV, such as decreasing the default rate of borrowers and maintaining the financial system. Also, setting a higher capital and liquidity requirement by capping LTV will grant lenders protection against drops in property prices.<sup>149</sup>

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<sup>147</sup> Debt-to-loan ratio is a way of enabling the lender to measure the ability of a borrower to manage the borrower's monthly repayments. For more information see D Cook, C Schellhorn and L Spellman, 'Lender certification premiums' (2003) 27 Journal of Banking & Finance 156.

<sup>148</sup> G Gabriele and R Moessner, 'Macroprudential policy – a literature review' (2013) 27 Journal of Economic Surveys 846.

<sup>149</sup> For more information about the advantages and disadvantages of the LTV see; S Ghosh, 'Credit growth and macro-prudential regulation: is ownership important?'(2015) 57 international Journal of Law &

At the same time, there are a number of disadvantages due to the higher liquidity requirement involved in capping LTV at low percentage. Liquidity constraints, for instance, are significantly affected by the down payment requirement, because it forces households to depress consumption in order to accumulate the down payment.<sup>150</sup> Moreover, adopting LTV may lead to exclusion of some segments, such as first home buyers and those on low incomes, from the financial market due to their inability to fulfil the high capital requirement.<sup>151</sup> It is therefore argued that the homeownership rate in Germany,<sup>152</sup> which has adopted low LTV of between 40 per cent and 60 per cent, is low whilst the average first time buyer is older than those in many countries where average LTVs are higher.<sup>153</sup>

It is surprising that whenever the Saudi government and legislative authority try to find a solution to enable them to address the housing shortage and the deficit in housing finance, article 12 of the Regulation of the Real Estate Finance Law undermines these efforts. Thus, there is strong sentiment that the adverse impact of applying low LTV on first-home buyers and the housing finance market means that there is potential lack of coordination between the governmental agencies, resulting in a contradiction between the aims of enacting the laws and their implementation. Indeed SAMA,<sup>154</sup> when suggesting capping the LTV at low levels via article (12) of the RREFL, appears not to have taken into account the major aims of enacting the housing finance laws, otherwise it would not

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Management 167 & G Engelhardt, 'Consumption, down payments, and liquidity constraints' (1996) 28 Journal of Money credit and banking 255.

<sup>150</sup> G Engelhardt, 'Consumption, down payments, and liquidity constraints' (1996) 28 Journal of Money credit and banking 255.

<sup>151</sup> D Igan and K Heedon, 'Do loan-to-value and debt-to-income limits work? Evidence from Korea' (*papers.ssrn*, March 2011) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1974849](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1974849)> accessed 4<sup>th</sup> November 2016.

<sup>152</sup> There are many theories have attempted to explain the reason behind the low homeownership in Germany, e.g; some has said Germany has a rather small owner-occupied sector, It has stayed on an almost constant level since 1945, while others attributed the low homeownership in Germany in despite its strength economy to the belief that "the financial burden of homeownership as well as the reduced mobility and flexibility in the labour market may limit the advantages of owning a house"; for further discussion about the homeownership in Germany see: I Helbrecht and T Geilenkeuser, 'Homeownership in Germany: Retirement strategies of households in a tenant society' (2010) 47 *Teorija in praksa* 975; P Westerheide, 'Market stability, housing finance and homeownership in Germany' (2012) *Challenges of the Housing Economy: An International Perspective* 153 & T Zumbro, 'The relationship between homeownership and life satisfaction in Germany' (2014) 29 *Housing Studies* 319.

<sup>153</sup> S Proxenos, 'Homeownership rates: a global perspective' (2002) 17 *Housing finance international* 3.

<sup>154</sup> During the discussion and studying the bill of housing finance laws 2012, before its enactment, SAMA, which participated in drafting these laws recommended to draft article (12) of the bill of Real estate finance law to be allocated to capping the LTV at 70%.

have done so. The development of the housing finance market requires good cooperation between the authorities to prevent unexpected results that conflict with the interests of both the public and the government alike.

The above discussion raises considerations as to the extent to which cooperation between the Saudi authorities regarding housing finance exists, and whether or not Saudi legislator is aware of the adverse impact of applying the LTV on housing finance. If so, to what extent is that impact inconsistent with the general aims of enacting the housing finance laws 2012? If so, moreover, how can the regulatory framework for regulating the housing finance market in general, and for adopting the macro-prudential policy in particular, be developed to achieve the Housing finance laws 2012 aims? Finally, is there an alternative solution that can be adopted to mitigate the adverse impact of the LTV, if it should seem necessary to keep it at a low level?

These questions require us to consider whether or not Saudi legislators have conducted research or published reports indicating the reason behind capping the LTV ratio at 70 per cent. These questions will be answered in Chapter Five.

#### **iv. Challenges in developing the housing finance market through establishing securitisation of the market to remedy liquidity shortage**

Since political, economic and legal circumstances influence the housing finance market, it is not surprising that they may have inadvertent consequences. The function of regulator, therefore, is to deal carefully with these circumstances and propose a complete solution to address unintended side-effects.

For example, when this thesis began in 2012, the Kingdom was enjoying one of its best economic eras<sup>155</sup> due to the huge financial surpluses resulting from oil sales and export.<sup>156</sup> Of course, the huge financial surplus was re-injected back into the financial system to enable it to expand operations in lending, including housing finance. Further unintended

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<sup>155</sup> In 2012, the Saudi budget archived the highest revenues in the last 50 years equals: 1247 billion Saudi Riyals, of course, thanks to the oil prices during that period, for more information about the Saudi budgets see: SAMA, 'The gross domestic product of Saudi' ([sama.gov.sa](http://sama.gov.sa), April 2013) (<http://www.sama.gov.sa/ar-sa/Indices/Pages/GrossDomesticIncome.aspx>) accessed 12<sup>th</sup> November 2016.

<sup>156</sup> Saudi Arabia is considered the world's largest oil exporter; for more information about its role in this industry see; B Samsam, 'World oil production capacity model suggests output peak by 2006-07' (2004) *Oil and Gas Journal* 18 & S James, 'World oil: market or mayhem?' (2009) *The journal of economic perspectives* 145.



side-effects occurred between 2014 and well into 2016 due to the sharp drop in oil prices and the consequent negative impact upon the Saudi economy and lending operations. Naturally, a shortage of liquidity is expected in the wake of the drop in oil prices due to the strong nexus between liquidity and oil prices. A study on the impact of the decline in oil prices on the Saudi economy, published by the International Monetary Fund ('IMF'), showed that 'a 1 per cent decline in oil prices leads to a 0.3-0.4 per cent decline in credit growth, a 0.1-0.2 per cent decline in deposit growth, and higher nonperforming loans'.<sup>157</sup> This was felt in the Saudi economy during the 1980s and 1990s when oil prices collapsed and negatively impacted upon the economic and the level of liquidity in the Kingdom.<sup>158</sup> The Saudi government has adopted various financial means of addressing the liquidity shortage, including privatisation.<sup>159</sup> For example, in late 2002, the Saudi Telecommunications Company was 30 per cent privatised, creating a huge government fund.<sup>160</sup> This suggests that the ability to offset the liquidity shortage was a result of the drop in oil prices.

The unintended effect, which is liquidity shortage, resulted from the drop in oil prices, and represents a threat to the housing finance market because of the latter's need for liquidity. This threat, coupled with the inability of primary lenders and banks to directly access capital markets due to the lack of a housing finance market, provides a mechanism for the cheap and efficient sale of housing finance loan holdings, and therefore makes the effectiveness of the housing finance market questionable. The Saudi housing finance market is traditional, and depends on granting credit to a borrower and holding that credit in a bank's portfolio for long period of time, typically around 30 years, until the whole of the credit is paid off. These features make housing finance market suffers an acute shortage of liquidity much more than in other markets, such as bond and stock markets,

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<sup>157</sup>H Abusaaq and others, 'Saudi Arabia selected issues' (*imf.org*, 14July2015) <<https://www.imf.org/external/pubs/ft/scr/2015/cr15286.pdf>> accessed 15<sup>th</sup> November 2016.

<sup>158</sup> R Auty, 'How natural resources affect economic development' (2000) 18 *Development Policy Review* 347.

<sup>159</sup> It is known amongst economists that privatisation achieves many goals including creating the liquidity. This matter is beyond the scope of this research. However, for more information about it see: T Jean, 'Privatization in Eastern Europe: incentives and the economics of transition' (1991) 6 *NBER Macroeconomics* 221.

<sup>160</sup> For more information about the factors that have been adopted to resolve liquidity constraints, see: M Al-Jasser and A Banafe, 'Globalisation, financial markets and the operation of monetary policy: the experience of Saudi Arabia' (*bis.org*, July 2005) <<http://www.bis.org/publ/bppdf/bispap23u.pdf>> accessed 10<sup>th</sup> March 2016.

which place it at a disadvantage and make it less attractive to investors.<sup>161</sup> The purchaser of shares in the stock market, for example, knows that his investment can be almost instantaneously converted into money, whereas this feature does not exist in the Saudi housing finance market.

The development of the housing finance market requires the creation of a means of enabling the flow of additional funds into the market in order to improve the quality of the housing finance market. Such development depend on the belief that fiscal innovation will play a crucial role in achieving a high percentage of homeownership, as has been observed in the United States, for example. The American housing finance market was developed in order to enable financial institutions to sell housing finance loans to government-sponsored enterprises (GSEs), which has created a new source of liquidity for financial institutions and enabled them to increase their volume of housing finance lending.<sup>162</sup> Some commentators and observers have therefore attributed the high percentage of homeownership in the United States to the development of a housing finance market that offers the desired liquidity and protection for the main participants in the market.<sup>163</sup>

The question arises here, is the Saudi government willing to adopt a solution enhancing liquidity within its housing finance market? If so, to what extent is the solution permanent and distant from the oil markets? It should be borne in mind that the Saudi government intends to give way to the banking sector, through Saudi vision 2030, in order to carry out the task of providing housing finance and creating a healthy environment in which the sector may flourish, including the provision of cheap liquidity.

For these reasons, it could be argued that the solution may be found in adopting the idea of securitisation, which without doubt is considered to be one of the main innovations of the American system, which as can be seen above, has enhanced the efficiency of the housing finance market and has increased the rate of homeownership.<sup>164</sup> The mechanism

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<sup>161</sup> J Prime, *Investment analysis* (Prentice-Hall inc 1946) 45.

<sup>162</sup> A Sanders, 'Barriers to homeownership and housing quality: The impact of the international mortgage market'(2005) 14 *Journal of Housing Economics*147.

<sup>163</sup> M Hwang, 'Financial real estate development: a case study of the US real estate market in the 2000s'in S Wachter, M Cho and M Tch (eds),*The Global financial crisis and housing A new policy paradigm*(Edward Elgar 2014)150.

<sup>164</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R, 2007)9.

of securitisation involves the conversion of housing finance loans into assets or bonds units, which can be traded in the secondary housing finance market and create the desired liquidity for primary lenders. Access to the secondary market grants many features to primary lenders in the housing finance market due to reduction in risk exposure and the increase in their volume of housing finance lending.<sup>165</sup> This, of course, would be reflected in the increased availability, affordability, and continuity of the supply of mortgages at the consumer level.<sup>166</sup> It is evident that if the former features are achieved then a large percentage of the Saudi population could afford to purchase their own property.<sup>167</sup> For all the above considerations, the establishment of a securitisation market might be considered very important for the development of the housing finance market. However, there are some concerns related to the causes of the global financial crisis 2007.<sup>168</sup> In the wake of enactment of the housing finance laws 2012, some members of the *AlShura* Council announced that the laws had taken into account the contributory causes of the global financial crisis of 2007, in order to prevent such a crisis occurring in Saudi Arabia.<sup>169</sup> However, this superficial announcement may have been an exaggeration, inasmuch as one of the major factors generating the crisis, a lack of transparency in securitisation structures, had not been adequately heeded by the Saudi legislator in the Housing finance laws 2012. Also, article (17) of the Real Estate Finance Law 2012 fails to establish a legal basis for securitisation, by preventing an entity that should perform the function of securitisation from carrying out an important process within it, namely issuing bonds. In addition, there is uncertainty surrounding specification of property rights in the event of the borrower's default under the Saudi legal system. Accordingly, there is a need to examine and investigate the legal gaps that can hamper the efforts to

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<sup>165</sup> A Sanders, 'Barriers to homeownership and housing quality: The impact of the international mortgage market' (2005) 14 *Journal of Housing Economics* 147.

<sup>166</sup> B Richard, 'Fannie Mea and the secondary mortgage market' (1971) 66 *Northwestern University Law review* 1.

<sup>167</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R, 2007) 6.

<sup>168</sup> S Wachter, M Cho and J Tcha, 'The global financial crisis and housing: a new policy paradigm' in S Wachter, M Cho and M Tcha (eds), *The global financial crisis and housing* (Edward Elgar 2014) 9.

<sup>169</sup> Securitisation coupled with the global financial crisis 2007 due to the role played by it, as will be explained in details in chapter six, for a brief background about the role played by this innovation in the global financial crisis see; V Acharya and others, 'The financial crisis of 2007-2009: Causes and remedies' (2009) 18 *Financial markets, institutions & instruments* 89.

establish a securitisation market in Saudi Arabia in order to develop the housing finance market. Chapter Six will be given to a discussion of this matter in greater detail.

## **2.6 Conclusion**

This chapter demonstrates that Saudi Arabia has witnessed two housing shortage phases. The first was between the 1970s and 1990s, whilst the second began in the late 1990s and continued until today. It is evident that in both phases the housing shortage was synchronised with a drop in the homeownership rate among the Saudi population. However, as the homeownership rate fell sharply, in the second phase homeownership reached just 47 per cent. This chapter has shown that the homeownership rate is usually used to measure the development of the housing finance market, which suggests that the low homeownership rate in Saudi Arabia is due to the lack development in the housing finance market.

The Saudi government has sought in both phases to develop the housing finance market. The first phase witnessed vast and successful government initiatives that led to demand outstripping supply and an increase in real estate values. However, the second phase did not witness equal success in developing the housing finance market, despite government intervention, an outcome which can be attributed to the demand for housing finance surpassing government initiatives in this sector.

It has been observed that the Saudi government targeted the private sector to help in catering for the huge demand for housing finance. The government has therefore sought to develop the housing finance market to create a healthy environment for the private sector to flourish. Despite the government's initiatives and series of legislative enactments to develop the housing finance market, as has been seen in this chapter, four matters remain undeveloped, and can be considered barriers to the development of housing finance. The following chapters will discuss in details the issues to resolve in completing the development of the Saudi housing finance market.

## **Chapter Three: Building up the housing finance market through granting efficient protection to borrowers and lenders**

### **3.1 Introduction**

This chapter aims to analyse the Supreme Judicial Council's (SJC's) decision, issued on 26<sup>th</sup> August 1981, which stated that all *Sharia* authorities, including courts and notaries public, should not implement mortgage documentation for loans provided by conventional banks in Saudi because those loans are usurious and thus are not *Sharia*-compliant. It is believed that the SJC's decision is hindering the development of the housing finance market by depriving lenders and borrowers alike of mortgage security. The chapter will ask whether or not the provisions of the housing finance laws 2012 overturn that decision. This question can be explored through conceptualizing the SJC's decision, to determine whether it should be considered a legal, administrative or judiciary decision. Then the chapter will aim to create an alternative solution that might bridge the gap produced by the decision.

The chapter is divided into the following sections: the first section (3.1) is the introduction to the chapter. Section two (3.2) emphasises the importance of providing the desired protection for lenders and borrowers in the housing finance market in general, then moves from the general to the particular to focus on the role of banks in the housing finance market in Saudi Arabia and the role played by the SJC, which deprives lender and borrower alike of the optimal security device: mortgage. The chapter then attempts, in section three (3.3), to analyse the SJC's decision. This requires shedding light on the judicial system in Saudi to determine the precise position of the SJC, by examining its authority over other courts and asking whether or not those courts are bound to respond to its orders. The analysis will involve three subheadings: (3.3.1) the judicial system and the role of the SJC pre and post the new Law of the Judiciary 2007; (3.3.2) the legal standing of the SJC's decision; (3.3.3) the attempts to overturn the SJC's decision. Then section four (3.4) examines the extent to which Islamic finance transactions<sup>1</sup> (IFTs),

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<sup>1</sup> Islamic Finance has been defined as; "Islamic finance is limited to financial relationships involving entrepreneurial investment subject to the moral prohibition of (i) interest earnings or usury (*riba*) and money lending, (ii) haram (sinful activity), such as direct or indirect association with lines of business involving alcohol, pork products, firearms, tobacco, and adult entertainment, (iii) speculation, betting, and gambling (*maisir*), including the speculative trade or exchange of money for debt without an underlying asset transfer, (iv) the trading of the same object between buyer and seller (*bay' al inah*), as well as (v)

which were created to avoid conflict with the SJC's decision, grant lenders and borrowers the desired protection in housing finance contracts. To do this, the section branches off into three subheadings, addressing the elements that diminish the protection granted to lender and borrower by IFTs: (i) the risk of recharacterisation of the IFTs; (ii) the lack of priority in IFTs; and (iii) lack protection of the borrower's equity. Then the chapter will introduce in section (3.5) a moderate solution that could address the lack protection without upsetting the SJC's decision through creating a new collateral security structure in the housing finance market. The final section of this chapter (3.6) is the conclusion, which summarises and analyses the key matters addressed throughout the chapter.

### **3.2 Background to the importance of providing intensive legal protection to borrower and lender in the housing finance market**

The well-functioning housing finance system requires legislation governing this field to provide stakeholders, whether borrowers or lenders, with the same degree of comfort, confidence and protection.<sup>2</sup> This concern is raised due to a potential creditor wanting to know whether and to what extent his interests, such as the priority over other claims to the financed property or assurance of the borrower's ability to repay due debts, will be secured and protected when he concludes a housing finance contract. At the same time, a potential borrower wants to protect and secure his interests in the housing finance arrangement through being granted ownership of the property.

A study published in 2008, which analysed a sample of 62 countries, including developed countries and a wide range of emerging economies, found that a more effective housing finance system exists in countries which provide stronger legal rights for both borrowers and lenders (through collateral security and bankruptcy arrangements), and which have a more effective credit information system in addition to a more stable macroeconomic environment.<sup>3</sup> Another study shows that strong protection granted to lenders will lead to

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preventable uncertainty (*gharar*) such as all financial derivative instruments, forwarding contracts, and future agreements". For more information see: F Vogel and S Hayes, *Islamic law and finance: religion, risk, and return* (Brill, 1998) 71.

<sup>2</sup> Deloitte, 'Saudi mortgage laws; A Formula for a well-functioning market?' (*deloitte.com*, August 2012) <[https://www2.deloitte.com/content/dam/Deloitte/xs/Documents/realestate/me\\_real\\_estate\\_mortgage\\_whitepaper\\_072013.pdf](https://www2.deloitte.com/content/dam/Deloitte/xs/Documents/realestate/me_real_estate_mortgage_whitepaper_072013.pdf)> accessed 10<sup>th</sup> November 2016.

<sup>3</sup> W Veronica and W Francis, 'Markets and housing finance' (2008) 17 *Journal of Housing Economics* 239, also for further information about the importance of offering the protection for the main participants in the mortgage market see: L Chiquier, O Hassler and M Lea, 'Mortgage Securities in Emerging

lower interest rates and thus, of course, should result in a decrease in the cost of housing finance.<sup>4</sup>

The above studies point to the importance of legal rights for lenders and borrowers alike in enhancing the efficiency of the housing finance market. For understandable reasons, lenders desire protection of their interests to minimise the adverse consequences of non-payment and insolvency if and when they do occur. At the same time, the general principles of equity require that the same level of protection be provided for borrowers to prevent overreaching by lenders, for example, or to protect them against lenders' insolvency.

However, in the Saudi context the provision of this protection for lenders and borrowers is restricted by the SJC's decision, which deprives them of the strongest type of security: mortgage.<sup>5</sup> On the other hand, it is argued that an alternative mechanism created by banks to protect their interests in the housing finance market does not offer the adequate protection for both lender and borrower, as will be seen later in section 3.4, a factor which weakens these mechanisms.

It should not underestimate the role that might be played by the institution of mortgage in promoting a powerful ideology of homeownership. By mortgaging real estate the individual is able to obtain a loan of substantial capital funds which can then be applied to the purchase of a house.<sup>6</sup> Through mortgage, the dream of homeownership becomes a reality for ordinary people who cannot afford to purchase a dwelling outright. Therefore, the mortgage facility helped to address the first housing shortage era in Saudi, when entire dwellings and houses built with the help of REDF loans were mortgaged in favour of the REDF.<sup>7</sup> Quite apart from the role of mortgage finance in facilitating housing finance activities in Saudi Arabia, many jurisdictions throughout the world have benefitted from this mechanism to promote the ideology of homeownership.<sup>8</sup>

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Markets' ([documents.worldbank.org](http://documents.worldbank.org/curated/en/654661468765314141/pdf/wps3370.pdf), August 2004) <  
<http://documents.worldbank.org/curated/en/654661468765314141/pdf/wps3370.pdf>> accessed 12<sup>th</sup>  
 November 2016.

<sup>4</sup> Q Jun and S Philip, 'How laws and institutions shape financial contracts: The case of bank loans' (2007) 62 *The Journal of Finance* 2803.

<sup>5</sup> See chapter two, section 5 .

<sup>6</sup> K Gray and S Gray, *Elements of land law* (5th edition, Oxford 2009) 695.

<sup>7</sup> S Al-Tasan, *An Evaluation of Housing Finance in Saudi Arabia: The Real Estate Development Fund's Policies and Alternative Options* (University of Durham, 1998).

<sup>8</sup> For example, during the 1990s, the homeownership rate in the UK was 67% of all households, of which in turn 62% were subject to some current mortgage liabilities. For more information about this point see; K Gray and S Gray, *Elements of land law* (5<sup>th</sup> edition, Oxford 2009) 694-699.

Naturally, when lenders in the housing finance market are deprived of such a security device, negative outcomes are predicted for housing finance sector, particularly in cases where an alternative security device cannot replace the mortgage. Therefore, we might wonder intuitively what the nature of the SJC's decision is, and what its causes and impacts are. These speculations lead us to analyse the SJC's decision in the light of the Saudi legal system. The aim of this analysis, as mentioned before, is to find a legal solution which will overturn this decision, or to find an alternative mechanism with which to grant optimal security to both borrower and lender in the housing finance market.

### **3.3 Analysing the SJC's decision and its impact on the housing finance market**

It is clear that security for loans is an important consideration for lenders, playing a substantial role in promoting the finance market by providing stability and enhancing the degree of realization by lenders. Axiomatically, when this element is absent or weak the lenders will be reluctant to lend and provide financial support, or will provide financing at a higher cost.

In 1982, the SJC in Saudi circulated a letter asking all *Sharia* courts and public notaries not to mortgage real estate in favour of banks that provide loans with interest (*riba*)<sup>9</sup> a practice considered to violate Islamic law.<sup>10</sup> This decision deprives banks of the mortgage facility which is designed to provide lenders with a valuable form of security over the housing finance they advance.

In order to understand the SJC's decision it is necessary to bear in mind the nature of the judicial system in Saudi, the hierarchy of the courts, and thus to see how compliance with this decision became binding for all courts and public notaries.

#### **3.3.1 The Judicial system and the role of the SJC pre and post the new Law of the Judiciary 2007**

The judicial system in Saudi is multifaceted. It is divided between the so-called *Sharia* courts, which have jurisdiction over all cases, the Board of Grievances, which is

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<sup>9</sup> There is no doubt that *Riba* is prohibited by the first two main sources of Islamic law, which are the Quran and the Sunnah. For more information about this concept, its forms and the concept behind the prohibition, see: U Chapra, 'The nature of *riba* in Islam' (2006) 2 The journal of Islamic economics and finance 7.

<sup>10</sup> S Khan, 'Secured Lending in Saudi Arabia' (1984) 3 Int'l Fin. L. Rev 27.



concerned with administrative cases to which the government is a party and numbers of committees,<sup>11</sup> which have been created to having jurisdiction over disputes arising in specific areas; for example, the Banking Disputes Resolution committee (BDC).<sup>12</sup> These courts and the Board of Grievances, in addition to other committees, are governed by, first, the general teachings of Islam, and then by a number of legislations and regulations enacted by the legislative authority to govern many aspects of life such as; commerce, finance, banking, ect.

The SJC's decision was made under an old judicial law (the Law of the Judiciary 1975) which was approved by the royal decree no (M/64) dated 14/7/1395H (24<sup>th</sup> July 1975). According to the Law of Judiciary 1975 the Saudi courts, or the so-called *Sharia* courts, consist of three kinds of courts. The Courts of First Instance have jurisdiction to hear cases relating to civil and criminal matters;<sup>13</sup> the Appellate courts have jurisdiction to hear appeals against judgements of the first instance courts. The last kind is the Supreme Judicial Council (SJC), which had a role, and continues to have a modified role, in the hierarchy of the courts<sup>14</sup> where it was authorised to oversee and supervises all level of *Sharia* courts.<sup>15</sup> The Minister of Justice chairs the SJC along with ten other judges, appointed by the King, to represent the SJC's member.<sup>16</sup> The SJC plays many roles: administrative, consultative, judicial.<sup>17</sup> For example, the SJC was authorised by law to study *sharia* matters referred by the Minister of Justice in order to clarify the manner in

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<sup>11</sup> R Aba-Namay, 'The recent constitutional reforms in Saudi Arabia' (1993) 42 International and Comparative Law Quarterly 295.

<sup>12</sup> N Turck, 'Resolution of Disputes in Saudi Arabia' (1991) Arab Law Quarterly 3

<sup>13</sup> J Karl, 'Islamic Law in Saudi Arabia: What Foreign Attorneys Should Know' (1991) 25 Geo. Wash. J. Int'l L. & Econ 131.

<sup>14</sup> B Seaman, 'Islamic Law and Modern Government: Saudi Arabia Supplements the Shari'a to Regulate Development' (1979) 18 Colum. J. Transnat'l L 413.

<sup>15</sup> A Al-Ghadyan, 'The Judiciary in Saudi Arabia' (1998) 13 Arab Law Quarterly 235.

<sup>16</sup> Article 6 of Law of Judiciary 1975 stated that:

"The Supreme Judicial Council shall be composed of eleven members in the following manner:

- Five full-time members of the rank of Chief of the Appellate Court, who shall be appointed by Royal Order. Said members shall constitute the Permanent Panel of the Council which shall be presided over by the member having the longest service in the judiciary
- Five part-time members who shall be the Chief of the Appellate Court or his deputy, the Deputy Minister of Justice, and three of among those having the longest service as Chief Judges of the General Courts in the following cities: Makkah, Madinah, Riyadh, Jeddah, Dammam, and Jizan. Together with the members referred to in the preceding paragraph, they shall constitute the General Panel of the Council, which shall be presided over by the Chairman of the Supreme Judicial Council".

<sup>17</sup> Article 8 of Law of Judiciary approved by royal decree no. M/64, 14 Rajab 1395 (23rd July 1975) ("Law of Judiciary 1975").

which those principles are to be applied within the relevant courts of the judicial system.<sup>18</sup> Also, the SJC might study matters referred by the King to ascertain and state its opinion on them.<sup>19</sup>

However, the SJC's judicial roles have been amended by the new law which was approved in 2007 (the Law of the Judiciary 2007)<sup>20</sup> to assign the SJC a more administrative role. For example, article (6) of the new law defined the new jurisdiction of the SJC as including, but not being limited to, issuing regulations related to a judge's personal affairs, issuing judicial inspection regulations, etc. It is clear that these jurisdictions are considered administrative matters, whereby the SJC exercises a monitoring and regulatory role over the judges' affairs and, where necessary, issues regulations to facilitate the exercise of this role.

Under the new law courts are set up in a three-tiered system consisting of the Supreme Court, the Courts of Appeal and the First Instance Courts while the so-called; the SJC authorised by the Law of Judiciary 2007 to look into the personnel affairs of the judges, or in other word the administrative role. On other hand, the judicial role has been transferred from the SJC to the Supreme Court. Accordingly, under the Law of Judiciary 2007, the component court that is supposed to review SJC's decision in respect of the prohibition on banks to extend mortgages is the Supreme Court.

To summarise the main difference between the Law of Judiciary 1975 and its amendments by the Law of Judiciary 2007 regarding the role of the SJC, it could be said that the SJC had administrative, judicial roles under the 1975 law, but that this position has changed with the 2007 law, which created a new entity called the Supreme Court and authorised it to exercise the judicial role, while the administrative role remains under the authority of the SJC.

### **3.3.2 The legal standing of the SJC's decision**

Consideration should be given to an important element of the decision made by the SJC, namely the question of the SJC's legal standing in terms of its authority and

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<sup>18</sup> Article 8 of Law of Judiciary approved by royal decree no. M/64, 14 Rajab 1395 (23rd July 1975) ("Law of Judiciary 1975").

<sup>19</sup> B Seaman, 'Islamic Law and Modern Government: Saudi Arabia Supplements the Shari'a to Regulate Development' (1979) 18 Colum. J. Transnat'l L 413.

<sup>20</sup> The new Law of Judiciary was approved by the royal decree (no/78) dated 19th Ramadan 1428 (1st October 2007) ("Law of Judiciary 2007").

responsibilities. The impact of this decision cannot be understood without first determining its legal nature; that is, whether it is to be considered judicial or administrative or something else. This point will facilitate analysis of the decision in order to see whether or not the provisions of the housing finance laws 2012 have overturned the SJC's decision.

In light of the general principles outlined by the Law of the Judiciary 1975, the SJC possesses both an interpretive role that does not amount to legislative action, as will be shown later, and a judicial function, in addition to its authority to supervise the lower courts as set forth in that law, which is somehow regarded as an administrative function.<sup>21</sup> Among a number of functions and responsibilities specified in article (8), there are two functions that might be considered interpretive and judicial. For example, article (8) delegates the SJC to express an opinion as requested by the Minister of Justice on matters related to the judiciary, and also authorizes the SJC to express its opinion on issues related to *Sharia* matters as requested by the Minister of Justice,<sup>22</sup> specifying “expression of opinions as requested by the Minister of Justice on matters related to judging and review of *Sharia* matters as to which the Minister of Justice finds it necessary to declare general *Sharia* principles”.<sup>23</sup>

Although the above statements explicitly authorise the SJC to play both an interpretive and a judicial role, there are some opinions emerging from the SJC’s members which treats these functions as administrative, and as not amounting to judicial or interpretive functions. Frank Vogel, in his book: *Islamic Law and Legal System Studies of Saudi Arabia*, interviewed some members of the SJC, asking them whether or not the SJC plays a judicial role. The answers were surprising, because *Alghusun*, a member of the SJC and the Board of Senior *Ulama*, has a specific philosophy regarding this matter: he believes that the provisions constituting the Law of the Judiciary 1975 are considered administrative clauses; accordingly the authority delegated to the SJC by these clauses is administrative as well.<sup>24</sup> This opinion was affirmed by the Chairman of the SJC from a

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<sup>21</sup> Article (7), Law of the Judiciary 1975, for more information about the role played by the SJC to supervise the judicial system in Saudi see: J Walker, ‘The Rights of the Accused in Saudi Criminal Procedure’ (1992) 15 *Loy. LA Int'l & Comp. LJ* 863.

<sup>22</sup> F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 108.

<sup>23</sup> Article (8) of Law of the Judiciary 1975.

<sup>24</sup> F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 115.

different standpoint when he told Vogel, in response to the latter's question about the SJC's role, "the council's decisions could bind judges only on administrative matters".<sup>25</sup> Vogel, in the same book, adduced some statements from which it can be inferred that the SJC plays an interpretive role, when he asked official government members: shall the judges follow the SJC when deciding a disputed point or are they free to apply their own *ijtihad* (opinion)? Of course, this question calls for an indication of the interpretive role of the SJC, because there is no controversy about the administrative one, which is axiomatic, while there are problematic aspects of the interpretive role. *Al-Faryan*, deputy Minister of Justice, answered that judges are bound by the SJC's decisions unless they can persuade the SJC regarding why they did not apply its decision and instead applied their own *ijtihad*; in that case it is unlikely that their judgement would be reversed.<sup>26</sup>

The same question was directed to the president of the Bureau of Experts of the Council of Ministers, who stated that in general the SJC's decisions bind the judges except in two eventualities: if they do not mind if their judgement is abolished by the SJC, or if they can persuade the SJC that their *ijtihad* (opinion) is not covered by its decision.<sup>27</sup> These statements from experts in the Saudi legal system give a clear indication, to some extent, of the interpretive role played by the SJC. Even SJC members opposed this opinion, on grounds that the correct interpretation of articles (6) and (7) of the Law of the Judiciary 1975 expressly indicates that the interpretive role is compatible with the pronouncements

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<sup>25</sup> The above statements need to be examined, because despite being issued by members of the SJC, they are not concerned with the criticism regarding the current issue, which is the SJC's decision on mortgages. Generally speaking, the members of the SJC are judges, except one who is a deputy of the Judicial Ministry (article (6)), while judges under the Saudi judicial system are chosen from among the graduates of *Sharia* colleges (article (37)), and they do not pursue legal studies, most subjects they study being disciplines within Islamic law. In consequence, it might be said that the background of these SJC members did not help them to interpret the judiciary law and its provisions accurately, because their background in Islamic law alone might have led to defective interpretation of the legal clauses. In addition, the Chairman's statement was made in a different context related to the concept of *ijtihad* in Islamic law. *Ijtihad* refers to the maximum effort expended by jurists or judges to master and apply the principles and rules of Islamic law so as to determine religious opinion about a specific matter or to advise the judge about a case, for more information see; W Hallaq, 'Was the Gate of *Ijtihad* Closed?' (1984) 16 Int'l. J. Middle East Stud 3. Whether or not the judges under general Islamic law are required to apply the opinions reached after the exercise of *ijtihad*, or can abandon that opinion in favour of another of the SJC's decisions. This matter was confirmed by the Chairman of the SJC when he told Vogel: "the SJC's understanding does not bind anyone, since the *qadi* (judge) has freedom in his judging within the limits of the texts of the *Sharia* and principles of its *fiqh* (jurisprudence)". This statement tacitly suggests that the SJC might issue judicial and legislative rules; its responsibilities are not limited to administrative tasks. For more information, see: F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 112.

<sup>26</sup> F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 109.

<sup>27</sup> F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 109.

of experts in the Saudi legal system. This point leads us to ask: is the SJC's decision in relation to mortgages administrative or interpretive or something else? If it is interpretive, then it will support the conclusion of this argument.

In fact, even though the aim of this decision might give the impression that it is merely an operational matter, preventing both judges and general notaries from "authenticating the mortgage of commercial bank loans on which such banks take interest from the debtor a certain percentage",<sup>28</sup> it is in its nature an interpretive, not a judicial ruling for many reasons. Firstly, the justification offered by the SJC for its decision is that loans provided by the commercial banks involve interest, which is prohibited in Islamic law. This ruling is considered a statement of general *Sharia* principles, because it establishes a general rule which all judges and general notaries are bound to follow, and this is compatible with article (8) of the Law of the Judiciary 1975 which authorised the SJC to play this role. Secondly, the reason for not defining the decision as judicial lies in the fact that the decision did not result from a lawsuit or trial. Rather, it was made in the wake of requests by many notaries and judges that the SJC relieve them of the role of registering and enforcing mortgages for commercial banks, because they believed that the banks' loans involve usury, which of course does not comply with Islamic law, so that if they engage in it they will commit a sin. It seems that notaries and judges referred to a hadith of the Prophet (BUH) condemning the writer of a usurious loan.<sup>29</sup> Hence, following this request, the SJC issued the aforementioned decision.

However, Vogel, in the same book, claimed that this decision is an administrative order because "notaries have no power to find facts, the order provides them with a mechanical, rule-of-thumb procedure to follow".<sup>30</sup> This claim might in some respects be untrue. Judges are empowered to find facts, since they are empowered to form judgements and make decisions about a lawsuit or a trial. Secondly, the decision was made, as mentioned above, in the wake of the request made by the notaries and judges asking to be relieved of this function because they did not want to commit a sin: which implies that they just

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<sup>28</sup> M Alameldin, 'Banking Disputes in Saudi Arabia' (1991) 36 Int'l Fin. L. Rev 10.

<sup>29</sup> For more information about usurious loan in Islam see: A Ahmad, 'Riba and Islamic banking' (2007) 3 Journal of Islamic Economics, Banking and Finance 1.

<sup>30</sup> F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 113.

wanted a legal tool that they could rely on when refusing to register and enforce a mortgage for a commercial bank.<sup>31</sup>

Finally, whether we consider the SJC's decision administrative or interpretive, the reality is that the provisions of the housing finance laws 2012, and in particular the Real Estate Finance Law 2012, could not overturn the SJC's decision. Thus, it could be argued that the existence of the SJC's decision, despite the enactment of the housing finance laws 2012, might be attributed to the previous result, namely that administrative and interpretive decisions require the same level of decision to overturn them. Thus, the SJC's decision still operates despite the enactment of the housing finance laws 2012 which support the former explanation. Nevertheless, in the last 30 years there have been many attempts to overturn the SJC's decision, to mitigate its negative impact on the finance sector in general and housing finance in particular.

### **3.3.3 The attempts to overturn the SJC's decision**

There is no need to show the impact of this decision on the banking sector because it is clear enough without proof that the banks thereby lose one of the strongest mechanisms for securing their rights. However, the question that might arise here is whether or not there were attempts to review or resolve this issue, particularly with the emergence of Islamic banking at the end of the 1980s, which provided products that comply with the general tenets of Islamic law.

In fact, there were many attempts to review and overturn this decision. For example, in the wake of the SJC's decision issuance, banks turned to the King to complain about it, pointing to the huge risks resulting from the decision, as well as to the losses they were incurring by it, and asked the authorities to find a proper solution to the problem. The response was a royal order issued not to resolve the issue, but to clarify it, to the effect that not all banking operations involve *riba*, and that therefore notaries and judges should not refuse to authenticate a mortgage in favour of the banks unless they find an explicit clause referring to the interest, in which case they have the right to refuse to do so.<sup>32</sup> This

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<sup>31</sup>M Alameldin, 'Banking Disputes in Saudi Arabia' (1991) 36 Int'l Fin. L. Rev 10.

<sup>32</sup>M Alameldin, 'Banking Disputes in Saudi Arabia' (1991) 36 Int'l Fin. L. Rev 10.

royal order was circulated to all courts, including judges and notaries, by the Ministry of Justice, which is considered part of the government, asking them to implement this order. Although the royal order was issued by the King,<sup>33</sup> it neither resolved the issue nor added anything new. It was merely a tool reiterating the judges' duties, because if looked at it from another standpoint, it will be seen that the order did not ask the judges to ignore the SJC's decision and implement the mortgage in favour of the banks – which usually do not use the term *riba* or interest in their contracts, but instead use synonyms for interest, such as profit, in order to circumvent the courts. It was not surprising, therefore, that the royal order did not make a huge difference; the judges and notaries continued to reject registration and enforcement of the mortgages.<sup>34</sup>

It is worth shedding light on some considerations related to the above attempt to overturn the SJC's decision. Saudi judicial system, namely that judges, who are respected in the community, do not carry out decrees or regulations which are considered improper or invalid due to inconsistency with the general principles of Islamic law. They instead reject them, thus contradicting the King, or simply ignore them and refrain from implementing them.<sup>35</sup> The legal umbrella under which they derive their power from is article (1) of the Law of the Judiciary 1975, which stated: "Judges are independent and, in the administration of justice, they shall be subject to no authority other than the provisions of *Shari'ah* and laws in force. No one may interfere with the Judiciary".

The provision of article (1) of the old judiciary law was not changed in the Law of the Judiciary 2007,<sup>36</sup> which include the same provision in article(1). Based on this article, no one has the authority to force judges to do something that they regard as distasteful, especially if it conflicts with Islamic law, because when legislation, including a royal order, conflicts with Islamic law, Islamic law will usually prevail.<sup>37</sup> Accordingly, it might be said that the practice of judges in relation to royal order is regarded as implicitly

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<sup>33</sup> Under the Basic law of Governance, which is considered Saudi constitutional law, the King has the power and authority to appoint all authorities: legislative, judiciary and executive, article (42).

<sup>34</sup> M Alameldin, 'Banking Disputes in Saudi Arabia' (1991) 36 Int'l Fin. L. Rev 10.

<sup>35</sup> F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 120.

<sup>36</sup> Article (1) of Law of the Judiciary 2007 states that "Judges are independent and, in the administration of justice, they shall be subject to no authority other than the provisions of Sharia and laws in force. No one may interfere with the judiciary".

<sup>37</sup> In fact, the above opinion based on the provision of article (48) of the Basic Law of Governance, which is considered the constitutional law in Saudi, which stated that "*The courts shall apply to cases before them the provisions of Islamic Shari'ah, as indicated by the Qur'an and the Sunnah, and whatever laws not in conflict with the Qur'an and the Sunnah which the authorities may promulgate*".

reflecting the principle of judicial independence, which gives judges the freedom to make judicial decisions without intervention by other authorities, executive or legislative.<sup>38</sup>

Another attempt to review the SJC's decision was made when, after nearly 20 years, it was mentioned during drafting the housing finance laws 2012, that the SJC's decision was regarded as an obstacle hindering the banks' operations and that it needed to be abolished in order to support their role in housing finance market.<sup>39</sup> The law firm, that drafted the housing finance laws 2012, suggested that the SJC's decision should be overturned by the royal decree that was expected to approve the laws. This suggestion was based on the conviction that a royal decree, considered the highest legal instrument in the Saudi legal system, could overturn the decision. However, this attempt was not given consideration either when the housing finance laws 2012 were being studied, or when the approval of the laws was issued, due to the decision's continued validity, which affirms the claim that this attempt to overturn the decision did not work.

No official statement was made about this matter, but it might be surmised that the legislative authority in Saudi considered some points that led it to ignore the suggestion. For instance, the Basic Law of Governance (BLG) 1991, which is considered Saudi constitutional law, gives judges and judicial institutions absolute power to implement the general principles of Islamic law and places emphasis on an important point, which is the independence of the judicial authority, stating that "there shall be no power over judges in their judicial function other than that of the Islamic *sharia*".<sup>40</sup> The interpretation of this article has given the SJC's decision immunity from intervention by other authorities, including the King.

For all above considerations, it could be argued that the SJC's decision shall only be reviewed or overturned by the Supreme Court under the Law of the Judiciary 2007 and that the fate of any action taken by other authorities, including the King, to review the decision will be to fail.

Notwithstanding unsuccessful attempts to overturn the SJC's decision, the circumstances have helped lenders in Saudi to create a new financing mechanism which grants them the adequate, to some extent, protection; that is, the establishment of the Islamic finance

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<sup>38</sup> A Al-Jarbou, 'Judicial Independence: Case Study of Saudi Arabia'(2004) 19 Arab Law Quarterly 5

<sup>39</sup> The above suggestion was mentioned in the draft of the housing finance laws 2012 that was referred to the government to be studied prior to its approval. I have got that draft due to having worked as legal advisor at the Council of Ministers.

<sup>40</sup> Article (46) of the Basic law of Governance.



industry. However, this mechanism has not been accepted by the SJC, for the same reasons that it rejected the banks' right to mortgage property. The next section will explain this matter in detail.

### **3.4 Islamic finance transactions (IFTs) and the housing finance market: solution or dilemma**

A significant event, occurring during the period between the first and second attempts to overturn the SJC's decision, which made such an overturn, theoretically, worth pursuing, was the establishment of Islamic finance in Saudi.

Generally speaking, the banking system was officially established in October 1952, its introduction being synchronised with the creation of the Saudi Arabian Monetary Agency (SAMA) or central bank,<sup>41</sup> and all banks established under the authority of SAMA were conventional banks, which implies that they operate transactions involving usury. This factor renders the SJC's decision acceptable at that time. However, in 1988, for the first time, SAMA permitted banks to operate by conducting the IFTs, initially the *Al-Rajhi* Company for currency exchange and commerce, which was common practice among ordinary people as it was an Islamic bank and this allowed many conventional banks to operate Islamic finance transactions when they took note of the huge public demand for Islamic finance products.<sup>42</sup>

Of course it can be argued that the establishment of the Islamic finance in Saudi was not sufficient to convince the SJC to overturn its decision, although its reason for preventing banks from registering and enforcing mortgages, namely the presence of usury, no longer existed in banks to the extent that they provided the IFTs. What then was the SJC's justification? This argument is rational and justified, but it is difficult to identify the reason behind the SJC's insistence on its decision, since there is no official statement or judicial judgement or opinion to indicate or guide us towards the SJC's viewpoint. However, it might be observed that there are two potential hypotheses which could explain the continued application of this decision and the SJC's unwillingness to review it despite the emergence of the IFTs.

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<sup>41</sup> J Al-Suhamaimi, 'Consolidation, competition, foreign presence and systemic stability in the Saudi banking industry' (2011) Bank for International Settlements Information, Press & Library Services 1.

<sup>42</sup> P Wilson, *A Question of Interest: The Paralysis of Saudi Banking* (Westview Press 1991) 33.

The first hypothesis rests on the modernity of the IFTs in Saudi, which was established during the 1980s. That modernity might be considered an excuse for the courts, judges and notaries not to endorse and accept the IFTs, by defining them as not *Sharia*-compliant. Of course this has led to regard all banks' operations, whether conventional or Islamic, as involving usury. Lack of understanding of the correct nature of Islamic finance and its products may be considered the reason why judges and notaries do not accept it, but regard it merely as a set of techniques for circumventing the SJC's decision. The IFTs was born in an environment of suspicion and distrust because Islamic finance transactions, which were subject to the different views of religious scholars as to whether to approve or disapprove them, according to the circumstances and arguments surrounding these modes.

At the beginning of the establishment of the IFTs were, and to some extent still are, approved or disapproved by the *Sharia* boards.<sup>43</sup> However, the central banks and conventional banks, as well as individuals, are sometimes confused by the different rulings of the *Sharia* boards on IFTs, as some of these boards construct a specific form of finance transaction to make it consistent with Islamic law, while other boards deem such forms of IFTs contrary to the general teachings of Islamic law.<sup>44</sup> This instability in the rulings on the IFTs resulted from the absence of consensus on them among Muslim scholars and the *Sharia* boards, which was justified, inasmuch as such an emerging industry needs time and considerable effort to attain stability through application of the ancient principles of Islamic law to modern banking instruments and products so as to bring them into compliance with the general teachings of Islam.<sup>45</sup>

It might be argued, however, that the judges should not be confused by the different rulings on IFTs issued by the *Sharia* boards, because a judge is supposed to have the capacity and knowledge needed to examine the structure of the IFTs and consider whether or not their forms comply with Islamic law. In particular, under the Saudi legal system that requires the study of Islamic law by those chosen to be judges, because the latter are supposed to be knowledgeable about Islamic law and have a good background in Islamic finance. This argument is sound to the extent that judges are chosen from among graduates of *Sharia* (Islamic law) colleges which teach a number of disciplines relating

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<sup>43</sup> K Ginena and A Hamid, *Foundations of Sharia governance of Islamic banks*(Wiley 2015) 256.

<sup>44</sup>F Al-Omar and M Abdel-Haq, *Islamic banking: theory, practice, and challenges* (Zed Books1996)55.

<sup>45</sup>R Wilson, 'Parallels between Islamic and ethical banking' (2002) *Review of Islamic Economics* 51.

to Islamic law; however, not all graduates from these colleges are experts in Islamic finance which is considered an independent discipline.

Even though Islamic finance is designed to be compliant with Islamic law and to create instruments subject to the general principles of Islamic law, it is very difficult to say that people who are experts in Islamic law will also be experts in the IFTs. Therefore, it was documented that the IFTs industry faced some challenges when first established, including the lack of teaching, training and research in this field.<sup>46</sup> The requests issued at the beginning of the Islamic finance industry emphasise the shortage of qualified people who possess a thorough knowledge of Islamic law as well as of modern economics and finance.<sup>47</sup>

For all above considerations, it could be argued that despite judges and notaries having graduated from *Sharia* (Islamic law) colleges, they do not necessarily possess a good understanding of Islamic finance, which in turn might explain why the SJC has not overturn its decision. The reluctance of the SJC to review and overturn its decision might be attributed to a lack of understanding of the IFTs, causing it to deem these forms of Islamic finance a means of circumventing the SJC's decision.

The fear and reluctance surrounding the IFTs, however, should disappear as the industry matures, since it has been developed, improved and served through the setting up of forums and seminars, in addition to teaching programmes in many universities.<sup>48</sup> These projects have helped to make the community, including notaries and judges, aware of the industry and its products, and they can ensure that it operates according to the general principles of Islamic law. These elements and efforts were not enough to convince the SJC to review its decision to exempt from its decision Islamic banks and conventional banks which provide the IFTs.

However, it might be said that this insistence by the SJC on its decision and its unwillingness to review it could point to another issue that has not been taken into account, and is considered the second hypothesis with which to explain the continuation of this decision up to the present. The second hypothesis supposes that pressure on the

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<sup>46</sup> M Iqbal, A Auşāf and K Tariqullah, *Challenges Facing Islamic Banking* (Islamic Research and Training Institute 1998) 48.

<sup>47</sup> T Zaher and M Hassan, 'A comparative literature survey of Islamic finance and banking' (2001) 10 *Financial Markets, Institutions & Instruments* 155.

<sup>48</sup> R Wilson, 'The development of Islamic finance in the gulf cooperation council states' in D Held and K Ulrichsen (ed), *The Transformation of the Gulf: Politics, Economics and the Global Order* (Routledge 2013) 146.

SJC has diminished because the banks have found suitable ways and mechanisms with which to provide themselves with protection, to some extent, for their loans and at the same time avoid upsetting the SJC's decision.

In fact, the banks did not stand still and do nothing about that decision, because they wanted to expand their operation and to make a profit. Therefore, they developed many ways to avoid facing such a decision, as will be shown later. But it was found that none of these methods provided complete protection for both creditors and debtors; they either protected the creditor at the expense of the debtor or vice versa. For example, some banks ask the debtor to mortgage his/her property in favour of an employee of the bank; then a public notary cannot refuse to register that property.<sup>49</sup> But this method does not protect the debtor against the creditor's insolvency nor is it a perfect tool for protecting creditors, because the employee in whose favour the real estate was mortgaged might use this trust to exercise his right as mortgagee against the mortgagor, even if he leaves the bank.<sup>50</sup>

The above hypothesis, which combines the SJC's deep distrust of the IFTs with the alternative means found by the banks to provide security and protection, might explain the retention of the SJC's decision up to the present. However, banks have continued to search for ways of providing the desired security along with full protection of their interests. It is worth glancing for a moment at most of the ways adopted by national Saudi banks to secure their loans through the use of the IFTs after developing them to serve their interest without the need to resort to *Sharia* courts or public notaries.

It was found that the banks tend to establish, under Company Law 1965,<sup>51</sup> a new company owned by a bank and another person who is usually a member of the board of directors of the bank; the function of this company is to enter into the finance agreement, so that the finance agreement will be tripartite, involving a bank, a customer and this company. How does this contract or agreement work? In brief, the main function of this company is to buy and resell a property to a customer on behalf of the bank, whose function is limited to financing the transaction, through applying Islamic finance transactions, such as: *ijarah muntahiah be atmlik* and *ijara with waad be alhibah*.<sup>52</sup> Therefore, this form or

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<sup>49</sup> M Iqbal, A Auşāf and K Tariqullah, *Challenges Facing Islamic Banking* (Islamic Research and Training Institute 1998) 41.

<sup>50</sup> S Khan, 'Secured Lending in Saudi Arabia' (1984) 3 Int'l Fin. L. Rev 27.

<sup>51</sup> Company law was approved by Royal Decree no. (M/6) dated 22/3/1385H (22<sup>nd</sup> July 1965).

<sup>52</sup> The concept behind the means of converting a finance transaction to an Islamic transaction, or in other words how to Islamise a conventional transaction, is: first, owning the property that is meant to be financed, and then reselling or leasing it to the borrower. For example, *ijarah muntahiah be atmlki* is very similar to

contract is a three-party contract between a bank, a customer and a company owned by the bank. The question arises here: Why do banks resort to establishing a company in order to implement IFTs? In fact, the banks have resorted to the method of establishing a company to circumvent article (10) of the Banking Control Law 1966 (BCL),<sup>53</sup> which prohibits banks from undertaking any activity relating to real estate unless that activity is necessary to conduct its banking business or for the purpose of its employees' housing, or from acquiring real estate in return for a debt due to the bank, because if the bank had acquired an item of real estate for finance purposes and registered it in its name, it would have contravened this article.

It is noteworthy that above-described agreement was designed in the late 1990s or 2000s and appeared not during the 1980s, because the articles<sup>54</sup> that have emerged concerning the SJC's decision were published at the mid of the 1980s and at the beginning of the 1990s respectively, and did not mention this mechanism of the IFTs. Also, the IFTs were used in the beginning as a means of expanding operations concerning personal loans, or short-term loans. The housing finance sector did not need this mechanism, due to the REDF's provision of interest-free loans for individuals. However, the circumstances changed, making it increasingly urgent to develop IFTs to cater for the huge demand for housing finance loans from 2006 up to the present. The question that needs to be answered in this context is: do the IFTs grant the adequate protection for lender and borrower alike in the housing finance market?

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a hire purchase contract whereby the bank buys a property and then releases it to the borrowers who will be eligible to own it at the end of the contract, while the bank still has the right to terminate the contract in the case of borrower default. By contrast, the so-called *ijara with waad be alhibah* is a lease with the promise of donation whereby the bank concludes two contracts with the borrowers: the first contract as a lease contract, involving the same condition of allowing the bank to terminate the contract in the case of default, while the second contract is merely a promise from the bank to the borrower that the latter will donate the financed property if the borrower has paid all obligations under that contract. For further information see: P Scherer, K Torchani and J Elsen, 'Islamic banking and finance in the light of German regulatory law' (2013) 28 *Journal of International Banking Law and Regulation* 27.

<sup>53</sup> The BCL was approved by Royal Decree no. (M/5) dated 22-2-1386 (11<sup>th</sup> July 1966).

<sup>54</sup> So far, there are two articles and one book have turned up which refer to above matter: M Alameldin, 'Banking Disputes in Saudi Arabia' (1991) 36 *Int'l Fin. L. Rev* 10 & S Khan, 'Secured Lending in Saudi Arabia' (1984) 3 *Int'l Fin. L. Rev* 27 & F Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 112.

### **3.4.1 Emerging legal challenges to Islamic finance transactions in the protection sector**

There is no doubt that the foregoing method (the IFTs) has achieved many goals such as: Islamizing conventional finance agreements and converting them into Islamic transactions; in addition, avoiding the SJC's decision and hence freeing lenders, particularly banks, from the authority of the SJC pertaining to mortgages, thus giving them plenty of space to conclude any of the aforementioned the IFTs. This step has been welcomed by many individuals who were looking for any transactions that could enable them to avoid committing the sin involved in concluding conventional transactions, as mentioned at the beginning of this chapter.

Therefore, the IFTs might be considered a strategy for helping lenders and borrower alike: helping the borrower to avoid committing the sin of *riba*, and helping the lender to avoid confronting the SJC's decision and obtain good protection for their loans.

Given the benefits of this vehicle in the protection field, the significant advantage to the lender of reserving and retaining the title to financed property will be found in the ground that no ownership rights vest in the borrower until the debt owed is fully paid. A further advantage for the lender is that, given the retention of title, no further procedure is needed to enable him to assert his rights against the third party. In addition, this device might be considered a simple technique used by the lender to obtain stable credit from the borrower.

But despite the above advantages and despite the fact that the IFTs are very important devices in the modern financial markets in Saudi, playing a substantial role in the lending market in general, and recently in the market for home loans, we should not ignore the risks that might flow from the IFTs, inflicting considerable harm on the element of protection. Those risks, as will be discussed in detail later, stemmed from the belief that the Saudi legal system, along with the financial system, is still developing; in addition, there are many legal defects that aggravated these risks. This is not to say that the Saudi legal system, including its legislative, judicial and executive authorities, cannot meet the demand by the financial markets and participants to develop the IFTs and other financial tools in order to achieve the desired protection for all parties. Rather, what should be emphasised is that the Saudi legal system is developing, which explains why some legal

defects have emerged from the application of IFTs. In contrast, developed legal systems which have financial tools similar to the IFTs have the capacity, through application of certain principles, to mitigate the risks generated by those tools and thus to grant both lenders and borrowers the desired protection in this field.

To understand how the developed legal system and its principles play a crucial role in mitigating the risks that might flow from financial tools similar to IFTs, it might be useful to briefly shed light on the English law, which will be used as a good example of a developed legal system. English law is a rich system containing many financial tools, similar to IFTs, that were established to meet commercial and industrial entrepreneurs' need for capital and at the same time to provide the desired protection for both lender and borrower. For example, the finance lease, hire purchase and repurchase agreements on financial markets – so-called repos<sup>55</sup> – are financial forms and agreements,<sup>56</sup> resembling IFTs, which were introduced to meet the market's need for capital.

Therefore, when Lord Scott, in *Re Spectrum Plus Ltd*,<sup>57</sup> explained the history and development of the floating charge,<sup>58</sup> which was brought in to cater to the specific need of companies for more capital, he pointed out that this modern form of security, which had become firmly established, was not created by statute; rather, equity lawyers and judges contributed to its development.<sup>59</sup>

Some of these financial tools are subject to the risk of recharacterisation, which of course impairs the protection they provide. This risk, however, is mitigated to some extent by the application of *stare decisis* under English law, which enables lawyers and participants in the financial markets to predict the courts' orientation towards such financial tools and then know the risk involved in these financial tools and know that the courts are bound

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<sup>55</sup> A 'repo' was created to serve both parties where a seller would sell securities to a counterparty buyer for cash, with a simultaneous agreement to repurchase the same or equivalent securities at a specific price at a later date. K Ong and E Yeung, 'Repos & securities lending: the accounting arbitrage and their role in the global financial crisis' (2010) *Capital Markets Law Journal* 1.

<sup>56</sup> For further discussion about the financial tools and their history under English law see: A McKnight, 'The reform of English law concerning secured transactions: Part 1' (2006) 21 *Journal of International Banking Law and Regulation* 497.

<sup>57</sup> [2005] 2 AC 680 at paras 95,97.

<sup>58</sup> G McCormack, 'Creating charges' in Gore-Browne and others(ed), *Gore-Browne on Companies*(Jordans 2005).

<sup>59</sup> G McCormack, 'Creating charges' in Gore-Browne and others(ed), *Gore-Browne on Companies*(Jordans 2005).

by the previous decision, as an application of the *stare decisis* principle.<sup>60</sup> For instance, the financial tools that involve transferring the title as a security – such as a repurchase agreement<sup>61</sup> whereby a dealer, or "repo seller", sells a security to a financier, or for cash<sup>62</sup> – are subject to two characterisations: as a true sale, or perhaps, through recharacterisation, as a loan secured by a mortgage of the receivables.<sup>63</sup>

In *Re George Inglefield, Ltd.*,<sup>64</sup> for example, in order to determine whether the contract between the parties was a true sale or a loan secured by the title, three indicia were prescribed with which to distinguish a sale transaction from a transaction of mortgage or charge:<sup>65</sup>

“First, in a sale transaction, the vendor is not entitled to get back the subject matter of the sale by returning to the purchaser the money that has passed between them. In the case of a mortgage or charge, the mortgagor is entitled (until he has been foreclosed) to get back the subject matter of the mortgage or charge by returning to the mortgagee the money that has passed between them.”

“Second, if a mortgagee realizes the mortgaged property for a sum that is insufficient to repay him, the mortgagee is entitled to recover from the mortgagor any balance, whereas in a sale and purchase contract the purchaser has to bear any loss suffered on a subsequent sale of the asset by him.”

“Third, if a mortgagee realizes the subject matter of the mortgage for a sum more than sufficient to repay (together with interest and costs) the money that has passed between him and the mortgagor, he has to account to the mortgagor for any surplus. Whereas, in

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<sup>60</sup>A Berg, ‘Recharacterisation after Enron’ (2003) *Journal of Business Law* 205.

<sup>61</sup> Repurchase agreement was identified by 1(a) the Global Master Repurchase Agreement as : “one party ... (Seller) agrees to sell to the other ... (Buyer) securities ... (Securities) ... against the payment of the purchase price by Buyer to Seller [“first leg”], with a simultaneous agreement by Buyer to sell to Seller Securities equivalent to such Securities at a date certain or on demand against the payment of the repurchase price by Seller to Buyer second leg”. A Ruchin, ‘Can Securities Lending Transactions Substitute for Repurchase Agreement Transactions’ (2011) 128 *Banking LJ* 450.

<sup>62</sup> L Schroeder, ‘A Repo Opera: How Criimi Mae Got Repos Backwards’ (2002) 76 *Am Bankr LJ* 7 565.

<sup>63</sup> K Ong and E Yeung, ‘Repos & securities lending: the accounting arbitrage and their role in the global financial crisis’ (2010) *Capital Markets Law Journal* 1.

<sup>64</sup> *Re George Inglefield, Ltd.*, 48 T.L.R. 536, 539 (C.A. 1932); *Welsh Dev. Agency v.*

<sup>65</sup> M Daley, ‘Funded participations - mitigation of grantor credit risk’(2009)24 *Journal of International Banking Law and Regulation* 288.



a sale and purchase contract, any profit realized by the purchaser is for the purchaser's account.”<sup>66</sup>

This case became judicial precedent and the three indicia might give lawyers and financial participants a sufficient level of certainty about the criteria for distinguishing between a sale transaction and a mortgage or charge to refer to them when they desire to conclude a repurchase agreement. Thus, the participants are aware of the court's orientation towards such an agreement, which enables them to use this case as one of *stare decisis* to avoid the risk of recharacterisation.<sup>67</sup>

Also, in *Welsh Development Agency v. Export Finance Co., Ltd*<sup>68</sup>, it was held that a court will uphold a transaction structured by the parties as a sale for the purposes of the registration of company charges provisions of the UK Companies Act, unless: (i) the transaction is, in substance, a mortgage arrangement and not a sale, or (ii) the transaction is a sham.<sup>69</sup> Again such indicators suggest the courts' orientation towards such a financial agreement, leading the participants and financial markets to take extra care when concluding these agreements in view of the fact that courts are bound by the principle of *stare decisis*.

In contrast, the absence of the *stare decisis* principle from the Saudi legal system and reliance instead on *de novo* case-by-case enforcement in the Saudi Arabian courts has denied participants knowledge of the court's orientation towards the nature of IFTs, thus making it more difficult to predict their nature, since IFTs are subject to the risk of recharacterisation.<sup>70</sup> Also, it could be argued that the absence of existing specific legislation to govern these financial tools increases the fear that they will provide insufficient protection, as will be explained in detail below.

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<sup>66</sup>M Raines and G Wong, ‘Aspects of Securitization of Future Cash Flows Under English and New York Law’ (2002) 12 Duke J. Comp. & Int'l L 453.

<sup>67</sup> P Spink and C Ong, ‘Substance versus form: Anglo-Australian perspectives on title financing transactions’ (2004) 63 Cambridge Law Journal 199.

<sup>68</sup> [1991] AC 270.

<sup>69</sup> M Raines and G Wong, ‘Aspects of Securitization of Future Cash Flows Under English and New York Law’ (2002) 12 Duke J. Comp. & Int'l L 453.

<sup>70</sup>M McMillen, ‘*Rahn* Concepts in Saudi Arabia: Formalization and a Registration and Prioritization System’ ([papers.ssrn.com](http://papers.ssrn.com), 31 August 2010)<  
[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1670104](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670104)> accessed 20<sup>th</sup> November 2016.

Accordingly, in light of the absence of the *stare decisis* principle from the judiciary system in Saudi, along with the absence of legislation to regulate and prescribe the provisions of IFTs, it is believed that there are three significant dilemmas which weaken the security protection granted by the foregoing IFTs, and that the contracting parties in the IFTs are likely to incur the risks stemming from these dilemmas, which are as follows:

**i. The risk of recharacterisation of the IFTs**

As has been explained earlier, the borrower acquires loans through the IFTs, namely *ijarah muntahiah be atmlik* and *ijara with waad be alhibah*, which rely on the mechanism of buying a property determined by the borrower, then concluding another transaction with the borrower which includes leasing the property to him while the homeownership remains with the lender, who promises to transfer the homeownership to the borrower when the whole debt is paid in full. In these transactions, the question arises: what is the legal nature of the agreement between the lender and his borrower; is it a lease or sale transaction? The lender's retention of title to the financed property, and the contractual relationship between lender and borrower, requires us to consider the borrower as a lessee in these transactions. However, if we look at these transactions from another viewpoint, in particular by considering that the borrower acquires this loan in order to own the property and these mechanisms are mere vehicles for achieving double interests for both borrower and lender, as mentioned above, then the borrower could be regarded as the buyer of the financed property. Another point supports the latter legal identity, namely the intention of the borrower, who, when he concludes the transactions, tends to consider himself a buyer not a lessee. This intention can be discovered and observed in many ways as will be shown below.

There is no doubt that a borrower who goes to a lender, bank, to gain the finance needed to buy a house considers himself a buyer not a lessee, regardless of the name given to the contract, because names do not change the legal nature of things. It is clear, also, that the contracting parties concluded these transactions for specific purposes; for example, the lender attempts to circumvent the SJC's decision through the use of the IFTs, while the borrower desires to obtain finance without committing the terrible sin represented by *riba*. These different aims or goals of the contracting parties can be considered a matter of form and substance, because what counts in revealing the legal nature of such transactions is the intention of the parties when they concluded the contract. Another presumption might

indicate the intention of the borrower to consider the contract one of sale not lease; namely the instalments because usually the instalments in sale contracts to somehow are higher than their counterparts in lease contracts.<sup>71</sup> For example, if a normal house costs £500 in monthly rent, the same house might cost £650 if it is sold in instalments. Of course, these figures are approximate because the precise figures depend on many other elements, such as the interest or discount rate applicable to the transaction. These presumptions form the central consideration according to which these transactions tend to treat the borrower as a buyer rather than a lessee.

Nevertheless, it is evident that the IFTs might be subject to the risk of recharacterisation since they can be considered a lease or a sale contract, which of course might have a negative impact on the protection they grant. The possible negative impact of such a recharacterisation can be discerned in the risk that might be borne by the lender and the borrower alike. For example, there are two scenarios which in fact are related to each other, with the second scenario dependent on the first. In the event of the insolvency of the borrower, the lender has a right based on the IFTs to terminate the finance contract and retain the title, pursuant to the clauses included in that contract which grant the lender this right in the case of the borrower default on paying the instalments owed.<sup>72</sup>

However, the risk that might affect the protection granted to the lender resides in the possibility of the borrower having recourse to the court to repossess the title from the lender. The borrower can base his litigation on the legal clause granting him ownership, in that the lender is a mere financier while he is the buyer of that property and the formulation of the contract was worded for specific purposes, namely circumventing the SJC's decision and avoiding involvement in conventional contracts which of course involve *riba*.

Support for acceptance of above litigation by the court can be derived from the general principles of Islamic law, especially as presented by the *Hanbali* School and adopted by the judicial authority in Saudi,<sup>73</sup> which demonstrates that the intention of the contracting

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<sup>71</sup> G Canner and others, 'Payment of household debts' (1991) 77 Fed. Res 218 & F Reiss, 'Buying versus renting farmland' (1972) 12 Illinois Agricultural Economics 37.

<sup>72</sup>A Boumediene, 'Is credit risk really higher in Islamic banks?' (*papers.ssrn.com*, August 2011) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1689885](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1689885)> accessed 12<sup>th</sup> November 2016.

<sup>73</sup> S Shamma, 'Law and Lawyers in Saudi Arabia' (1965) 14 International and Comparative Law Quarterly 1034 & S Solaim, 'Saudi Arabia's judicial system' (1971) The Middle East Journal 403 & A Al-Ghadyan, 'The Judiciary in Saudi Arabia' (1998) 13 Arab Law Quarterly 235.

parties enjoys full legal effect.<sup>74</sup> The borrower would build his litigation on this principle, by saying that his intention when concluding the contract was to buy the house, not rent it from the financier; and further that this intention rested on a view of the contract as a sale contract, not a lease contract.<sup>75</sup> In this case, the court may resort to adopting the above-mentioned principle that the intention of the parties enjoys full legal effect, and accordingly hold that the financed property shall be repossessed by the borrower because the contract is a sale contract, not a lease contract, and the borrower is therefore the owner of the property being financed. The rationale of this potential judgement is, as mentioned earlier, that the intention exerts the full legal impact under the general principles of Islamic law. In *Alshedi real estate company v Alrajhi bank*,<sup>76</sup> for example, the claimant (the borrower) accused the defendant (the lender) of trying to sell the property being financed under an IFT whereas the property belonged to him because the homeownership

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<sup>74</sup> It is noteworthy that the general principles of Islamic law, which were interpreted by the four schools, *Hanafi, Malki, Shafai, Hanbali*, control and govern the matters related to retention of title. However, as seen in the above scenario, it is not clear how the concepts in this matter were applied, because in that case the lender is considered the financier, seller, and owner of the financed property and included some clauses in the finance agreement granting him the right to terminate the contract without involvement from the court. It seems that the authority granted to the lender is wide and uncontrolled, and needs to be determined and controlled by legislation to be enacted just as on other matters and subjects controlled by laws, such as the Finance Lease Law and Mortgage Law. Although the principles of these laws were controlled by Islamic law, it may be said that the purpose of legislating on these aspects is to unify the opinions raised on these matters and to make it easier for individuals and professionals alike to gain access to what they want. For further information see: C Childress, 'Saudi-Arabian Contract Law: A Comparative Perspective' (1990) 2 Thomas LF 69.

<sup>75</sup>A. Oussama, 'Intention and Method in Sanhūrī's Fiqh: Cause as Ulterior Motive' (1997) 4 Islamic L. and Soc'ty 200.

<sup>76</sup> To see the full judgement visit: The Ministry of Justice, 'The judicial judgment for 1429' (*bog.gov.sa*, July 2014) <

was granted to the lender as a security. The court ruled that the defendant should stop the sale process because he only retained the homeownership as a security.

It could be argued that as long the court has directed its orientation towards the legal nature of IFTs, then there can be no concern over the potential effect of recharacterisation, since both the market and the participant will be aware of the legal nature of IFTs before concluding a housing finance contract. However, there is a point to take into account before responding to the former argument, which is that the judiciary system in Saudi does not apply the principle of *stare decisis*;<sup>77</sup> in other words, it is difficult to rely on the above case as a fixed judicial orientation that will not be changed in the future.<sup>78</sup>

The lack of application of *stare decisis* within the Saudi judicial system has increased the risk involved in IFTs because, as mentioned above, the transactions impose two legal natures on the borrower: lessee and buyer, each of which has duties and rights differing from those of the other.<sup>79</sup> In addition, the absence of adherence to *stare decisis* appears here as an important element, since its presence would have helped in deducing the orientation of the court towards the legal nature of the borrower/buyer in the IFTs, if the decision had been published within the legal system in Saudi and the binding precedent principle were applied.<sup>80</sup> In other words, adherence to the foregoing principle may lead to reduction of the risk involved in the IFTs, in turn enabling the financial markets to include investors, and encouraging customers to take extra care when dealing with such transactions. Meanwhile, the adoption of these principles will give the markets sufficient scope for developing and improving the financing tools to render them consistent with the courts' judgements.<sup>81</sup>

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<sup>77</sup> *Stare decisis* is Latin word means let the decision stand and in practice means that any court made a decision then the courts which are equivalent or lower that court are bound to apply the same decision in the same cases. For further information of this concept, see: J Holland and J Webb, *Learning legal rules* (9<sup>th</sup> edition, Oxford 2016) 152 & E Finch and S Fafinski, *Legal skills* (5<sup>th</sup> edition, Oxford 2015) 127.

<sup>78</sup> For further information about the judicial system in Saudi and whether or not adopts *the stare decisis* see: R Moore, 'Courts, law, justice, and criminal trials in Saudi Arabia' (1987) 11 *International Journal of Comparative and Applied Criminal Justice* 61 & A Al-Ghadyan, 'The Judiciary in Saudi Arabia' (1998) 13 *Arab Law Quarterly* 235.

<sup>79</sup> M McMillen, 'Islamic Banking: Home Purchase Financings I: The Lease' (*papers.ssrn.com*, 31 July 2012) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2276262](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2276262)> accessed 20<sup>th</sup> November 2016.

<sup>80</sup> M McMillen, 'Rahn Concepts in Saudi Arabia: Formalization and a Registration and Prioritization System' (*papers.ssrn.com*, 31 August 2010) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1670104](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670104)> accessed 20<sup>th</sup> November 2016.

<sup>81</sup> An example illustrated how the adherence of the principle of *stare decisis* might mitigate the risk involves in the finance transactions that subject to the characterisation. The Federal Court of Australia published the judgement on *Beconwood Securities Pty Ltd (Beconwood) and others v Australia and New Zealand Banking*

Another case affirms that the risk of recharacterisation might impair the protection provided by the IFTs, and at the same time illustrates the reluctance of the Saudi judicial system to consider an IFT either a sale or a lease transaction. A claimant who had concluded an Islamic finance transaction with the defendant (a rental car company) argued that he had rented a car from the defendant through an *Ijarah munthiah be altamleek* transaction; however, the car being damaged, he argued that the court should oblige the defendant to replace the damaged car with a new one. The claimant build his argument on the belief that the contract between him and the defendant is lease contract. The defendant, however, rejected the claim, arguing that the contract between them was a sale contract and that title was thus retained by the defendant to secure his rights, because at the end of the *Ijarah munthiah be altamleek* agreement, the title of the car would be transferred to the renter (the claimant). However, the court recharacterised the agreement as a lease contract.<sup>82</sup>

For all the above considerations, it could be said that, although IFTs offer a level of security for both the lender and the borrower, they involve a huge risk concerning the potential recharacterisation of the legal nature of IFTs. This factor might reflect negatively on the certainty of the arrangement, with the result that the markets and the participants might not increase their operations in the housing finance market by means of IFTs while the Saudi judicial system is still reluctant to consider them either sale contracts or lease contracts.

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*Group Limited and others.* Beconwood entered into a securities lending and borrowing agreement which involved transferring shares in the amount of around AU\$7m to Opes Prim Stockbroking, in return for a loan facility of AU\$1,35m. Later, Opes supplied Beconwood's securities to Australia and New Zealand Banking Group Limited and others under a separate borrowing and lending agreement. However, Opes collapsed and insolvency procedures started; then Beconwood resorted to the court to retain possession of the securities which were transferred to the borrower. He tried to recharacterise the agreement as a mortgage or charge to enable him to repossess the title of that agreement. He built a legal foundation for his claim by arguing that the agreement, in reality, was a mortgage pursuant to the mechanism of that agreement because Beconwood borrowed money from Opes in return for securities transferred to the latter to secure the loan. The Federal Court of Australia, however, dismissed this argument, holding that title to the shares was absolutely transferred to Opes, who had the right to dispose of it.

The impact of the above judgement on the financial market is globally significant, since the court upheld a new principle in this agreement, indicating to investors who want to conclude such transactions that any attempt to recharacterise the legal nature of this transaction or its parties will be dismissed by the court, as happened in the case in question. Accordingly, both investors and individuals will be aware of this principle when concluding transactions of this type, due to the publication of this judgement. For further discussion about this case and its effect of the financial markets see: W Jeremy and E Julia, 'Securities lending: title transfer upheld down under'(2008) 2 Law & Fin. Mkt. Rev 348. Also see; L Michael, 'Securities "lending" agreement transfer legal title to securities' (2008) Company Law Newsletter 231.

<sup>82</sup>To see this judgement see: Board of Grievances, 'The Judgments and principles for 1429' (*bog.gov.sa*, July 2010) <<http://www1.bog.gov.sa/ScientificContent/JudicialBlogs/1429/Pages/default.aspx>> accessed 10<sup>th</sup> November 2016.

With respect to the second scenario, it is worth glancing for a moment at the feature granted by the mortgage to the lender (mortgagee), which is considered significant, and then determining whether or not the IFTs grants such a feature. Pursuant to the general principles of mortgage stipulated in the Mortgage Law,<sup>83</sup> which included the general principles of mortgage (*rahn*) in Islamic law, the mortgagee is granted priority against other lenders in the financed property.<sup>84</sup> Therefore, the lender or mortgagee will gain this right if he uses the mortgage mechanism as a device for securing the loan.<sup>85</sup> The inability to record or enforce the mortgage method due to the SJC's decision has forced lenders, including banks, to use alternative methods that are supposed to grant them the desired security, as embodied in the IFTs. However, these transactions do not provide the same feature, because the loans resulting from the IFTs are considered ordinary debt, not privileged debt, and do not grant the lender priority against other lenders. So if the borrower succeeded in repossessing the title of the financed property, which is what might happen according to the above first scenario argument, the lender would then lose the advantage of priority against other lenders, in the case of the borrower's insolvency, in regard to the property financed.

One will notice here the difference between the rights stemming from a mortgage, which grants lenders strong protection and secures their loans,<sup>86</sup> and the counterpart rights stemming from the IFTs, which grant ownership to the lenders with the possibility of repossession by the borrower, as mentioned above. In addition, the debts arising from the IFTs rights will forfeit the advantage of being treated as privileged debts.

The risk of recharacterisation of the IFTs is really a double-edged sword because it can be used by both contracting parties to enforce their own rights, which of course gives an indication of the uncertainty surrounding the security that IFTs offer. The insecurity that

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<sup>83</sup> Article (1) of the Mortgage Law that was approved by the Royal decree no (M/75) dated 2ed July 2012 stipulated the same concept, whereby the mortgagor has priority against other lenders.

<sup>84</sup> In fact the mortgage in the west has the same feature mentioned above in Islamic law which is the mortgagee is granted priority against other lenders in the financed property, for further information about this topic see: G Nelson and D Whitman, 'Adopting Restatement Mortgage Subrogation Principles: Saving Billions of Dollars for Refinancing Homeowners' (*papers.ssrn.com*, 9<sup>th</sup> May 2006) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=932083](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=932083)> accessed 10<sup>th</sup> November 2016.

<sup>85</sup> M McMillen, 'Rahn Concepts in Saudi Arabia: Formalization and a Registration and Prioritization System' (*papers.ssrn.com*, 31 August 2010) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1670104](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670104)> accessed 24<sup>th</sup> November 2013.

<sup>86</sup> H Chaplin, 'The story of mortgage law' (1890) *Harvard Law Review* 1 & R Skilton, 'Developments in Mortgage Law and Practice' (1942) 17 *Temp. LQ* 315.

hovers over IFTs due to potential recharacterisation might be mitigated if the court's orientation towards these transactions were known and bound by other courts. However, that practice does not exist within the Saudi judicial system. Ultimately, the risk of recharacterisation might, in fact, extend to affecting another matter, namely the lack of priority of IFTs should the lender succeed in repossessing the title, in which case the risk of impairing the lender's right could arise, as will be discussed below.

## **ii. The lack of priority in IFTs**

It is evident from the above section that IFTs are subject to the risk of recharacterisation when a dispute arises between lender and borrower, which causes the court in some cases to consider the IFT a sale contract rather than a lease contract. In this case, the borrower is entitled to repossess the title of the property being financed while the lender is entitled to the due debt arising from the housing finance transaction which means the lender's loss of the protection. However, there is another possible scenario, in case the borrower succeeds in repossessing the title of the property being financed, but the borrower then goes bankrupt. The question arises here: Do the IFTs protect the lenders' rights against other lenders involved in the property being financed?

The substantial shortcomings of the IFTs as security devices might be fully grasped when they are compared with mortgages. Although the IFTs have served lenders by granting them good security devices in place of mortgage, uncertainly still prevails in case the borrower defaults and simultaneously goes into bankruptcy. In fact, the legal rights due under the IFTs might be impaired by any equities subsequently arising, because the IFTs do not provide the same advantage afforded by mortgage to a mortgagee, who is given priority over other creditors.<sup>87</sup> It is worth noting that, by a fundamental principle of mortgage law generally, fixed legal rights acquired through a mortgage will not be affected by other due financial claims should the borrower declare insolvency; this principle was stated in article (18) of the mortgage law.<sup>88</sup>

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<sup>87</sup> Although the mortgagee has priority over other lenders, there are some cases where the mortgagee's position has subjected to some changing in particular when the mortgagee's priority clashes with the tax claim, for further information about this case see: P Alces, 'Unexpired Leases in Bankruptcy: Rights of the Affected Mortgagee'(1983) 35 U. Fla. L. Rev 656 & G Gilmore, 'Circular Priority Systems' (1961) 71The Yale Law Journal 53.

<sup>88</sup> Mortgage Law was approved by Royal decree no [M/49] dated 3 /7/2012.



Such a substantial deficiency as the lack of a priority feature will reduce the value of the lender's security interests, granted to him by the IFTs, so that the lender must bear the risk arising from these transactions. As mentioned earlier, any feature that reduces the effectiveness of security devices will lead of course to an increase in the interest rate to cover the risk created by this negative feature, and in the end the borrower will bear that increase.<sup>89</sup>

In these circumstances, either the lack of alternative security devices available under the Saudi legal system, or the legal limitations that prevent the lenders from using a perfect security device, that is, mortgage, will cause lenders to feel obliged to accept the IFTs and deal with them despite the risk involved in these transactions.

Therefore, to grant good protection to the lender through IFTs it is necessary to find a remedy for that lack of protection, which is the lack of priority. To do this, it is necessary to review the categories that are granted the advantage of priority against other creditors in the case of a debtor's insolvency under the Saudi legal system; then, to attempt to deduce the criterion used by the legislator to grant priority to those categories. Finally, the criterion which will be deduced will be applied to our case to see whether or not it is possible to grant the lender this right within Islamic finance transactions (IFTs).

The Saudi regulator has granted some categories the advantage of priority over other creditors through protecting their rights in the event of a debtor's insolvency. For instance, all due debts to the government have been given this advantage.<sup>90</sup> Also, the mortgagee's right in mortgage transactions has been protected by granting him priority against other creditors<sup>91</sup> and reimbursement of expenses incurred in connection with bankruptcy.<sup>92</sup> Another category which has been protected under the Saudi legal system is alimony, which was ensured by law; therefore, when the wife or husband declares insolvency, the right arising from alimony is granted priority against other creditors.<sup>93</sup>

Although the Saudi legislator did not explicitly mention the approach of giving some creditors priority over others, it could be argued that the legislators might adopt certain

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<sup>89</sup>S Harris and C Mooney, 'A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously' (1994) *Virginia Law Review* 2021.

<sup>90</sup> According to article (19) of State Revenue law which was enacted by the Royal decree no (M/86) Dated 18/11/1431H.

<sup>91</sup> According to article (21) of Mortgage Law.

<sup>92</sup> According to article (21) of Mortgage Law.

<sup>93</sup> According to article(37) of Civil pension law which was enacted by royal decree no (M/41) dated 26/7/1393.

criteria, such as protecting the public purse or safeguarding the interests of weaker – perhaps involuntary – creditors who are not in a position to bargain effectively for security.

However, it has been noted that when the legislator tends to grant some categories this advantage, he asserts in law or regulation the right of priority, to give it legitimacy. Accordingly, as long as the legislator is convinced that he should grant some categories this advantage, there is no legal obstacle to doing so.

The due debts from housing finance loans or the IFTs deserve special treatment since these debts arose from tools which are considered a long-term financing device, namely the IFTs. In particular, these tools are employed in place of mortgage to protect the lenders' interests. Usually, the period of paying back these loans is between 15 and 25 years, in contrast to personal loans whose payback takes between 2 and 7 years. These differences make it necessary to give the lender within the IFTs good protection, including the priority over other creditors in the event that the borrower goes into bankruptcy and has already repossessed the title from the lender. In addition, the need to grant this advantage to lenders who deal with the IFTs is especially important since this advantage will enhance trust in the housing finance market and make lenders feel that their interests will be protected during the whole period of the housing finance loan. Finally, granting lender this advantage will not influence the borrower's interests where the impact of this step will be limited to the third party, while the borrower's will not be affected.

Is it questionable to apply to lenders in the IFTs the advantage that was granted to the aforementioned categories? Based on the above considerations, there is no legal obstacle to granting lender this advantage, besides which, the benefits that will be gained are obvious and do not need more proof. Also, the borrower's interests will not be undermined by this suggestion, since the law guarantees his interests and there is no way that suggestion could mitigate them. In view of these considerations, it is safe to say that this proposal will enhance and reinforce financing activities and grant the lender adequate protection.

### **iii. The lack of protection of the borrower's equity**

Borrowers use the IFTs, which are considered a title retention device, in certain high-risk transactions to fill the gap between the amount of credit available and the amount of credit required by prospective sellers to enable them to purchase homes. The reasonable

assumption of the borrower is that if he completes payment pursuant to the contract he will receive title from the lender, who retains title to the property being financed under the IFTs. However, the consequences of retention of title by the lenders might lead to unsatisfactory outcomes, which of course would conflict with the main purpose of creating such transactions, namely to enhance and facilitate the mechanisms of housing finance.

The retention of title by the lender jeopardises the position of the borrower and exposes him/her to two legal risks: first, the risk that the title of the property being financed might be transferred to a third party without the borrower's consent; and second, as revealed by comparison with mortgage, the risk that the borrower under an IFT might be exposed to additional loss, as will be explained below in detail.

1- Naturally, borrowers seek protection to protect their interests because the prospectively financed home will become one of the most important assets of the borrower, if not the best and most valuable one.<sup>94</sup> This is particularly true of medium-income borrower, who must give the transaction greater attention and care to ensure that the finance mechanism provides them with good protection.<sup>95</sup> In fact, borrowers are not generally given the same protection as lenders by the IFTs. As has been seen, the lender (bank) within the IFTs enjoys to some extent the perfect assurance represented by ownership, through the company owned by the lender (bank) that protects lender's interests despite the above-mentioned risks that might impair it, as embodied in the risk of the recharacterisation the transaction and the potential risk that might result from it. An ownership of course is considered to some extent a perfect security device.<sup>96</sup> Meantime, the borrower is granted possession of the financed property and enjoyment of its use during the term of contract as long he pays the due instalments; but such possession cannot prevent the occurrence of events that may result in damage to the borrower and impact on his interests – because possession “is good against the whole world except the person who can shew a good title”.<sup>97</sup>

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<sup>94</sup> A Dupuis and D Thorns, ‘Home, home ownership and the search for ontological Security’ (1998) 46 *The Sociological Review* 24.

<sup>95</sup> T Shapiro, ‘Race, homeownership and wealth’ (2006) 20 *Wash. UJL & Pol’y* 53.

<sup>96</sup> B Azmy and D Reiss, ‘Modeling a Response to Predatory Lending: The New Jersey Home Ownership Security Act of 2002’ (2004) 35 *Rutgers Law Journal* 645.

<sup>97</sup> J Christospher, ‘Concurrent fee simple and the registration act’ (2002) 130 *The Law Quarterly Review* 8.

The impact of possession on the borrower's protection can be observed when it is compared with mortgage, in which both parties have the same level of security, with the mortgagor enjoying the ownership and title to the financed property, while the mortgagee enjoys the perfect security granted to him through the property being mortgaged in his favour.<sup>98</sup> However, recording financed property in favour of the company owned by the lender (bank) under the IFTs makes the ownership subject to transfer to the third party under any circumstances, which can be and should be contractually prevented, that in turn will jeopardise the borrower's equity for loss.

For instance, if a lender declares insolvency or enters negotiations with creditors under the Law of Settlement Preventing from Bankruptcy,<sup>99</sup> all properties which were financed by the lender under the IFT will be seized by the court or liquidator, being considered part of the lender's assets, as he owns the titles of those properties. The borrower in this case cannot establish his rights without incurring the delay and expense of trial, which of course works against the principle of strong protection.<sup>100</sup> The situation might be worse inasmuch as IFTs are not required by the Saudi legal system to be registered, because IFTs are concluded between the lender and borrower without further registration requirements. This leaves the borrower's interest unsecured in light of the ownership of the property being financed having been granted to the lender.<sup>101</sup>

It might be argued that this scenario is imaginary and the chance of its arising is slight, making it difficult to rely on it to demonstrate the lack of protection granted

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<sup>98</sup> For further information about the rights and liabilities of the mortgagee and mortgagor see: L Warm, 'Some Aspects of the Rights and Liabilities of Mortgagee, Mortgagor and Grantee' (1935) 10 Temp. LQ 116 & F Denton, 'Right of a Mortgagee to Recover Damages from a Third Party for Injury to Mortgaged Property in Ohio' (1937) 3 LJ Student B. Ass'n Ohio St. U 161. However, for further information about mortgage in Saudi see: M McMillen, 'Rahn Concepts in Saudi Arabia: Formalization and a Registration and Prioritization System' (*papers.ssrn.com*, 31 August 2010) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1670104](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1670104)> accessed 11<sup>th</sup> November 2016.

<sup>99</sup> The Law of Settlement Preventing from Bankruptcy was approved by the Royal decree no (M/ 16) dated 25<sup>th</sup> January 1996. It is noteworthy the Ministry of Commerce and Industry announced on 17<sup>th</sup> March its intention to regulate all aspects of bankruptcy and asked those who were interested, such as lawyers, financiers, etc., to contribute by contacting the Ministry and providing any suggestions or advice on this topic.

<sup>100</sup> P Garrett, 'Land Contracts as Security Devices' (1965) 12 Wayne L. Rev 391.

<sup>101</sup> It must be noted that the new mortgage law 2012 obliges all mortgage contracts to be registered. However, the IFTs cannot be considered as a mortgage contracts because they are not, they are just housing finance contracts are used to replace the mortgage contract that deprived by the SJC's decision.

to the borrower by IFTs. But in fact, this situation is not imaginary and the risk is not slight: some local Saudi newspapers, for example, reported a case that illustrates how granting ownership to the lender under an IFT might expose the borrower's interest in the property being financed to the risk of transferral of the title to a third party. A trader entered into an IFT with a financial institution to obtain finance, to be paid back in instalments over 10 years, to buy a building.<sup>102</sup> The financial institution required, in order to secure its interest, that the title of the building be transferred to it until the debt owed was fully paid at which point the trader could recover the title. However, when a dispute arose between the trader and the financial institution about the application of some the provisions contract, the latter did not turn to the court to settle it, but instead exploited the situation and exercised its discretion to starts selling the property, as it owned the title of the building being financed, so that there was no need to resort to the court. The trader in turn resorted to the court to repossess the building and to prevent the financial institution from selling it; but the dispute was still being heard by the court, which had not yet reached a decision on the case.<sup>103</sup>

The above case showed that IFTs offered, to some extent, good protection to the lender but not to the borrower, because the ownership granted to the financial institution made it possible for it to transfer the title to a third party, leaving the borrower's interest at risk of loss. Therefore, it is necessary to limit the authority of lenders within IFTs, in order to maintain the rights of borrowers.

2-The comparison with mortgage revealed that the borrower under an IFT might be exposed to extra loss due to the ownership granted to the lender. There is no doubt that the purported transformation of the title to the lender via IFTs is regarded as a loan secured by the title of the property being financed. In case the borrower should not meet his liabilities under the IFT by paying the owed debt,

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<sup>102</sup>A Albarqawi, 'Real estate cases ended by obliging the company to remove the advertising' *Sabaq* (Riyadh, 1<sup>st</sup> July 2016) <<http://linkis.com/sabq.org/Rsj3A>> accessed 12<sup>th</sup> November 2016.

<sup>103</sup>The above concern was observed by the Ministry of Justice when the deputy Prime Minister of Justice alluded that all mortgage contracts must be registered according to the Mortgage law 2012 because the Ministry of Justice observe that some lenders require to transfer the title of the property being financed to secure their rights under the housing finance contracts without registering these contracts which might expose the borrowers to the risk of losing their properties. Probably, the deputy minister of Justice alluded to the IFTs because there is no legal provisions require them to be registered. See: Aleqtisadiah, 'The Mistery of Justice: the Public notaries are entitled to apply the Mortgage law 2012' *Aleqtisadiah* (Riyadh, 10<sup>th</sup> December 2016) <[http://www.aleqt.com/2016/12/10/article\\_1109093.html](http://www.aleqt.com/2016/12/10/article_1109093.html)> accessed 15<sup>th</sup> December 2016.

then the lender, as the owner of the property being financed, could sell it without the need to resort to the court. The question that arises here is whether or not the lender, when realising the subject matter of the housing finance for a sum more than sufficient to repay (together with interest and costs) the money that has passed between him and the borrower, must account to the borrower for any surplus. There is no certain answer to this question since there is no legal provision legislating and regulating this case. However, it is probable that the general principle of a sale transaction would be applied in this case, implying that the lender is the owner and is entitled to the value of the property being financed, so that if the borrower wants to acquire his interest in proceeds exceeding the unpaid amount of the loan, then he needs to turn to the court, which of course would cost money and time.

In contrast, the mortgage and its principle are clear under Islamic law<sup>104</sup> and they became much clearer when the Saudi legislator enacted the Real Estate Mortgage Law 2012, which explains this case in detail.<sup>105</sup> Article (29), for example, states that if a mortgagee realizes the subject matter of the mortgage for a sum more than sufficient to repay the money that has passed between him and the mortgagor, he has to account to the mortgagor for any surplus. Therefore, if the borrower used the mortgage to finance the purchase of a home, the mortgage would not have exposed his interest to the kind of risk involved in IFTs.

For all the above considerations, it could be argued that IFTs do not give the borrower the same protection as that granted to the lender.

In light of the above analysis of IFTs and the protection provided by these transactions to both parties, the question arises here: is there a possibility of evaluating the IFTs so as to fill the above legal gaps and at the same time to create new individual financing techniques that maintain the interests of both parties?<sup>106</sup> The following section will answer this question.

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<sup>104</sup> K Eid, 'The rights & duties of a mortgage secured debt from the point view of the Saudi Legislator' (2011) 3 *Interdisciplinary Journal of Contemporary Research In Business* 96 & W Gnichtel, 'Lease Financing in Saudi Arabia' (1984) 3 *Int'l Fin. L. Rev.* 34.

<sup>105</sup> The Real estate finance Law was enacted by the Royal decree no( M/ 25) dated 12/08/1433 (12<sup>th</sup> July 2012).

<sup>106</sup> M McMillen, 'Islamic Sharia –compliant project finance: collateral security and financing structure and financing structure case studies' (2001) 24 *Fordham International Law Journal* 1184.

### 3.5 Old wine in new bottles: creating a new collateral security structure in the housing finance market

Considering the above criticisms of IFTs, and the belief that the SJC's decision is to some extent immune from attempts to overturn it, along with the fact that the absence of *stare decisis* principles and reliance on *de novo* case-by-case enforcement in the Saudi Arabian courts make it difficult to predict the outcome of court action, there is an increased need for the executive and legislative authorities to address this issue. It is necessary to rethink the situation and seek an alternative collateral security structure which would grant the same level of protection to both lender and borrower. Although it would be difficult for such a mechanism to grant the perfect security provided by a mortgage, it would at least deter several criticisms the grounds for which are inherent in IFTs.

Implementing the proposed technique would involve addressing a variety of legal and financial issues, some of them being noted in this chapter. However, the alternative solution needs to be developed and evolved to meet certain requirements; for example: keeping ownership under the authority of the borrower to grant him the desired protection against the lender's insolvency; establishing an entity independent of lender and borrower to hold the collateral on behalf of the lender; and finally, keeping granting both parties, lender and borrower, the same level of protection.

The most difficult task in developing such a technique is to find a person or create an entity that will hold the collateral and keep it at the same distance from lender and borrower, and will be trusted by both parties to the housing finance agreement. These characteristics, however, can be found and in fact are embodied in the Islamic concept of the *adel*. Islamic law has long experience with the idea of the *adel*, who is similar to a trustee in the western sense.<sup>107</sup> In simple words, the *adel* is a trusted and honourable person selected by both lender and borrower to hold the collateral.<sup>108</sup> Usually, the *adel* is

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<sup>107</sup> For information about the concept of trustee, its function in the personal property in the west see: G Gilmore, *Security interests in personal property* (The law book Exchange, Ltd, 1999) 1280.

<sup>108</sup> M Gaudiosi, 'The influence of the Islamic law of *waqf* on the development of the trust in England: The case of Merton College' (1988) 136 *University of Pennsylvania Law Review* 1231.

required to have specific fiduciary responsibilities towards both parties. As we are looking for a technique to serve the whole housing finance sector rather than purely individual matters, we need to apply the *adel* concept to an entity rather than a person. In doing so, it may seem difficult to find an entity that can be trusted by different banks, financial institutions, and individuals from different parts of the country and with different orientations. However, these fears might be allayed if we succeed in developing this concept and establishing a special purpose vehicle (SPV) owned by the government to fulfil such fiduciary responsibilities. Involving the government in the proposed technique should grant the entity trust, efficiency and strength.

The government is advised to establish a special purpose vehicle (SPV) under article 155 of the Companies Law<sup>109</sup> which grants the right to establish a special purpose vehicle SPV to exercise fiduciary responsibilities. This company will be considered a third party in all housing finance contracts. To make the picture clearer, the borrower will retain ownership of the property being financed to grant him the proper protection in this bargain. At the same time, to secure the lender's rights and interests, the property being financed will be mortgaged in favour of the SPV owned by the government. This way, besides granting the borrower the desired protection, the arrangement limits his powers to act in relation to the property, thus securing the lender's interests while not violating the SJC's decision.

The SPV owned by the government (the *adel*) is obliged to refrain from selling the property given as security without a final judgement being issued by the high court to give the lender the right to sell the property to satisfy the debt in case of borrower default. Also, the SPV cannot revoke the mortgage without the consent of both lender and borrower, when the borrower has paid the entire debt. To prevent negligence or fraud, the consent should be provided in writing and signed by a person recognized by the SPV.

In order to ensure the success of such a collateral security structure, it would be necessary to determine the functions, responsibilities, ownership, and capital of the proposed company and enact them in the form of a regulation or law. This step of course will make sure that such a SPV achieves its desired goals and aims.

The question arises here as to whether the government would be willing to adopt this proposal to enhance the efficiency of the housing finance market and protect the rights of

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<sup>109</sup>The new Company law was approved by the Royal Decree no(M/3) dated 28/01/1437H.



all parties. In fact, the need to adopt such a proposal is not limited to the above advantages, but rather extends to the benefits of establishing a securitization market, which is regarded as impossible given the role played by the SJC's decision, as will be shown in chapter six. In the last ten years the government has established many SPVs to exercise different functions in different fields, such as the SANAPL investment and the National Water Company, which enhance the possibility of adopting this proposal. Establishing the newly SPV will have a positive effect on the national economy and contribute to the development of the housing finance market.

### **3.6 Conclusion**

The SJC's decision, as noted, has overshadowed the legal rights of both lender and borrower by depriving lenders of one of the greatest security devices, which is the mortgage. Therefore, the decision has played a substantial role in hindering lenders from extending and increasing their financing operations in general and housing finance in particular. The negative impact was not limited to lenders but has affected borrowers as well by increasing the cost of housing finance due to the weakness of the protection granted to lenders.

The chapter has reviewed many failed attempts in the last 25 years to overturn the SJC's decision, which gives an indication that any attempt to do so will be doomed. Therefore, the motivation to overturn this decision must stem from the Supreme Court itself, to give the action legitimacy and secure its acceptance by the courts and public notaries.

The Saudi legal system is fertile ground for granting the lender an alternative security device which would give the desired protection represented in Islamic finance transactions. The IFTs have served both lenders and borrowers by providing a good tool for individuals wishing to conclude a financing contract without committing the sin of *riba* through entering into conventional transactions, and simultaneously granting to some extent good security for lenders with which to protect their loans while circumventing the SJC's decision. This is the bright side of these transactions. But on analysis it was found that there are three main risks surrounding the IFTs: the risk of recharacterisation of these transactions due to their fluctuation between sale and lease contracts, while there is a huge difference between the protection offered by the sale and by the lease; the lack of

protection granted to the borrower; and finally the absence, in these transactions, of priority given to the lender.

It may be concluded that the current level of protection present in the IFTs has the potential to reduce housing finance activities due to the lack of protection granted to both lender and borrower. Procedures could be adopted that would enhance trust in the financing market and at the same time would enable lenders and borrowers to become more fully informed about the risks they are running.

Nevertheless, the chapter has presented a new technique for creating a collateral security structure derived from both Islamic law and the Saudi legal system, which gives the proposal immunity against potential violation of the principles of Islamic law. The development of the housing finance market, in fact, needs an innovation of this type which can satisfy all parties, whether the government, religious people, the judicial authority or the private sector, because its structure avoids upsetting the general teachings of Islam, which is of greatest concern to the judicial authority and religious people, while protecting the lenders' interests in the housing finance market.

## **Chapter Four: Can the Land Fees Law 2016 contribute in developing the housing finance market? The challenges and difficulties**

### **4.1 Introduction**

This chapter aims to analyse the extent to which the Land Fees Law 2016 can play a critical role in addressing the current issue of increasing land prices. It is believed that, as mentioned in Chapter Two, increasing land prices are hindering the development of housing finance by depriving the developer, financiers and first home buyers from gaining access to the market. The chapter will ask, therefore, whether the LFL 2016 via imposing a fee, tax, on land, will tend to precipitate either a decrease in the market value of land or an increase in its supply. This question can be explored by reviewing some economic researches and studies regarding the effect of land taxation on land values and supply. Then the chapter will discuss a legal concern that emerges from the wording of the LFL 2016 regarding the lack of fairness and possible overlapping of liabilities and obligations arising from the LFL 2016 and *Zakah*, which is considered an Islamic instrument similar to tax.

For the sake of clarity, and in order to provide the appropriate context, the discussion in this chapter is presented in the following sections: (4.1) an introductory section; (4.2) a section which attempts to shed light on the legislative and policy aims underpinning the enactment of the LFL 2016, and whether the aim of its enactment is to achieve political success or to deal with land prices; (4.3) examines the effect of land taxation on lands. However, the section will start by providing some background to the subject of land taxation and its forms, before moving from the general to the particular to focus on the effect of land taxation on lands. The chapter then attempts, in section four (4.4), to discuss the potential lack of fairness and possible overlap liabilities resulting from the LFL 2016 with other obligations arising from *Zakah*. The discussion will involve two subheadings: (4.4.1) the wording of the LFL 2016 and the lack of fairness; (4.4.2) the possible of overlap between the liabilities and obligation resulting from the implementation of LFL2016 and *Zakah*. The final section of this chapter (4.5) is the conclusion, which summarises and analyses the key matters addressed throughout the chapter.

## **4.2 Land Fees Law (LFL): achieving political success or resolving land prices**

In 2015, the so-called: The Council of Economic and Development Affairs (CEDA),<sup>1</sup> recommended that approval of the LFL 2016 to be accelerated. This suggestion was approved by the Council of Ministers and was subsequently referred to the *Shura* Council, by the King's order, to be studied, albeit subject to a 30 day deadline.<sup>2</sup> It is evident from the King's order that the LFL 2016 takes the form of legislation rather than of government policy; the clarification was needed because, before this order was issued, it was uncertain which of the two forms the provision of the LFL 2016 would take. The law has since been studied by the *Shura* Council and approved finally by Royal decree,<sup>3</sup> which is the final law-making procedure that must be satisfied before implementing the law. According to article (6) of the LFL 2016, the implementation of the LFL will itself be gradual, and will initially affect only the three largest cities in Saudi: Riyadh, Dammam and Jeddah, while the law also defined the lands which are to be eligible for taxation as those over 5000m<sup>2</sup> in size. The question that needs to be answered is whether the enactment of the LFL 2016 aimed to address the increase in land values or to achieve political success. During the law-making process, the LFL 2016 underwent many questionable vicissitudes which require some clarification, because these ambiguities pre the final stage of the law-making process raised some suspicions about the aim of enacting the LFL as a means of addressing land prices. First of all: the referral of the LFL 2016 to the CSU for study and determination of religion opinion on it, despite the fact that the CSU is not part of the law-making process under the Saudi legal system,<sup>4</sup> leads us to question the aim of that referral. It could be argued that the legislative authority in the country wanted to make sure that the LFL was consistent with Islamic law and so attempted to avoid any step that might contravene it. This argument might be accepted if

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<sup>1</sup> The CEDA is one of two Subcabinets established by King Salman, the current king of Saudi Arabia, when assuming the throne in 23 January 2015, while the second body is; the Council of Political and Security Affairs. As appears from their names, the first concerns about economic and development affairs in the kingdom while the second council concerns about security and politically internationally and nationally.

<sup>2</sup> Royal order (B/ 23) Dated (19<sup>th</sup> October 2015).

<sup>3</sup> Land fees law was approved by the royal decree (M/4) dated 13<sup>th</sup>/11/2015 and then the implement regulation of the law which enables the government agencies from implementing the law was approved by the Council of Minsters dated 13<sup>th</sup> June 2016.

<sup>4</sup> For further information about the law-making process in Saudi see: F Al-Fadhel, 'Legislative Drafting and Law-Making Practices and Procedures under Saudi Arabian Law: A Brief Overview'(2012)1 IJDLR 95.

the CSU's decision had been taken into account when the LFL 2016 was enacted. However, there is no significant indication that the legislative authority considered the CSU's decision when enacting the LFL 2016. Thus, regardless of whether or not the CSU's decision was rational and correct, the decision was clear in stating that the government should not levy tax on land because tax does not comply with Islamic teachings; besides which, there are many reasons for the increase in land prices, so that levying tax on land is not the only possible solution. Hence, the government could resolve this issue without levying taxes.<sup>5</sup> In other words, the decision means that there is no legitimacy, from an Islamic perspective, in the levying of taxes or fees on lands, while there are means other than taxation for addressing the issue of land prices. This implicit meaning of the CSU's decision confirms that the legislative authority did not take it into account when enacting the LFL 2016, because if they had done so they would not have enacted and approved such a law.

The above argument is important for understanding the aim of the enactment of the LFL 2016, so as to determine whether or not the law can serve the development of the housing finance market. The aim of the LFL 2016 has been inconsistently presented, as the former Minister of Housing (Mr. *Alduwahi*) described it in terms of decreasing the market value of land, whilst the current Minister of Housing (Mr. *Alhuqail*) stated that the LFL 2016 seeks to increase the market supply of land, in which there is currently a shortfall. These different official statements about the aim of the LFL 2016 might confirm that the law is incomplete in view of the persistent lack of clarity with respect to its primary aims. There is indeed a level of uncertainty and lack of clarity surrounding the aim of enacting the LFL 2016. That uncertainty can be discerned in the official statement issued by the Minister of Housing, who asserted that enactment of the LFL 2016 does not aim to increase government revenue, but rather to encourage landlords to develop their lands, in order to reorient the balance between demand and supply.<sup>6</sup> This statement was issued

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<sup>5</sup> M Aloni, 'Lands and real estate include in Zakat bill' *Aleqtasadih* (Riyadh, 13 October 2013) <[http://www.aleqt.com/2013/10/13/article\\_792667.html](http://www.aleqt.com/2013/10/13/article_792667.html)> accessed 1<sup>st</sup> June 2014.

<sup>6</sup> In interview with *Al-Arabiya* channel the Housing of Ministry stated that the aim of the land taxes law is not to raise the government revenue, for more information about this interview visit; *alarabiyanet*, 'the price of 1.5 million housing units could drop to the half' (*alarabiya.net*, 9July2-16)< <http://www.alarabiya.net/ar/aswaq/2016/06/09/%D8%A7%D9%84%D8%AD%D9%82%D9%8A%D9%84-%D8%B3%D9%86%D8%B9%D9%84%D9%86-%D8%AE%D9%84%D8%A7%D9%84-%D8%A3%D8%B3%D8%A8%D9%88%D8%B9%D9%8A%D9%86-%D9%82%D9%88%D8%A7%D8%B9%D8%AF-%D8%B1%D8%B3%D9%88%D9%85-%D8%A7%D9%84%D8%A3%D8%B1%D8%A7%D8%B6%D9%8A-%D8%A7%D9%84%D8%A8%D9%8A%D8%B6%D8%A7%D8%A1.html>> accessed 19<sup>th</sup> October 2016.

after falling oil prices spurred rumours that the government was in fact targeting surplus land taxes as a means of resolving budgetary shortfalls. The budgetary situation of Saudi has changed radically in recent years and, on this argument, it would not be naïve to suppose that the government is not trying to increase revenue.

However, the above official statement denying the government's intention to finance the deficit budget by levying fees, taxation, on land is not quite accurate, because the revenue produced by taxes is often an important resource for governments.<sup>7</sup> From an economic perspective, property taxes, including land taxation, have generated a significant proportion of the government's revenue and it is difficult to deny this fact. Accordingly, an economist who carried out research about property taxes in Latin America asserted that property taxes constitute the best option for a government that seeks to increase public revenue. He noted that: "the property tax remains the predominant option for raising revenues at the local government level in Latin America".<sup>8</sup> This assurance from an economic perspective about the function of land taxation in generating a good proportion of government revenue might refute the Minister of Housing's denial that the aim of enactment of the LFL 2016 was to generate a new source of finance for the government. In particular, its enactment occurred in the wake of falling oil prices along with the government's expressed desire to diversify its income away from reliance on oil to other sources, as mentioned in Saudi Vision 2030.<sup>9</sup> Rationally, taxation is considered one of the main resources with which governments can increase revenue and address budget deficits,<sup>10</sup> so it would be naïve to believe that the government, when enacting the LFL 2016, did not aim to address the budget deficit caused by falling oil prices.

Another argument might incorporate the idea that the enactment of the LFL was aimed at achieving political success. In fact, the accelerated procedures for enactment of the LFL 2016, represented in CEDA's recommendation to accelerate the LFL's approval, followed by the King's order to the *Shura* Council to finish studying the LFL, albeit

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<sup>7</sup> R Pollock and D Shoup, 'The effect of shifting the property tax base from improvement value to land value: an empirical estimate' (1977) 53 *Land Economics* 67; C Ding, 'Land policy reform in China: assessment and prospects' (2003) 20 *Land use policy* 109 & B Dachis, D Gilles and T Matthew A, 'The effects of land transfer taxes on real estate markets: evidence from a natural experiment in Toronto' (2011) *lbr007 Journal of Economic Geography* 1.

<sup>8</sup> C Cesare, 'Toward More Effective Property Tax Systems in Latin America' (2002) 14 *Land Lines* 9.

<sup>9</sup> Saudi Vision, 'A development digital infrastructure' (*vision2030.gov.sa*, April 2016) <<http://vision2030.gov.sa/en/node/97>> accessed 13<sup>th</sup> November 2016.

<sup>10</sup> D Shoup, 'The ideal source of local public revenue' (2004) 34 *Regional Science and Urban Economics* 753.

subject to a 30-day deadline occurred against a backdrop of huge public demand, pressure from which has apparently led to the enactment of the LFL 2016 on the assumption that this would serve to normalise the housing market by lowering land values, while simultaneously punishing landlords who own massive lands illegally. During the last five years a huge public demand arose for the government to levy taxes on such landowners, a demand based on the belief that the landowners had gained those massive lands by illegal means.<sup>11</sup> Many local newspaper columnists and social network activists demanded that the government accelerate enactment of a land taxation law.<sup>12</sup> Although the allegations and demands were not accompanied by any evidence confirming the charge, it might be argued that the government catered to those demands to gain political and economic success at the same time. From a political perspective, enactment of the LFL 2016 succeeded in responding to public demand, thus helping to allay public tension which has been increasing in recent years in relation to land prices. From an economic perspective, enactment of the LFL 2016 paves the way for the government to levy more and more new taxes and fees and to increase the current fees, inasmuch as the government's accession to the public's desire and demand for enactment of the LFL 2016 removed potential public opposition to the levying of new taxes and fees to address the budget deficit and falling oil prices. This argument may be true to the extent that the LFL 2016 was followed by the imposition of new taxes and fees, thus strengthening the assumption that, through the law's enactment, the government aimed to prepare the ground for further taxes and fees.

In fact, many concerns remain unaddressed regarding the aim of the LFL 2016. However, this may be due, in part, to a lack of research supporting the vision of the law. When the

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<sup>11</sup> For example, there were three Saudi activists who have written many articles in the local Saudi newspapers and stoical networks demanding the government to levy taxes on lands to address the increase land prices because they believe that Taxation will lead to decrease land prices. Of course, Saudi activists have significant impacted on Saudi community who have been persuaded by their arguments. For example see this article that was written in 2012, three years pre the enactment of the land fees law 2016: K Albwardi, 'Specialists, the approval of land taxation will survive the Ministry of Housing' *Alhayat*(Riyadh, 13<sup>th</sup> July 2012)<<http://www.alhayat.com/Articles/3560177/%D9%85%D8%AA%D8%AE%D8%B5%D8%B5%D9%88%D9%86-%D8%A5%D9%82%D8%B1%D8%A7%D8%B1-%D9%81%D8%B1%D8%B6-%D8%A7%D9%84%D8%B1%D8%B3%D9%88%D9%85-%D8%B9%D9%84%D9%89-%D8%A7%D9%84%D8%A3%D8%B1%D8%A7%D8%B6%D9%8A-%D8%A7%D9%84%D8%A8%D9%8A%D8%B6%D8%A7%D8%A1-%D8%B3%D9%8A%D9%86%D9%82%D8%B0-%D9%88%D8%B2%D8%A7%D8%B1%D8%A9-%D8%A7%D9%84%D8%A5%D8%B3%D9%83%D8%A7%D9%86>>accessed 25<sup>th</sup>November 2016.

<sup>12</sup> E Alzamel, 'The successful land taxation conditioned by these conditions' Makkah (Makkah, 1<sup>st</sup> November 2015)< <http://makkahnewspaper.com/article/106008/Makkah/%D8%B9%D8%B5%D8%A7%D9%85-%D8%A7%D9%84%D8%B2%D8%A7%D9%85%D9%84-%D9%85%D9%83%D8%A7%D8%B4%D9%81%D8%A7%D8%AA>-> accessed 27<sup>th</sup> November 2016.

effects of land taxation in other jurisdictions are reviewed, there would appear to be no potential negative impacts on the value of land itself, as will be seen later. This is not to say that landowners, who often reap significant capital gains benefit from rising house prices, are exempted from contributing to the community that permits and facilitates their wealth. The argument, rather, is merely that it is difficult to find empirical or theoretical evidence to support the notion that land taxation decreases the value of the land that is taxed. There is thus no need to consider such an outcome as an aim of the LFL 2016.

The Saudi legislator has determined the issue to be the unacceptable increment in land values, which presents obstacles to all participants in the housing market, whether first-time homebuyers, financiers, or developers. However, failure to determine the aims of the LFL in sufficiently clear terms may lead to unpredictable and undesirable results. In particular, some economic studies suggest that it is likely that any increase in rates of land taxation will ultimately be borne by the final consumer of developed land.<sup>13</sup>

For all the above considerations, it could be argued that the lack of clarity surrounding the aim of the LFL 2016 might impair its application and make its objectives questionable. This might raise a very important question, which is: does levying tax on land tend to precipitate either a decrease in the market value of land or an increase in its supply? The following section will discuss this matter.

### **4.3 Land taxation: its background, kinds and impacts**

As seen in chapter two there is a clear nexus between housing and land, which has caused certain commentators to assert that demand for land is a consequence of demand for housing.<sup>14</sup>

This dynamic inter-relationship requires us to understand the nature of any interaction and its effects on housing markets, in order to better predict how variations in housing prices evolve over time.<sup>15</sup> Cultivating such an understanding will assist in determining the potential impact on housing prices if a key factor such as tax is imposed as an attempt to impact upon the market price of land and its availability.

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<sup>13</sup> M Neutze, 'The price of land for urban development'(1970) 46 Economic Record 313.

<sup>14</sup> D Hongyan, Ma Yongkai and An Yunbi, 'The impact of land policy on the relation between housing and land prices: Evidence from China' (2011) 51The Quarterly Review of Economics and Finance 19.

<sup>15</sup> R Bostic, S Longhofer and C Redfean, 'Land leverage: decomposing home price dynamics'(2007) 35 Real Estate Economics 183.



In fact, there are many empirical studies conducted in many countries and regions that have confirmed this interaction between housing and land values.<sup>16</sup> For instance, it has been recognized that high land prices lead to increases in private property prices, which confirms the hypothesis that high land prices in urban areas are caused by high property prices.<sup>17</sup> Such a significant relationship between housing and land might be heavily influenced by governmental oversight and changes in policy which affect the utility and value of land.<sup>18</sup> One of the most common policies used heavily by the governments to deal with value of land is; land taxation.<sup>19</sup> When did land taxation use? And what are its kinds and impacts on lands, the next section will shed lights on this matter.

Generally speaking, land taxes are considered to be one of the oldest forms of taxation, some having indicated that they stretch back to the Roman era.<sup>20</sup> However, it is correct to say that the concept of land taxation has since developed and evolved, its impact being initially felt in the eighteenth century and persisting ever since. Therefore such the LFL 2016 presented by Saudi legislative authority is clearly not novel, being based as it on principles of economics traceable to the works of Adam Smith, most notably *The Wealth of Nations*.<sup>21</sup> Smith is often credited with establishing the fundamental rules of economics, including taxation. These rules are considered a reference point for economists to rely on in their research, as will be shown below.

With regard to land taxes, Smith established several general principles that can be considered fundamental in this field. For instance, in Smith's conception of the landlord/tenant relationship, the landlord acts as a monopolist because he enjoys the benefits of ownership without the consequent burdens of maintenance, which fall on the

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<sup>16</sup> For example see; J Ooi and L Sze-Teck, 'Price discovery between residential land & housing markets' (2004)15 *Journal of Housing Research* 95 & A Alyousha and T Christopher, 'Ricardian causal ordering and the relation between house and land prices: evidence from England'(1998) 5 *Applied Economics Letters* 325.

<sup>17</sup> J Ooi and L Sze-Teck, 'Price discovery between residential land & housing markets' (2004)15 *Journal of Housing Research* 95.

<sup>18</sup> E Glaeser and G Joseph, 'The impact of zoning on housing affordability' (*nber.org*, March 2002) <<http://www.nber.org/papers/w8835>> accessed 10<sup>th</sup> November 2016.

<sup>19</sup> There are many examples illustrated the intention of government to use land taxation for different purposes, for more background of those experiences see; W Oates and R Schwab, 'The impact of urban land taxation: The Pittsburgh experience' (1997) *National Tax Journal* 1; R Bird, 'Land taxation and economic development: the model of Meiji Japan' (1977) 13 *The Journal of Development Studies* 162 and B Needham, 'Land taxation, development charges, and the effects on land-use' (2000) 17 *Journal of Property Research* 241.

<sup>20</sup> E Glaeser and G Joseph, 'The impact of zoning on housing affordability' (*nber.org*, March 2002) <<http://www.nber.org/papers/w8835>> accessed 10<sup>th</sup> August 2016.

<sup>21</sup> A Smith, *The wealth of nations* (Penguin books 1986) 251.

tenant.<sup>22</sup> Smith believed, therefore, that taxes on ground-rents would not increase the rent for the land because only the owner would bear the burden of paying the tax.<sup>23</sup> This concept was confirmed by other economists when some stated that “the effect of these taxes would be such as Adam Smith has described; though one must add that he immediately went on to register reservations on distributional grounds against pushing such taxes far”.<sup>24</sup>

It seems the discussion during Smith’s era focused on grounds as a capital asset used primarily to generate income, for instance by leasing land out for agricultural use. Landlords were therefore conceived of as monopolists by Smith and others,<sup>25</sup> who believed that landowners secured significant capital and income benefits without incurring any corresponding custodial responsibilities. Smith’s contribution in shaping the general outlines of land taxation is plain, as he succeeded in distinguishing between various types of taxes on land and their different effects.<sup>26</sup> For example, Smith states that “Ground-rents are a still more proper subject of taxation than the rent of houses. A tax upon ground-rents would not raise the rents of houses. It would fall altogether upon the owner of the ground-rent, who acts always as a monopolist, and exacts the greatest rent which can be got for the use of his ground.”<sup>27</sup> Smith also established what he termed the four “canons” of taxation, which should serve as guiding principles for economists and law makers:

- ‘People should contribute taxes in proportion to their income and wealth;
- Taxes should be certain, not arbitrary;
- Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it;

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<sup>22</sup> A Smith, *The wealth of nations* (Penguin books 1986) 251.

<sup>23</sup> A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Ward,Lock,and Tyler,1961)130.

<sup>24</sup> A Prest, *The taxation of urban land* (Manchester University Press 1981) 35.

<sup>25</sup> For example Henry George in his famous book: *Progress and Poverty* focuses on this point and asserted that landlords are monopolists. For further discussion see: H George, *Progress and Poverty* (The modern library1880) 339.

<sup>26</sup> L Rose, ‘The development value tax’(1973) 10 *Urban Studies* 271.

<sup>27</sup> A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Ward,Lock,and Tyler,1961)129.

- The costs of imposing and collecting taxes should be kept minimum.<sup>28</sup>

Land taxes have since, of course, undergone significant further development as land has been put to use for different purposes, either residential or commercial. Such different usages generally enhance the capital value of the land, which can then be used to raise money and grant warranties. Such diverse uses of land granted economists and policy-makers scope to determine the proper form that taxes on such uses should take and their likely effects. It is therefore to be expected that forms of land tax across the world should vary, as they will invariably reflect differing policy goals shaped by differing political and economic circumstances.<sup>29</sup>

Some economists, for instance, have attempted to assess the feasibility of imposing taxes on urban land in order to reduce the margin between rural and urban land values. The study suggests that such forms of land tax would not achieve this goal. It was observed that it is very difficult to devise a tax that can directly reduce the incremental increase in the market value of land that had been converted from rural into urban use. The study also concluded that the burden of any tax imposed on developed land will ultimately be shifted to the final consumer.<sup>30</sup>

Before reviewing certain examples of land taxes it is worthwhile to note that the philosophy underpinning land taxation revolves around the conception of landlords as monopolists, and treats them accordingly. This philosophy attributes incremental increases in the value of land to the actions of the whole community, rather than to individual landowners.<sup>31</sup> The community acts through the government, on the basis that the community elects the government to represent them and, it follows, to provide the infrastructure and public services necessary to ensure that land retains its inherent value and to provide the right environment for growth. Public services are, of course, funded by

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<sup>28</sup> A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Ward,Lock,andTyler,1961) 653.

<sup>29</sup> Some has tried to distinguish between the aim of imposing land taxes and the justification for imposing taxes. The former, as indicated above, is a product of different political and economic circumstances driving domestic economists and policymakers to adapt land taxes to achieve fixed targets. The latter, however, is derived from the main purpose of levying a tax, which might be one of several aims commonly held by economists beside the need to maintain the national fisc, such as the redistribution of wealth and income, control of the economy, to modify behaviour, etc, for example, levy taxes on tobacco and alcohol is kind of controlled social by taxes, for more information see; G Morse and D Williams, *Principles of tax law* (7<sup>th</sup>ed,Sweet & Maxwell 2012) 4.

<sup>30</sup> M Neutze, 'The price of land for urban development'(1970) 46 Economic Record 313.

<sup>31</sup> A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Ward,Lock,andTyler,1961) 127-129 & D Shoup, 'The ideal source of local public revenue' (2004) 34 Regional Science and Urban Economics 753.

the community, as taxpayers, whose contribution to government revenue is integral.<sup>32</sup> On this basis, it is argued, a proportion of any capital or income benefits accruing to landowners should be passed on to the wider community, and so also to the government through increased revenue returns.<sup>33</sup>

The above philosophy was tacit in Winston Churchill's criticism of landlords who enjoyed increases in the market value of lands whilst contributing nothing to the broader community, when he stated: "Roads are made, streets are made, services are improved, and electric light turns night into day ... and all the while the landlord sits still" he added, "He renders no services to the community, he contributes nothing to the general welfare, he contributes nothing to the process from which his own enrichment is derived."<sup>34</sup>

Following this philosophy, various forms of land tax were innovated in an attempt to divert some of these incremental increases in land value to the public purse,<sup>35</sup> without due consideration of the potential consequences, such as the effect on real estate prices, the affordability of housing and attendant welfare concerns.<sup>36</sup> This may be attributed to an over willingness to bolster the treasury at the expense of certainty within a given system of land taxation, as the effects of imposing land taxes in other policy areas, such as the need to balance supply with demand, are under-researched, as is discussed below.

Generally speaking, there are three forms of property taxation, including land taxation, which are considered dominant in this field: development value tax; property transfer tax, and land value tax. Sometimes some of these forms are given different names, while having the same meaning, an example being stamp duty, which is similar to property transfer tax in the UK.<sup>37</sup> Thus, any form of property taxation usually falls within one of

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<sup>32</sup> For further discussion about the role played by the community to increase the land value see: H George, *Progress and Poverty* (The modern library 1880) 339.

<sup>33</sup> M Neutze, 'The price of land for urban development' (1970) 46 *Economic Record* 313.

<sup>34</sup> J Muellbauer, 'Land of opportunity' *Financial Times* (London, 25 September 2014) 5.

<sup>35</sup> The importance of property tax as a rich source for the government to increase their revenue can be seen in the state of New Jersey which its property tax provides nearly %64.8 of the total state tax collection. For more information about this point see; R Lindholm, 'Land taxation and economic development' (1956) 41 *Land economics* 121.

<sup>36</sup> See for example, W Oates, 'The effects of property taxes and local public spending on property values: An empirical study of tax capitalization and the Tiebout hypothesis' (1969) 77 *Journal of political economy* 957.

<sup>37</sup> Many countries impose the land transfer taxes due to their importance to public finance, such as the UK, which called; Stamp Duty Land Tax (SDLT) which is due for those who desire to buy a property or land over a certain price in England, Wales and Northern Ireland, for more information visit; Gov,UK, 'Stamp duty land tax' (gov.uk, ) <<https://www.gov.uk/stamp-duty-land-tax/overview>> accessed 19th November 2016. Most states in the US apply taxation form closes to the land transfer tax, for more information about this form of taxation in these countries see; B Dachis, D Gilles and T Matthew, 'The effects of land transfer

the aforementioned taxation forms even if it is given a different name. The impacts of such taxation on property and land are variable. However, economists have tried to shed light on the impact of some of these forms and to discover their effects, for example, on land values or on housing.

For example, 'Development Value Tax' (DVT) it is generally the case that where permission to develop land is forthcoming, the market value of the land will subsequently increase.<sup>38</sup> Governments will thus ordinarily levy tax for the granting of such permission; the DVT. The effect of such a tax is controversial amongst economists; some believe this form of taxation will serve to increase the market value of land whilst ensuring an appropriate redistribution of that increase,<sup>39</sup> whereas others hold that "[such a] tax on this capital gain of development land has no effect whatever on its market price".<sup>40</sup>

The question arises here whether, if we accept the assertions of those who believe DVTs to facilitate increasing land values, the burden of such a tax would be incurred by landlords or would instead be passed on to the final consumer.<sup>41</sup>

*Neutze* has examined the above concern when researching a proposed levy on rural lands as a means of addressing the disparity between urban and rural land values; he concluded that whilst the conversion of rural land to urban land leads to an increase in value, the levying of a tax to capture part of this increase, and so to maintain balance between urban and rural land values, would be unlikely to succeed, as the cost of any such tax would ultimately be borne by the final consumer.<sup>42</sup>

This kind of land tax exists in Saudi, although with a different application because the Saudi government does not impose a specific rate of tax to be deducted from landlords in the form of cash when they develop their lands; instead the government deducts part of the land that will be developed, equal to 33% of its size, and allocates that part to serve

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taxes on real estate markets: evidence from a natural experiment in Toronto'(2011) lbr007 Journal of Economic Geography 1.

<sup>38</sup> L Rose, 'The development value tax'(1973) 10 Urban Studies 271.

<sup>39</sup> J Anderson, 'Use-value property tax assessment: effects on land development'(1993) 69 Land Economics 263.

<sup>40</sup> E Mishan, *Twenty-one popular economic fallacies* (Lane, Allen, 1969) 65.

<sup>41</sup> For example, Mieszkowski, examined the impact of tax on commodity prices including lands, and concluded that commodity prices will rise and that at least 75% of the burden of the tax differential falls on consumers, for further information about this study see: P Mieszkowski, 'The property tax: An excise tax or a profits tax?' (1972) 1 Journal of Public Economics 73.

<sup>42</sup> M Neutze, 'The price of land for urban development'(1970) 46 Economic Record 313.

the public through building, for example, general partitions, schools, etc.<sup>43</sup> It is worth mentioning that this kind of tax is imposed on massive lands over 500,000m<sup>2</sup> in size.

The property transfer tax, which is the second form of property taxation, has often occurred as a response to challenging economic circumstances, with policy-makers turning towards new sources of revenue and new methods of collection, as happened in Toronto in 2008, for example.<sup>44</sup>

The last form of taxation is so-called land value taxation, which seems to be a desirable strategy for central cities to employ when seeking to encourage development.<sup>45</sup> The concept of this form of taxation resides in an economic theory that shifting the tax burden away from improvements towards land will encourage development.<sup>46</sup> This form of taxation is based on the belief that the effect on current landowners, who must bear increased holding costs, will be to encourage them to improve their properties or sell them to someone who will.<sup>47</sup> The certain effect of this form of taxation is to increase public revenue, rendering it, without doubt, a preferred form of taxation and one which is regarded as among the most important sources of increased revenue.<sup>48</sup> However, the effect of this form on housing and land prices varies in the opinion of economists who have studied this matter theoretically, because it is believed that a land value tax is neutral in

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<sup>43</sup> Article 3.3 of Guidelines the procedures of approval residence lands 1996 obliges landlords to allocate parts of their lands that will be developed for parks, schools, Mosques, streets provided the size allocated for these facilities not exceeded more than 33% of the total land size. For more information about this guidelines visit: Ministry of Municipal and Urban affairs, 'Guidelines the procedures of approval residence Lands' (*momra.gov.sa*, May 2005) <<https://www.momra.gov.sa/GeneralServ/Specs/guid0003.asp>> accessed 15th November 2016.

<sup>44</sup> In 2008, Toronto's municipal government imposed the so-called 'land transfer tax' (LTT), as a means of addressing governmental overspend in previous fiscal years. The effect of the LTT was perhaps surprising, with Toronto seeing a decrease in the volume of real estate transactions of around 14%, with concomitant effects on residential mobility. Nevertheless, this case demonstrates the potentially uncertain consequences of land taxation, although the LTT did see an annual increase in Toronto's budget of \$19 million. Undesirable results, leaving aside any increase in revenue receipts, have been observed in many regions and countries. Such unintended consequences must be carefully considered when land taxation is advanced as a means of addressing a particular issue. For further information about this topic see: B Dachis, D Gilles and T Matthew, 'The effects of land transfer taxes on real estate markets: evidence from a natural experiment in Toronto' (2011) *lbr007 Journal of Economic Geography* 1.

<sup>45</sup> R Bird and E Slack, 'Taxing Land and Property in Emerging Economies: Raising Revenue... and More?' (2006) *International Tax Program* paper 605.

<sup>46</sup> B Bentick, 'The impact of taxation and valuation practices on the timing and efficiency of land use' (1979) *The Journal of Political Economy* 859.

<sup>47</sup> S Bourassa, 'Land value taxation and housing development: Effects of the property tax reform in three types of cities' (1990) *American Journal of Economics and Sociology* 101.

<sup>48</sup> S Cord, 'How Much Revenue Would a Full Land Value Tax Yield? In the United States in 1981, Census and Federal Reserve Data Indicate It Would Nearly Equal All Taxes' (1985) 44 *American Journal of Economics and Sociology* 279 & J Brueckner, 'A modern analysis of the effects of site value taxation' (1986) *National Tax Journal* 49.

its effect on land development decisions and therefore discourages capital intensity in development.<sup>49</sup> This notion is consistent with some empirical studies which were carried out in some countries to assess the effect of land value taxation on development and on property prices, and found that this form of taxation is a useless tool and discourages intensive land use.<sup>50</sup> In contrast, some studies suggested that land value taxes would increase the long-run equilibrium investment in sites that are subject to taxes by 25%.<sup>51</sup> However, one of these studies refers to a very important point, namely, that increasing capital investment will increase the cost of construction and operating inputs, which in turn will be reflected in the cost of land and housing alike. This finding was confirmed by another study which investigated restrictive land use regulations, including land value taxes on housing, and found that the land value taxes might reduce the affordability of single-family homes by limiting the homebuyer's choices and probably obliging him to bear the increased development cost.<sup>52</sup>

Surprisingly, some theoretical findings mentioned above are consistent with empirical studies carried out to assess the extent of the effect of land taxation on landlords' behaviour in terms of developing their lands, and to assess the taxation regime's effectiveness in increasing land supply. The result was negative: landlords' behaviour was not changed by this form of taxation; instead they retained the lands for a long time

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<sup>49</sup> S Bourassa, 'Land value taxation and housing development: Effects of the property tax reform in three types of cities' (1990) *American Journal of Economics and Sociology* 101.

<sup>50</sup> For example, The Korean experience of land taxation, for instance, shows clearly how such systems can act to discourage intensive land use. The Korean system was designed, on the one hand, to impose very low taxes on holding properties, including lands. On other hand, a 10% value added tax on development was levied, based on the anticipated increase in market value. However, any capital gains benefits accruing as a consequence of development were perceived to be offset by corresponding level of capital gains taxes. This was viewed as a barrier to investment in large scale developments, due to the inherent difficulty of predicting the feasibility of new housing projects. Here we might note a very important point to consider when levying taxes on lands in Saudi; the very low tax on property in the Korean tax system acts to discourage the development of land despite any potential increase in that land's market value. This suggests that to levy taxes on lands would not, of itself, lead to an increase in the market supply of land, nor would it encourage further development of land, particularly if the tax is designed to reflect and capture any potential capital gains benefits arising from the development. For further information about the Korean's experience with land taxation see: K Kim, 'An analysis of inefficiency due to inadequate mortgage financing: The case of Seoul, Korea' (1990) 28 *Journal of Urban Economics* 371 & R Green, M Stephen and V Kerry, 'Urban regulations and the price of land and housing in Korea' (1994) 3 *Journal of Housing Economics* 330.

<sup>51</sup> R Pollock and D Shoup, 'The effect of shifting the property tax base from improvement value to land value: an empirical estimate' (1977) 53 *Land Economics* 67.

<sup>52</sup> K Ihlanfeldt, 'The effect of land use regulation on housing and land prices' (2007) 61 *Journal of Urban Economics* 420.

in order to increase their value. Thus the effect of the taxation regime was negative in relation to increased land prices.<sup>53</sup>

For all the above considerations and in light of findings on this form of taxation, land value taxation may have different effects on different classes of property and community, and it is possible that studies of commercial or industrial properties in those places would yield positive results.

Given that the LFL 2016 employs a similar form of land value taxes to be imposed on land, the question arises here: what possible outcome might result from such land taxation in Saudi? It is evident from the above-mentioned literature and studies that have investigated the effect of land value taxes that the certain effect of employing such taxation is to increase public revenue, which was to some extent the consensus among economists.<sup>54</sup> This certain outcome, however, is contrary to the official statement issued by the Minister of Housing in Saudi, to the effect that the aim of enacting the LFL 2016 was not to increase government revenue. This causes us to wonder whether or not the LFL 2016 underwent thorough research and study before its enactment to ensure the economic feasibility of levying fees, taxes, on lands, since the official statement about the aim of enacting it indicated that the law sought to encourage landlords to develop their lands, leading to the injection of more lands on the market and a consequent balance between supply and demand. However, achieving this aim is not certain and is subject to many elements and variations, as seen above. This is not to say that land value taxation will not lead to an increase in the supply of lands in the market; rather it may have different effects on different classes of property and community. The underlying question that needs to be answered is whether the LFL 2016 was subject to study and research

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<sup>53</sup>Low rates of land taxation have also been recognised as a factor hindering the development of housing in the Philippines due to landlords, who act as a monopolists, holding vacant idle lands in order to reap consistent increase in value. The lack of incentive to develop idle lands, in spite of the existing system of land tax, led to a paucity of land in the market and, therefore, served to increase their value. However, negligible property taxes on idle land are not enough to encourage the circulation of land, and thus to enhance the performance of the land market, as long as the increase in land value exceeds the liability of landowners to tax. In the Philippines it was suggested that the rates of property tax on idle land be raised, in order to incentivize landowners to develop their lands and to bolster supply to the market, which would of course its performance and efficacy. For further information see: W Strassmann, B Alistair and T Raul, 'Land prices and housing in Manila' (1994) 31 *Urban Studies* 267.

<sup>54</sup>B Needham, 'Land taxation, development charges, and the effects on land-use' (2000) 17 *Journal of Property Research* 241 & R Bird and E Slack, 'Taxing Land and Property in Emerging Economies: Raising Revenue... and More?' (2006) *International Tax Program* paper 605 & D Shoup, 'The ideal source of local public revenue' (2004) 34 *Regional Science and Urban Economics* 753 & R England, 'State and Local Impacts of a Revenue-Neutral Shift from a Uniform Property to a Land Value Tax: Results of a Simulation Study' (2003) 79 *Land Economics* 38.



before enactment to ensure its economic feasibility, or whether it was a tool employed to achieve political success, as suggested above. The lack of indications of such study or research pre-enactment of the LFL 2016 impairs the hope of the law's effectiveness.

Some countries' experience with the development of their respective housing markets suggests that levying tax on land does not necessarily lead to a corresponding increase in supply.<sup>55</sup> This reasoning is consistent with Barker's 2004 report concerning the availability of housing in the United Kingdom. The report examined to what extent taxation might be utilised as a mechanism to directly increase the supply of land to the market, as taxation is often viewed as an effective means of countering externalities, such as fluctuations in the availability of housing.<sup>56</sup> The report concluded that such an approach would be unlikely to succeed, because the planning system has a role in influencing the value of lands. The report added "In the context of land, tax may also be a blunt instrument, because of the individual nature of each site with regard to the balance between the social and private costs of development."<sup>57</sup> The report referred to so-called windfall profits, otherwise known as development gains, which flow from the decision to develop land whilst landowners retain the increase in value and urged the government to adopt certain policies enabling them to share in these windfall profits, so that incremental increases in land value could be better disseminated among the wider community.

Although the Saudi legislative authority has already enacted the LFL 2016 and its implementation has already begun, Saudi needs a report similar to Barker's, which would be conducted by respected economists to determine the issue and prescribe possible solutions. Since the official statement on the aim of the law's enactment is not certain from an economic perspective, as seen above, the effectiveness of the solution it presents may be impaired. In particular, some economic studies have indicated that the burden of any tax imposed on lands will ultimately be shifted onto the final consumer,<sup>58</sup> which implies that the issue of land prices could be further aggravated for all participants in the

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<sup>55</sup> As mentioned in the Korean and Philippian's experience in footnote 45.

<sup>56</sup> K Barker, 'Review of housing supply: delivering stability: securing our future housing needs' (*ayrshire-jsu.gov.uk*, December 2003) <<http://www.ayrshire-jsu.gov.uk/download/review%20of%20housing%20supply%20-%20interim.pdf>> accessed 15<sup>th</sup> November 2016.

<sup>57</sup> For more information about Barker's report see: K Barker, 'Review of housing supply: delivering stability: securing our future housing needs' (*ayrshire-jsu.gov.uk*, December 2003) <<http://www.ayrshire-jsu.gov.uk/download/review%20of%20housing%20supply%20-%20interim.pdf>> accessed 15<sup>th</sup> November 2016.

<sup>58</sup> M Neutze, 'The price of land for urban development' (1970) 46 *Economic Record* 313.

housing finance market. Nevertheless, the positive side of the LFL 2016 is, as stated in article (11), that all revenue collected by imposing land taxation will be allocated for housing projects in Saudi Arabia. Such new revenue of course will be considered a new resource for the government, thus achieving two aims: addressing the negative impact of falling oil prices, and enabling the government to address the housing shortage by providing a new source of income with which to finance its housing project.

To summarise, this section revealed the importance of land taxation as a general source of income to increase government revenue. However, the effects of land taxation on land values varies greatly, as do its effects on the supply of lands and the development of housing markets. It is clear that land taxation can play a crucial role in increasing the market value of land, as seen in the case of the DVT. However, the extent to which land taxation is likely to arrest rising land prices, or to reverse such a trend, may be questioned, due primarily to a lack of research.

#### **4.4 The wording of the LFL 2016 and the possible legal difficulties regarding lack of fairness and the overlap with other obligations stemming from *Zakah***

It is argued that it could be considered unfair in principle to impose taxation in order to achieve policy aims that the tax in questions appears poorly equipped to achieve, those aims in this case being a desire lower the value of land and/or to increase the supply of land to the market. As noted above, the LFL 2016 is unlikely or it is questionable to assist in either respect. Moreover, the overlap between liabilities and obligations imposed under the LFL 2016 and those arising from *Zakah*, which requires landowners to pay annually 2.5% of their land values according to the general principles of Islamic law, raises the spectre of double taxation, as landowners may be subject in practical terms to two separate property taxes on the same land. With these considerations in mind, landowners are also required when they develop their land to allocate approximately one third of their land's size to be put towards public services<sup>59</sup>, as mentioned at the beginning of the chapter.

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<sup>59</sup> Article 3.3 of Guidelines the procedures of approval residence lands 1996 obliges landlords to allocate parts of its lands that will be developed for parks, schools, Mosques, streets provided the size allocated for these facilities not exceeded more than 33% of the total land size. For more information about this guidelines visit: Ministry of Municipal and Urban affairs, 'Guidelines the procedures of approval residence

Accordingly, there are two concerns over the wording of the LFL 2016. The first involves the extent to which the wording, in the context of the Saudi legal and political environment, conforms to the most basic principles of tax equity and fairness. The second concern is related to the reasons for the possible overlap between, on the one hand, the liabilities and obligations stemming from the implementation of the LFL 2016, and, on the other hand, those stemming from *Zakah*. The following sections will discuss these concerns in detail.

#### **4.4.1 The wording of the LFL 2016 and the lack of fairness**

The principle of justice is very important to observe when imposing taxes, because the imposition of any tax is dependent upon public and individual acceptance of its legitimacy. To be sure, it is difficult to persuade all individuals who are liable to pay tax to accept the concept with equanimity, but employing and applying the principles of justice, fairness and equity in the levying of taxes may act to minimise any discontent. Justice and equity are often addressed in a single context, in which lawyers and economists alike discuss whether or not tax is fair. Also, we must to consider the aim of the LFL 2016 to achieve the equity and fairness.

Tax equity, which in this context means, simply, fairness, encompasses both ‘horizontal’ and ‘vertical’ equity. Horizontal equity,<sup>60</sup> in simple terms, calls for like treatment of people in equal positions,<sup>61</sup> i.e. people whose economic circumstances are similar ought to incur broadly similar liabilities to tax.<sup>62</sup> This view is supported by both legal and economic conceptions of equity, with the ability-to-pay argument stemming primarily from the latter.<sup>63</sup>

Vertical equity, following the same reasoning, seeks to ensure that the burden of tax is borne by individuals in proportion to their circumstances, and is a necessary corollary of

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Lands’ (*momra.gov.sa*, May 2005) <<https://www.momra.gov.sa/GeneralServ/Specs/guid0003.asp>> accessed 11<sup>th</sup> November 2016.

<sup>60</sup> The principles of *Horizontal* equity requires that similarly situated individuals faces similar tax burdens. For more information about this theory, its function and effects see: D Elkins, ‘Horizontal equity as a principle of tax theory’ (2006)24 *Yale Law & Policy Review* 43.

<sup>61</sup> D Elkins, ‘Horizontal equity as a principle of tax theory’ (2006)24 *Yale Law & Policy Review* 43. & R Musgrave, ‘Et, ot and sbt’ (1976) 6 *Journal of Public Economics* 3.

<sup>62</sup> G Morse and D Williams, *Principles of tax law* (7<sup>th</sup>ed, Sweet & Maxwell 2012) 6.

<sup>63</sup> G Morse and D Williams, *Principles of tax law* (7<sup>th</sup>ed, Sweet & Maxwell 2012) 8.

horizontal equity.<sup>64</sup> Besides above theories, Adam Smith prescribed four “canons” might lead to the concept of justice and the need requires to involve them in taxation system in order to realise the justice for taxpayers, as mentioned above.<sup>65</sup>

The question emerges here as to whether Saudi legislator, in enacting the LFL 2016, has adequately realised the principle of justice. To give the LFL 2016 a fair and realistic appraisal, we must examine both the aims of the LFL and its principal target in the light of the main purposes of taxation in general, which are to increase revenues and/or to modify taxpayer behaviour.<sup>66</sup>

The Minister of Housing has stated on several occasions that the enactment of LFL 2016 is not aimed at increasing government revenue.<sup>67</sup> Unfortunately there is less certainty regarding what the LFL is aimed at achieving, there being a degree of vacillation between decreasing land values and increasing supply, as mentioned in the former section. As revenue enhancement can be excluded from our consideration, we must turn our focus to the aim of modifying taxpayer behaviour, in this case to incentivise the development and sale of land and to discourage landowners from sitting on valuable property holdings.

Bearing this aim in mind, the LFL 2016 was designed to target only those landowners with extensive portfolios, whereas small scale landowners are exempt, even though both groups belong to the same community and are subject to the same laws. The phrase “extensive” is taken to represent holdings of 5,000m<sup>2</sup> or more, and this implies that landholdings falling beneath this threshold will not incur any liability to tax.

Thus, it could be argued that horizontal tax equity is not realized in the LFL, because landlords who retain lands for a long time in order to reap incremental increases in land value do not incur broadly similar liabilities to tax. This is because the law exempts those who own less than 5000m<sup>2</sup> from taxation liabilities, while those own more than 5000m<sup>2</sup> are subject to liabilities. The distinction between landowners who live in the same community and who engage in the same land owning exercise is not supported by any economic nor legal reasons. Also, it is difficult to argue that vertical tax equity is realised in the LFL 2016 because individuals do not incur the same liabilities of tax in proportion to their circumstances. All landlords who own land of less than 5000m<sup>2</sup>, will not incur

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<sup>64</sup> R Musgrave, ‘Horizontal equity, once more’ (1990) 43 National Tax Journal 113.

<sup>65</sup> See Section 4.3.

<sup>66</sup> G Morse and D Williams, Principles of tax law (7<sup>th</sup>ed, Sweet & Maxwell 2012) 4.

<sup>67</sup> K Alrubaish, ‘15 articles show the main purpose on enacting Land Fees law’ *Riyadh Newspaper* (Riyadh, November 2015) 5.

liabilities that arise from the LFL 2016 even though they engage in behaviour that is targeted by the LFL 2016 for distinction. For example, some landowners keep their lands undeveloped in order to reap incremental increases in land value.

If we accept, based on the assertions of the Ministry of Housing that the land market suffers from a shortage in the supply of lands due to the aforementioned behaviour of landlords,<sup>68</sup> then the rational response would be to target all landlords who sleep on their holdings, regardless of size. Moreover, it is unclear whether landlords are being targeted due to the size of their holdings or the fact they have allowed land to sit idle for prolonged periods of time. If the latter interpretation is chosen, then the LFL 2016 ought to apply equally to those landlords who sleep on their portfolios, whatever their size or value. If the former interpretation is chosen, it would be illogical to impose taxes on people simply for owning extensive lands, as to do so might undermine the Saudi economy and damage the reputation of the country. Such a policy rationale might also act to deter external investment.

Furthermore, if the philosophy behind land taxation regards the contribution of the wider community as integral to the value of land, with the attendant notion that some of these gains ought to be recaptured from land owners in the form of tax, why did the LFL exclude holdings below 5,000m<sup>2</sup> from liability to tax where the value inherent in such property is equally a product of social capital?

It could be argued that the LFL 2016 has been designed to catch larger holdings because it is assumed that, if the LFL were to succeed in encouraging landowners to develop and circulate their lands, the shortfall in supply would be addressed. This is possible, however if we accept that the high economic value of large landholdings provides sufficient justification for subjecting them to unique tax liabilities, this might encourage landowners to change their behaviour and look to decrease the size of their portfolios to evade the taxation liabilities. Here, the taxation system will not achieve the main aim which is modifying landowners' behaviours representing in retaining land for long time aiming to increase their values and impacting on the supply of lands.

For all the above discussion, it could be argued that the LFL 2016 does not meet the criteria of Horizontal equity, which may undermine its efficacy should it be implemented. Even if we attempt to apply the principle of Vertical equality, the LFL as it stands would be similarly lacking, as a large section of landowners, who own less than 5000m<sup>2</sup>, will

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<sup>68</sup> Chapter Two, section 5.

pay nothing despite the significant value of their landholdings, because such small and medium lands are considered a particularly valuable form of asset in the main cities of Riyadh, Jeddah and Dammam where the price per square metre is over \$400.<sup>69</sup>

Accordingly, the attempt to realize the goals of equity and justice in the LFL, whilst at the same time achieving its main aim, requires that the LFL 2016 be adjusted to cover all lands, as there are no legal or economic reasons to support the allocation of tax on the proposed basis. It seems correct to say that this adjustment would go some way towards achieving the condition of justice in the levying of taxes, mandated by article (20) of the Basic Law of Governance (BLG)<sup>70</sup> that states “Taxes and fees may be imposed only if needed and on a just basis. They may be imposed, revised, abolished, or exempted only in accordance with the Law”.

#### **4.4.2 The possible overlap between the liabilities and obligations stemming from the implementation of the LFL 2016 and those stemming from *Zakah***

As mentioned in Chapter Two, the LFL faced opposition from the Council of Senior *Ulama* (CSU)<sup>71</sup> because the latter understood from the wording and formulation of the law that it represents taxation, rather than a fee or *Zakah*.<sup>72</sup> This understanding required the CSU to study the law from the standpoint of whether or not taxation is contrary to Islamic law. Such an understanding of the law as taxation rather than fees, for example, might be attributed to the fact that the law proposed imposition of a payment on lands equalling 100 Saudi Riyal (\$24) per square meter.<sup>73</sup> In addition, the law was titled as a

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<sup>69</sup> Riyadh Chamber of Commerce and Industry, ‘The guidelines for the real estate sector’ (Riyadh Chamber of commerce and industry, 2ed, 2015)

<sup>70</sup> The Basic Law of Governance was approved by the Royal Order No. (A/90) dated 2 March 1992.

<sup>71</sup> Chapter two, section five.

<sup>72</sup> M Aloni, ‘Lands and real estate included in Zakat bill’ *aleqtisadiyah* (Riyadh, 13 October 2013) <[http://www.aleqt.com/2013/10/13/article\\_792667.html](http://www.aleqt.com/2013/10/13/article_792667.html)> accessed 12<sup>th</sup> November 2016.

<sup>73</sup> Alarabiah, ‘The expectations suggest land taxation approach \$ 24’ (*alarabiya.net*, 24 March 2015) <<http://www.alarabiya.net/ar/aswaq/2015/03/24/%D8%AA%D9%88%D9%82%D8%B9%D8%A7%D8%AA-%D8%A8%D8%A8%D9%84%D9%88%D8%BA-%D8%B1%D8%B3%D9%88%D9%85-%D8%A7%D9%84%D8%A3%D8%B1%D8%A7%D8%B6%D9%8A-%D8%A7%D9%84%D8%A8%D9%8A%D8%B6%D8%A7%D8%A1-24-%D8%AF%D9%88%D9%84%D8%A7%D8%B1%D9%8B%D8%A7-%D9%84%D9%84%D9%85%D8%AA%D8%B1.html>> accessed 12<sup>th</sup> November 2016.

(*darebah alaradi Nezam*), which means land taxation law, thus arousing the CSU's fears that the law represents taxation rather than fees. And that, of course, would not get their approval because they believe that taxation is contrary to Islamic law, as mentioned in Chapter Two.<sup>74</sup>

The legislative authority in Saudi, therefore, has attempted to redraft the law to increase the likelihood of the CSU accepting its provisions. For this reason, the legislative authority has overhauled the provisions of the LFL 2016 in two respects: the law's name and the rate of payment that should be imposed on lands.

With regard to the name of the law, the legislative authority has amended it to remove any reference to taxation, and to refer instead to the imposition of fees, despite there being a significant difference between the two concepts. Both taxes and fees are considered compulsory contributions. Taxpayers and beneficiaries of public services are due to pay specific amounts to the government, but for different purposes. Therefore, the purpose of making payment to the government is considered the fundamental criterion in distinguishing between tax and fee. When taxpayers make payment they receive nothing in return because taxes will be used by the government to finance public services, while the beneficiaries of public services pay fees in return for those services.<sup>75</sup> For example, people are due by law to pay income tax but they receive nothing in return, but they pay passport fees in order to obtain a passport. Another feature that been used to differentiate between fees and taxes is the method of approving these contributions.<sup>76</sup>

The form of amendment of the law's name seems to be attributable partly to a perception that Saudi people would be more willing to accept a fee, as opposed to a tax, based on the commonly held belief that the latter is contrary to Islamic law whereas the former is not. This belief is derived from many religious opinions to the effect that the concept of taxation is contrary to general principles of Islamic law. In many cases Saudi religious scholars have issued religious opinions (*fatwa*) aimed explicitly at the prohibition of taxation in the context of Islamic law, and stating that to involve oneself in the imposition

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<sup>74</sup> Chapter Two, section 5.

<sup>75</sup> V Thuronyi, *Comparative tax law* (Kluwer Law International 2003) 23.

<sup>76</sup> For instance, French legislation requires any tax to be imposed annually by the parliament, while fees can be imposed by administrative approval. For more information about the difference between tax and fee see; V Thuronyi, *Comparative tax law* (Kluwer Law International 2003) 23 & P Joyce and D Mullins, 'The changing fiscal structure of the state and local public sector: The impact of tax and expenditure limitations' (1991) *Public Administration Review* 240.

or collection of a tax is similarly impermissible.<sup>77</sup> For this reason a compelling argument could be made that the legislative authority hoped the amendment would pre-empt possible opposition from the CSU and public alike.<sup>78</sup>

It seems that changing the name of the law from land taxation to land fees has had the desired effect, because some CSU members have lent their support to the notion of imposing fees on large lands, after of course changing the name of the mechanism to a fee, to address the increase in land values. For example, Dr *Saad Alkhatlan*, a member of the CSU, has stated, in the wake of the intention to impose fees rather than a tax on lands through an amendment to the law, that such a step is consistent with the general teachings of Islam in view of the possible impact of rising land prices and attendant public unrest. He added that the outcome that would be achieved by this step would be a decrease in “land values”, and that the only segment that might incur some detriment from the imposition of land fees were those monopolists and landowners who retain their lands for a long time to utilise holdings and reap the benefits of the expected increase in land values. Given the softening of the CSU’s view following the amendment there is perhaps an indication by this member that altering the name of the law is likely to change the attitude towards the idea of taxation.

Nevertheless, there is an important distinction to be drawn between the concept of taxation and that of fees, as seen throughout this chapter; also noteworthy are the changing public attitudes towards the idea of imposing a payment on lands. The attempts of the legislative authority to avoid possible opposition from the CSU did not end with the change in emphasis from taxation to fees. The level of the charge imposed was also altered from the level set out in the initial draft. This latter change may be viewed similarly as a means of harmonising the law with public attitudes and those of the CSU, so as to make the law acceptable to both. This time the legislative authority emphasised the level of payment proposed by the law, the aim being the *islamisation* of land taxation.

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<sup>77</sup> For further information about above religious opinions visit: The general presidency of scholarly research and Ifta, <<http://www.alifta.net/Fatawa/fatawaDetails.aspx?View=Page&PageID=5503&PageNo=1&BookID=3&language=>>> accessed 12<sup>th</sup> November 2016.

<sup>78</sup> It is noteworthy, this is not something exclusive within Saudi jurisdiction because it has been observed politicians in many countries use synonym term for tax in order to avoid the possible opposition from public and oppositions parties. For further information about how politicians use synonym names for tax to avoid the possible opposing from electors, for example, see: H Spitzer, ‘ Taxes vs. fees: A curious confusion’ (2002) 38 *Gonz.L.Rev.*335 & V Thuronyi, *Comparative tax law* (Kluwer law international 2003) 64.



*Islamisation* here means greater commitment to Islamic laws and values and achieving compliance with the general Islamic law.<sup>79</sup>

As mentioned above, the law proposed imposing a \$24 charge per square meter on any eligible lands. In order to achieve the *islamisation* of the payment proposed by the law, the legislative authority looked for an instrument that could play the same role as taxation and at the same time comply with Islamic law. The tool possessing such features is embodied in *Zakah*. It is evident that the legislative authority was looking for a moderate solution, one that would achieve the main goals of the law but, at the same time, would not face opposition from the CSU. The moderate solution contended for here is derived from Islamic law, and could occupy the same position as a tax due to the similarities between the two instruments, tax and *Zakah*, as will be seen later. Accordingly, the legislative authority has amended the level of land taxation from \$24 per square meter to 2.5% of the land's value annually.

To understand this step, and the reason the legislative authority felt it was necessary, it will be useful to shed some light on *Zakah* and its function as a general principle of Islamic law. *Zakah* is considered the third pillar of Islam<sup>80</sup> and all Muslims are obliged to pay *zakah*<sup>81</sup> according to the first two sources of Islam, the *Quran*<sup>82</sup> and the *Sunnah*. Therefore, it is safe to say that *zakah* is a religious obligation imposed by God and that all Muslims are committed by Islam to paying it. When Muslims pay *zakah* they believe they will be deserving of God's mercy, while those who reject paying *zakah* will be punished in the hereafter. This aspect of *zakah* distinguishes it from tax, which is imposed by human beings, as the obligation to contribute is a legal, rather than a religious, duty.

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<sup>79</sup> E Jackson and L Parker, 'Enriched with Knowledge: Modernisation, Islamisation and the Future of Islamic Education in Indonesia' (2008) 42 RIMA: Review of Indonesian and Malaysian Affairs 21.

<sup>80</sup> There are five pillars of Islam and all Muslims are obliged to follow them, which are: *Shahadah*: The declaration of faith, made by saying: There is no god worthy of worship except God and Muhammad is His messenger. *Salat*: the ritual of obligatory prayers. *Zakat*: paying an alms (or charity) tax to benefit the poor and needy. *Sawm*: fasting during the month of Ramadan. *Hajj*: pilgrimage to Mecca (the Holy city located in Saudi Arabia). For more information about these pillars see; M, Ayoub, *Islam: Faith and history* (One World 2004)55.

<sup>81</sup> A Nadzri, R Abd and M Omar, 'Zakat and Poverty Alleviation: Roles of Zakat Institutions in Malaysia' (2012) 7 International Journal of Arts and Commerce 61.

<sup>81</sup> Quran is considered the main source and the first source of Islamic law, and "it represents the word of God to Muslims". For more information about Quran see: J Karl, 'Islamic Law in Saudi Arabia: What Foreign Attorneys Should Know' (1991) 25 Geo. Wash. J. Int'l L. & Econ 131.

<sup>82</sup> Sunnah is considered the second source of Islamic law and it means; 'a set of rules deduced from the stories, texts, and conduct of the Islamic prophet'. For more information about Sunnah see; K Roy, 'New York Convention and Saudi Arabia: Can a Country Use the Public Policy Defense to Refuse Enforcement of Non-Domestic Arbitral Awards' (1994) 18 Fordham International Law Journal 920.

Unlike tax, *zakah* “is viewed by Muslims as a means of purification rather than obligation”<sup>83</sup>, besides which, it is commonly believed that paying *zakah* will not lead to a decrease in wealth. This belief is derived from *Sunnah* in which the Prophet Mohammad, Peace be upon him, stated that, “Wealth is not diminished by giving (in charity)”. This confirmation from the Prophet has created a new climate of obligation associated with benefits in life as well as in the hereafter.

The term *zakah* is Arabic and means literally “growth, blessing and increase”.<sup>84</sup> However, when used in Islamic law it refers to the specific share of a person’s wealth that should be contributed, as determined by the ‘legislator’, either God or the Prophet Mohammed,<sup>85</sup> Peace be upon him, to be distributed according to established deserving categories.<sup>86</sup> Technically, *zakah* has been defined as “an act of worship performed to draw closer to Allah by extracting an obligatory right from certain kinds of wealth and giving it to specified groups at a specified time, in accord with specific conditions”.<sup>87</sup> *Zakah* does, however, share some similarities with tax, in that both are compulsory payments imposed on wealth. These similarities may enable *zakah* to play the same role as tax, indicating in turn that, from a policy perspective, *zakah* could be utilised to achieve many of the same goals.

Leaving to one side their obvious similarities, the difference between tax and *zakah*, can be explained in the following terms: the general principles of tax stem from human considerations, such as “no taxation without representation”<sup>88</sup>, whilst the general principles of *zakah* are based upon divine precepts. Furthermore, the main goal of tax, generally speaking, is to increase governmental revenue, whereas *zakah* is imposed so as to be spent on the eight established categories of people who need help and support from the community.<sup>89</sup> In addition, the rate of *zakah* (*Nisab*) differs according to the asset that

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<sup>83</sup> A Nadzri, R Abd and M Omar, ‘Zakat and Poverty Alleviation: Roles of Zakat Institutions in Malaysia’ (2012) 7 International Journal of Arts and Commerce 61.

<sup>84</sup> A Mohamad and T Adnan, ‘Critical appraisal of companies' obligations to pay Zakat in the Malaysian context’ (2013) 24 International Company and Commercial Law Review 375.

<sup>85</sup> In Islamic law, Muslims used the term “legislator” to refer to God or the Prophet Mohammad.

<sup>86</sup> H Rassool, ‘The crescent and Islam: healing, nursing and the spiritual dimension. Some considerations towards an understanding of the Islamic perspectives on caring’ (2000) 32 Journal of advanced nursing 1476.

<sup>87</sup> Y Al-Qaradawi, *Fiqh al-zakah* (The Other Press, 1973) 155.

<sup>88</sup> M Herb, ‘No representation without taxation? Rents, development and democracy’ (2005) Comparative Politics 297 also see: M Mutascu, ‘Taxation and democracy’ (2011) 14 Journal of Economic Policy Reform 343.

<sup>89</sup> The categories are: the poor, the needy, the wayfarers, the heavily indebted, slaves seeking their freedom, new converts to Islam, and the cause of Allah. By agreement of all Muslim jurists, it is not permitted to pay *zakah* to anyone who has not been mentioned in the *Quran*, for that *zakah* will not be accepted by God. For

is subject to it. The *zakah* on livestock, for example, differs from that on gold and so forth. These rates are fixed and cannot be changed, whatever the circumstances, because they have been determined by God and the Prophet. The rate of tax, however, is subject to adjustment and change depending upon the prevailing economic or political climate. For example, the Chancellor George Osborne surprised the housing market in his annual statement of 2014 by changing the stamp duty rate.<sup>90</sup>

In the Saudi context, however, these differences arguably make *zakah* preferable to tax, as it is more likely to be accepted and approved by the public and the CSU alike. From the perspective of the government, for example, an act promulgated in 1956 expressly stated that *Zakah* shall be collected from all Saudis in keeping with the general principles of Islamic law.

For all the above considerations surrounding *zakah*, the legislative authority believed that amending the payment proposed by the law from taxation to *zakah* might achieve the objective of imposing taxation on lands, due to the similarities between tax and *zakah*, while at the same time forestalling any opposition to such an amendment, since *zakah* is derived from Islamic law and is acknowledged throughout Muslim society, thus removing any possible religious objection to it. According to the general teachings of Islam, a Muslim is responsible for paying *zakah al-mal* or alms on money, equivalent to 2.5 percent of its value, with lands considered one type of *mal*.<sup>91</sup> Thus, the payment proposed by the law was amended from a \$24 charge per square meter of any eligible lands to 2.5% of the value of the lands.

Accordingly, the legislative authority succeeded in enacting the LFL 2016 by amending its name to become a land fees law instead of a land taxation law, along with amending the payment proposed by the law from a \$24 charge per square meter of any eligible lands to 2.5% of the value of the lands.

Although the enactment of the LFL 2016 is considered a good achievement by the legislative authority, which met its objectives without upsetting such an important organisation as the CSU, there is concern that in its implementation, this law might

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more information about these categories see; K Hassan and M Jauanyed, 'Zakat, external debt and poverty reduction strategy in Bangladesh' (2007) 28 Journal of Economic Cooperation 1.

<sup>90</sup> For more information; H Osborne, 'George Osborne's stamp duty reform may boost ailing housing market' *The Guardian* (London, 11 December 2014) <<https://www.theguardian.com/business/2014/dec/11/george-osborne-stamp-duty-reform-boost-ailing-housing-market>> accessed 12<sup>th</sup> November 2016.

<sup>91</sup> N Muhammad and S Ali, 'The Role of Zakat in Improving the Economic Status of Beneficiaries in Khyber Pakhtunkhwa' (2013) 7 Journal of Managerial Sciences 243.

represent an overlap of liabilities and obligations flowing from the LFL 2016 and *Zakah*, respectively. This potential overlap may be attributed to a failure on the part of the legislative authority to determine whether the liabilities resulting from the LFL are *zakah* or fee. The name of the LFL 2016 suggests that neither the law itself nor the liabilities it imposes are *Zakah*, yet the determination of the levy imposed annually by the LFL at 2.5% supports the assumption that the levy is *zakah*. This failure to determine whether the aforementioned liabilities are, or are not, *Zakah* raises the prospect that individuals will be required to effectively pay *zakah* twice, as is explored further below.

It is perhaps necessary to begin determining the exact location of the overlap in question. As mentioned, all Muslims are required to pay *zakah* for any of their lands that are subject to *zakah*. So, if we assume that a land is eligible for both *zakah* and the liabilities resulting from the LFL 2016, then the landowner is required to pay, firstly, 2.5% of the land's annual value as *zakah* and, secondly, a further 2.5% of this value as the fee imposed by the LFL. This implies that they are obliged to pay 5% of the land's value as *zakah* while Islamic law states clearly that they are obliged to pay *zakah* equals 2.5%. This assumption is based on the belief that the legislative authority intended, when amending the level of the charge set by the law, to achieve the *Islamisation* of the LFL, by changing the levy imposed by the law from \$24 to 2.5% of the land value, as mentioned above. However, Muslims are committed to paying *Zakah* once, not twice, according to Islamic law and if landowners are forced to pay 2.5% a *zakah* imposed by the LFL 2016 and then pay *Zakah* imposed by Islamic law, it would seem that the legislative authority has altered the general teachings of Islamic law, which of course would be unacceptable and prohibited.<sup>92</sup>

Therefore, in the wake of enactment of the LFL 2016, the CSU's members received many queries from public asking whether, if they paid the liabilities prescribed by the LFL 2016, they would also be required to pay *Zakah*, because the similarities between *Zakah* and the LFL 2016 confused them, creating the impression that the two were the same.<sup>93</sup>

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<sup>92</sup> N Coulson, 'The state and the individual in Islamic law' (1957) 6 *International and Comparative Law Quarterly* 49.

<sup>93</sup> A Albarqai, 'Ibn Manne: land fee is *Zakah* and the government has right to confiscate lands from landlords who do not pay the fees' *Sabaq* (Riyadh, 17<sup>th</sup> August 2016) <<https://mobile.sabq.org/%D8%A7%D8%A8%D9%86-%D9%85%D9%86%D9%8A%D8%B9-%D9%85%D8%AC%D8%AF%D8%AF%D8%A7-%D8%B1%D8%B3%D9%88%D9%85%D8%A7%D9%84%D8%A3%D8%B1%D8%A7%D8%B6%D9%8A-%D8%B2%D9%83%D8%A7%D8%A9-%D9%88%D9%84%D9%84%D8%AF%D9%88%D9%84%D8%A9-%D8%AD%D9%82-%D8%B3%D8%AD%D8%A8%D9%87%D8%A7-%D9%84%D8%B9%D8%AF%D9%85-%D8%AF%D9%81%D8%B9%D9%87%D8%A7>> accessed 17<sup>th</sup> November 2016.

Such queries confirmed the concern raised above regarding the possibility of overlapping liabilities and obligations stemming from the LFL 2016 and *Zakah*.

This raises a question as to why the legislative authority did not simply designate the LFL as a form of land *zakah*. If this approach had been taken it might have served to achieve the desired *islamisation* of the law, and thus avoid criticism from the public and the CSU, whilst maintaining the core aim of levying a charge on land to encourage landowners to modify their behaviour through incentivising the sale, and hence the circulation, of property. The fact that the possibility of adopting this approach was never openly contemplated by the legislative authority as a means of avoiding any unfair overlap with *zakah* injects further ambiguity.

It might be argued that the principal reason for this lack of due consideration may lie in an attempt to avoid possible evasion by *zakah* payers. It is clear that *zakah* is an Islamic instrument and that only Muslims are obliged to pay it, as it forms part of the general teachings of Islam. By contrast, non-Muslims, who by definition do not subscribe to those teachings, are not subject to the same obligations.<sup>94</sup> This fact might be open to exploitation by those who are prepared to evade payment of *zakah* by any means, and might therefore register lands in the names of non-Muslims, whose ownership would not be caught by *zakah*.<sup>95</sup> This is simply one potential avenue for avoidance, and serves to illustrate the need for appropriately careful drafting. It follows that the measure must be drafted so as to minimise opportunities for avoidance, thus ensuring that there is no way to circumvent the payment of *zakah*, a possibility which could force the legislative authority to abandon the policy of calling the LFL a land *Zakah* law.

This argument is valid to some extent. However, to avoid such potential evasion of *zakah* payment, it is suggested that the LFL take two forms: one to be imposed on Muslims and the other on non-Muslims. This suggestion can be employed to bridge the gap that can be observed in relation to implementation of the proposal to impose *zakah*. The suggestion is that the tax be imposed on lands owned by non-Muslims, whilst the law to impose *zakah* on lands owned by Muslims remains as it was when originally put forward. This twofold proposal should take into account the general principles of tax equity which, in this case, require non-Muslims to be treated as Muslims from a taxation perspective.

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<sup>94</sup>Y Al-Qaradawi, *Fiqh al-zakah* (The Other Press, 1973) 145.

<sup>95</sup>According to the Foreign Investment Law 2000, foreigners can own properties in Saudi under specific conditions, for further discussion see: T Alshubail, 'Developing the legal environment for business in the Kingdom of Saudi Arabia: comments and suggestions'(2013) 27 A.L.Q.371.

Similarly, tax equity considerations necessitate that the same rate of *Zakah*, which is 2.5 per cent of the cost of the land subject to it, be adopted when levying the tax on lands owned by non-Muslims. This equal treatment is, as noted above, also mandated by article (20) of the BLG.

Taking the above considerations into account, it is recommended that the legislative authority amend the LFL 2016 to become a land *zakah* law, to avoid the potential overlap that would arise as a result of individuals incurring a double liability and obligation under the combination of *zakah* and the charge imposed by the LFL – which implicitly changes the principles stated by Islamic law. Adherence to this recommendation would make the law more consistent with the legal system in Saudi Arabia, which is derived from Islamic law and as such looks on any charge imposed by the legislative authority as a potentially impermissible tax, whether or not it is clothed in the guise of a fee. In particular, the Saudi legal system involves some legislation dealing with *Zakah*, such as the Law of *Zakah* Collection 1370 (1950).

#### **4.5 Conclusion**

It is no exaggeration to state that land prices have significantly affected the development of housing finance. Financers, developers and first-time buyers have all been affected, to their detriment, whilst the only group to have benefited are landowners, for obvious reasons. Despite the above concerns, the only solution advanced to address this issue was the enactment of the LFL 2016. There is no doubt about the importance of land taxes as a revenue source, but this was never the stated aim of the law according to the official statement from Saudi government. Nevertheless, any uncertainty with respect to the law aims of land taxes invites concern as to their eventual implementation and outcome, as it suggests a lack of any coherent vision on behalf of the legislator.

Such concerns are somewhat legitimised by a lack of research confirming the notion that land taxation might act to either decrease land values or increase land supply, as there is simply no empirical evidence or model-based estimate to suggest such an effect. The situation could in fact be worsened, as the final consumer of developed land is most likely to bear the burden of any tax levied on the lands. There is thus a real prospect that land taxes will complicate the issue, rather than contributing to its resolution. In spite of the above concerns, the Saudi legislature has now enacted the LFL 2106, in an attempt to address increasing land prices by encouraging development.

In addition to the concerns raised above regarding the extent of the liabilities imposed by the LFL 2016, and whether it is well-equipped to meet the objectives set by the legislative authority, which has been suggested to be doubtful, the LFL may also be criticised as being inherently unfair. The chapter demonstrated that the possibility of unfair treatment emerges from the provisions of the LFL 2016, due to the law's exemption of some lands from its liabilities, without legal or economic justification. To address this possible legal defect and to realise the goals of equity and justice in the LFL 2016, the chapter requires that the LFL be adjusted to cover all lands.

Also, the chapter showed that the behaviour of landowners who act according to market forces in retaining their lands is insufficient reason to subject those landowners to the possibility of unfair treatment through the possible overlap of the liabilities and obligations imposed by the LFL 2016 and *Zakah* respectively. Therefore, the chapter has sought to offer a moderate solution which could serve to address the lack of fairness inherent in the LFL by avoiding this possible overlap.

The necessary question is whether the LFL, as enacted, will serve to address this issue and contribute to the development of the housing finance market, or whether it will in fact have the converse effect. It is of course far too early to judge the full impact of the LFL, however there is still a need for the government to establish an independent committee to prepare a report on the state of the land market and to propose appropriate solutions to some of the aforementioned problems. The Barker Report provides a useful template in this respect<sup>96</sup> and it is now time for the Saudi government to take similar steps and commission a thorough review of all issues affecting the supply of land in Saudi

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<sup>96</sup> For more information about above report and recommendations see; K Barker, 'Review of housing supply: delivering stability: securing our future housing needs' (*ayrshire-jsu.gov.uk*, December 2003) <<http://www.ayrshire-jsu.gov.uk/download/review%20of%20housing%20supply%20-%20interim.pdf>> accessed 10<sup>th</sup> November 2016.

## **Chapter Five: Building up the housing finance market through developing regulatory framework for adoption of the Loan-to-value (LTV)**

### **5.1 Introduction**

This chapter aims to develop a framework for regulating the housing finance market in general and for adoption of the Loan-to-value (LTV) in particular, through analysing article (12) of the Regulation of the Real Estate Finance Law (RREFL),<sup>1</sup> which is believed to be hindering the development of the housing finance market by depriving potential first home buyers of access to the market. Article (12) requires a down payment amounting to 30% of the total house purchase, or in other words a loan to value (LTV), which has been defined as “the ratio of a possible loan amount against the value of house as collateral”,<sup>2</sup> of 70%. Such possible impacts of the LTV are in fact contrary to the general aim of enactment of the housing finance laws 2012 in Saudi, namely to facilitate access to housing finance.<sup>3</sup> Therefore, the chapter argues that article (12) is in fact an example of a defect in the regulatory framework that should regulate the housing finance market, and demonstrates the need to address it.

The chapter will ask: how should the regulatory framework pertaining to the housing finance market be developed so as to avoid such conflict between the general aims of the housing finance laws 2012 and the implementation of article (12)? And how can the adverse impact of article (12) regarding the LTV on the housing finance market be mitigated?

To answer the above questions, it is necessary to benefit from the experience of other developed jurisdictions in dealing with such a tool (LTV), since Saudi lacks the degree of experience that would enable the country’s financial authorities to deal with a tool as sensitive as the LTV. In particular, the country has witnessed the markedly low

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<sup>1</sup> REFL represents one of the housing finance laws 2012 which are: the Finance Lease Law (‘FLL’) and the Law on the Supervision of Finance Companies (‘LSFC’).

<sup>2</sup> H Hwa Se, ‘Loan to Value as macro-prudential policy tool: Experiences and lessons of Asian Emerging countries’ (*dsf.nl*, January 21 2013) < <http://www.dsf.nl/wp-content/uploads/2014/10/DSF-Policy-Paper-No-33-Loan-to-Value-as-Macro-Prudential-Policy-Tool.pdf> > accessed 12<sup>th</sup> November 2016.

<sup>3</sup> The secretary of the *Shura* Council, for example, stated that the bills outlining the new laws would provide a new means of real estate finance in Saudi Arabia, which would facilitate the setting up of new finance companies alongside the banks that currently provide this service. A Falah, ‘*Shura* Council discusses the different opinion with the Minister Council about the finance laws’ *Alwatan* (Abha, 6 March 2011) < [http://www.alwatan.com.sa/Local/News\\_Detail.aspx?ArticleID=44330](http://www.alwatan.com.sa/Local/News_Detail.aspx?ArticleID=44330) > Accessed 12<sup>th</sup> November 2016.



homeownership rate of 47%, while applying the LTV and capping it at a low rate could lead to the exclusion of potential first home buyers from access to the housing finance market. Two jurisdictions, the UK and Hong Kong, have been chosen with the aim of drawing on their experiences in dealing with the macro-prudential policy, including the LTV, taking into account the differences and similarities between them and Saudi.

To this end, the chapter has been divided into seven sections. The first section (5.1) is the introduction. The second section (5.2) gives the reasons for choosing the UK and Hong Kong for utilisation of their experiences. Section three (5.3) will shed light on the development of the macro-prudential policy in general, and in particular of the LTV, besides presenting their advantages and disadvantages.

The chapter then moves on to section four (5.4), to analyse article (12) of the RREFL, its impact on the first home buyers and the lack of regulatory framework for adoption the LTV. The analysis will involve three subheadings: (5.4.1) decision-making, (5.4.2) the integration of policies and legislations, and (5.4.3) accountability.

Section five (5.5) discusses the macro-prudential regime in the UK. The discussion will be divided into the following subheadings: (5.5.1) will provide the background of the housing sector in the UK and the dangerous role that the housing market might play as a threat to the economy; (5.5.2) will shed light on the legal reform adopted in the wake of the global financial crisis 2007, leading to the creation of a robust macro-prudential regime; and in (5.5.3) the section will discuss the Financial Policy Committee (FPC), which is designated the competent authority to regulate and implement the macro-prudential policy, of which the LTV is one element. The discussion will involve two subheadings: (5.5.3.1) will review the FPC's powers and the way the legislator succeeded in minimising those powers in view of the adverse impact of the macro-prudential policy. Then, in (5.5.3.2), the chapter will discuss the question: How does the FPC exercise its powers?

Section six (5.6) will discuss Hong Kong's experience in mitigating the impact of LTV and the creative method it adopted. The discussion will involve three subheadings: (5.6.1) will give an overview of Hong Kong's housing sector and its experience in dealing with the LTV policy; (5.6.2) will highlight the mechanism for adopting the LTV policy; and finally (5.6.3) will shed light on Hong Kong's experience in addressing the adverse impact of the LTV policy through the Mortgage Insurance Programme (MIP). Lastly, section seven (5.7) will sum up the main findings of this chapter and offer recommendations.

## **5.2 Why the UK and Hong Kong have been chosen for utilisation of their experience?**

Generally speaking, there are three reasons for choosing the legal experience of the UK as a model to draw some lessons in the area of housing finance: the similar circumstances between the UK and Saudi Arabia in relation to the housing sector, recent financial reforms that have taken place in the UK, and the practice of strong cooperation between financial authorities, the UK Government and UK Parliament pertaining the adoption of macro-prudential policy in the UK. Both the Saudi and UK Governments are under pressure to find a solution to their housing problems, in spite of significant differences between them in rates of homeownership, which of course favours the UK.<sup>4</sup> Also, in both jurisdictions component authorities have begun to adopt macro-prudential policies in spite of the adverse effects these policies seem to have on the housing finance sector, and this will be discussed later. The financial system in the UK has recently been subject to significant reforms and overhaul which make its experience of the adoption of macro-prudential policies unique. The UK financial system reforms include granting competent authorities the power to take further action if needed, which includes but is not limited to the use of macro-prudential policies, to protect the financial system from any possible source of threat.<sup>5</sup> However, the adoption and application of these policies requires finding a legal basis, and a way of enabling main participants in the housing market to participate. For all these reasons, this chapter seeks to draw from the UK's experience in respect of procedures implemented before the adoption of the LTV policy; these procedures reveal a presence of adequate preparation and strong cooperation between financial authorities, the UK Government and the UK Parliament.

With regard to Hong Kong, there are two reasons for choosing this legal model to draw lessons from it. The first is because financial authorities in Hong Kong have already had success in dealing with the adverse impacts of LTV, and have created a mechanism to mitigate its impact. The second reason is the long experience of Hong Kong in this field, dating back to the 1990s. In addition to the long experience of the application of LTV in

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<sup>4</sup> For further discussion about the housing crisis in the UK see: B Reid, 'Housing crisis? What crisis?' (2015) 167 *Scottish Planning & Environmental Law* 8 & K Barker, 'How many houses should we plan for?' (2015) 13 *Journal of Planning & Environment Law* 10 and A Minhinick and J Boswall, 'The solution to the housing crisis' (2015) 159 *Journal Article* 33

<sup>5</sup> P Rawlings, 'Reform of bank regulation in the United Kingdom: the opening salvo' (2010) 25 *Journal of International Banking Law and Regulation* 522.

Hong Kong, there are similarities between Saudi Arabia and Hong Kong that have inspired the choice of the Hong Kong model.

The first reason is related to monetary policy. The Hong Kong dollar has been tied to the US dollar under a currency board regime since October 1983,<sup>6</sup> while the Saudi Riyal has also been tied to the US dollar through SAMA since May 1981.<sup>7</sup> It is worth mentioning that US monetary policy impacts on interest rates in both countries.<sup>8</sup> The second reason is that both jurisdictions are distinguished by their real estate markets, which feature a high risk of volatility, and which represents a threat to the banking sector. It can be seen from this chapter that the real estate market in Hong Kong features a strong volatility risk which potentially threatens the banking sector, while the property market in Saudi is not immune to this condition, due to the geopolitical environment provided by its location. Saudi is situated in the heart of the Middle East which is marked by instability, due to the outbreak of a number of wars in the last 30 years between Israel and Arab countries, or between other parties, as in the Gulf War of 1991, the Iraq War of 2003 and currently the action of Saudi and its allies against *Hothy* rebels in Yemen 2015. These wars of course reflect negatively on the property market, subjecting it to a high risk of volatility. All these similarities make Hong Kong a good object to draw from its experience.

It could be argued that the analogy with Hong Kong is not a strong one as far as Saudi Arabia is concerned. The latter is a large land mass with plenty of room to build on it whereas the former is a small island with little or no building room. This argument would be sound if the intention in comparing Saudi with Hong Kong involved the amount of land to build on, for example, or the geographic challenges facing house-building in both countries. However, this is not the subject matter, rather it concerns the methods used by the financial authorities in dealing with the macro-prudential policy so as to avoid possible adverse impacts on the housing finance market.

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<sup>6</sup>S Gerlach and P Wensheng, 'Bank lending and property prices in Hong Kong' (2005) 29 *Journal of Banking & Finance* 461

<sup>7</sup>M Al-Jasser and A Banafe, 'Monetary policy instruments and procedures in Saudi Arabia' (1999) 5 *BIS Policy Papers* 203

<sup>8</sup>S Gerlach and P Wensheng, 'Bank lending and property prices in Hong Kong' (2005) 29 *Journal of Banking & Finance* 461

### **5.3 The development of the macro-prudential policy, including LTV: background, advantages and disadvantages**

Generally speaking, when the economy is growing and there are indications of competitive sources seeking loans from the financial institutions, the financial market becomes restrictive. This is attributed to two factors: lenders become more selective in selecting their customers, while financial regulators adopt some aggressive monetary policies to limit the excessive lending. During prosperous times, interest rates and down payments increase, and vice versa when the economy takes a downward turn.<sup>9</sup>

However, the above picture changed in the wake of the global financial crisis of 2007 which strongly reaffirmed the link between financial crisis and excessive credit growth in housing finance. The argument being that booming housing prices are caused by the easing of monetary policy during a downturn, together with sharp decreases in interest rates.<sup>10</sup> The general monetary and macro-prudential policies adopted during the period 2007 to 2008 were not sufficient to prevent the build-up of systemic risks which, of course, generated booming housing prices.<sup>11</sup>

Therefore, in the wake of the financial crisis of 2007-2008, there was a consensus that the current policy framework for central banks (supervisory authorities) needed further action to design suitable macro-prudential policy, although the history of using the macro-prudential policy including the LTV dates back to the 1990s,<sup>12</sup> for protecting the banking sector from systemic risk,<sup>13</sup> which has been defined as “a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy”.<sup>14</sup>

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<sup>9</sup> P Garrett, ‘Land Contracts as Security Devices’ (1965) 12 Wayne L. Rev. 391 & S Ghosh, ‘Credit growth and macro-prudential regulation: is ownership important?’ (2015) 57 International Journal of Law & Management 167.

<sup>10</sup> A Keller, ‘The possible distortional effect of the loan-to-value ratio and its use as a macro-prudential tool by the European systemic risk board’ (2013) 28 Journal of international banking law and regulation 266.

<sup>11</sup> T Wong and H Cho-hoi, ‘Loan-To-Value Ratio As A Macro-Prudential Tool – Hong Kong Experiences’ (*researchgate.net*, 2010) <[http://www.researchgate.net/profile/Cho-Hoi\\_Hui/publication/229046588\\_Loan-To-Value\\_Ratio\\_As\\_A\\_Macro-](http://www.researchgate.net/profile/Cho-Hoi_Hui/publication/229046588_Loan-To-Value_Ratio_As_A_Macro-)> accessed 12<sup>th</sup> November 2016.

<sup>12</sup> H Hwa Se, ‘Loan to Value as macro-prudential policy tool: Experiences and lessons of Asian Emerging countries’ (*dsf.nl*, January 21 03) < <http://www.dsf.nl/wp-content/uploads/2014/10/DSF-Policy-Paper-No-33-Loan-to-Value-as-Macro-Prudential-Policy-Tool.pdf> > accessed 12<sup>th</sup> November 2016.

<sup>13</sup> S Victoria, ‘The role of macroprudential policy’ (*estaticos.expansion*, November 2009) <[http://estaticos.expansion.com/estaticas/documentos/2009/11/doc\\_banco\\_inglaterra23112009.pdf](http://estaticos.expansion.com/estaticas/documentos/2009/11/doc_banco_inglaterra23112009.pdf)> accessed 12<sup>th</sup> November 2016.

<sup>14</sup> J Caruana, ‘Systemic risk: how to deal with it?’ (*bis.org*, February 2010) <<http://www.bis.org/publ/othp08.htm>> accessed 12<sup>th</sup> November 2016

Since then, in order to maintain financial stability, policymakers in the world have adopted some policies including, but not limited to, the macro-prudential policy such as: high down payments to improve the soundness and stability of the financial markets, regardless of whether the economy is growing or taking a downturn.

Central banks (supervisory authorities), in turn, have taken on the task of designing and supervising the application of macro-prudential tools in order to protect the banking and lending sectors. Central banks in some countries, such as in Hong Kong, Norway<sup>15</sup> and Sweden<sup>16</sup> have already taken further action by adopting macro-prudential policies in order to prevent the build-up of booming housing prices, while other countries are considering taking these actions.<sup>17</sup> All jurisdictions aim to adopt these tools in order to protect financial stability, and, at the same time, prevent the causes of the 2007 financial crisis from arising again.<sup>18</sup>

The LTV ratio emerges as an instrument used by central banks and financial institutions to directly affect the amount that can be lent to individuals against an amount of collateral, thereby helping to control the financial instability caused by excessive lending.<sup>19</sup> However, the possible impacts of capping the LTV at a low ratio, namely excluding potential first-time home buyers from the housing finance market and reducing access to finance by often younger and less wealthy groups, require further and extensive consideration.

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<sup>15</sup> S Victoria, 'The role of macro-prudential policy' (*estaticos. expansion*, November 2009) [http://estaticos.expansion.com/estaticas/documentos/2009/11/doc\\_banco\\_inglaterra23112009.pdf](http://estaticos.expansion.com/estaticas/documentos/2009/11/doc_banco_inglaterra23112009.pdf) accessed 12th November 2016.

<sup>16</sup> For example, in October 2010 the Swedish Financial Supervisory Authority (FSA), which was established in 1991 as a single integrated regulator responsible for the supervision and regulation of banking, securities, and insurance industries, with a statutory mandate for financial stability and consumer protection, introduced an LTV ratio on mortgages which applied 85% as LTV to all new mortgages or extensions to existing mortgages that used the home as collateral. For more information see D Salim and W Xiaoyong, 'Experiences with Macro-prudential Policy— Five Case Studies' (*imf.org*, June 2015) <<http://www.imf.org/external/pubs/ft/wp/2015/wp15123.pdf>> accessed 16th November 2016.

<sup>17</sup> M Funke and M Paetz, 'A DSGE-based assessment of non-linear loan-to-value policies: Evidence from Hong Kong' (2012) 1 & A Keller, 'The possible distortional effect of the loan-to-value ratio and its use as a macro-prudential tool by the European systemic risk board' (2013) 28 *Journal of International Banking Law and Regulation* 266.

<sup>18</sup> For more information about the possible role played by the macro-prudential policy in safeguarding financial stability, and to prevent the creation of bubbles in the housing finance market, see G Galati and R Moessner, 'Macro-prudential policy—a literature review' (2013) 27 *Journal of Economic Surveys* 846 & A Ashvin and N Malhar, 'Safeguarding Banks and Containing Property Booms: Cross-Country Evidence on Macro prudential Policies and Lessons from Hong Kong SAR' ([papers.ssrn, 12 December 2011](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1971435)) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1971435](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1971435)> accessed 12th November 2016.

<sup>19</sup> For more information about the LTV, its function and impact see; A Keller, 'The possible distortional effect of the loan-to-value ratio and its use as a macro-prudential tool by the European systemic risk board' (2013) 28 *Journal of international banking law and regulation* 266 & C Lim Cheng, 'Macroprudential policy: what instruments and how to use them? Lessons from country experiences' (*papers.ssrn*, October 2011) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1956385](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1956385)> accessed 12th November 2016.

Although the LTV is often viewed as a tool used to contain the housing bubbles, it is argued that the implementation of this tool is a barrier to the development of the housing finance market, when there is no alternative solution to mitigate its adverse impact. The reason for considering the LTV a barrier lies in its role in hindering the potential first homebuyers from gaining access to the housing finance market. The ease of access to the housing finance market helps to increase the rate of homeownership, and both elements – the ease of access to the market and the homeownership rate – are often used to measure the quality of the development of a country's housing finance market.<sup>20</sup>

In general, the adoption and application of the macro-prudential policy, including the LTV, uses two approaches: mandatory and advisory.

–**The perspective approach:** under this approach central banks (supervisory authorities) require lenders to abide by explicit limits which are set up by them.<sup>21</sup>

–**Guidelines approach:** Some central banks (supervisory authorities) provide general guidelines for lenders in relation to macro-prudential tools, but do not require them to follow these guidelines. In these cases, supervisory authorities do not take action against lenders who do not follow the guidelines.<sup>22</sup> In these jurisdictions (whether industrial or emerging), it has been observed that where data is not available on LTV ratios for different points in time, the application of the LTV policy is often not mandatory but just advisory.<sup>23</sup>

The adoption and application of LTV policy differs from country to country, as a result of different political, economic and financial circumstances which might affect the possible impact on the application of the policies.

It has been widely accepted that the possible impact of the LTV policy in excluding two important segments of society from the housing finance market exposes it to political pressure.<sup>24</sup> Politicians are interested in supporting these segments of the electorate and will do whatever they can to inhibit the policy's consequences.

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<sup>20</sup> E Roche, 'Loans around the world' (1997) 14 *Secondary Mortgage Markets: A Freddie Mac Quarterly* 1 & S Proxenos, 'Homeownership rates: a global perspective' (2002) 17 *Housing finance international* 3.

<sup>21</sup> Financial Stability Board, 'Thematic Review on Mortgage Underwriting and Origination Practices' (*fsb.org*, 17<sup>th</sup> March 2011) < [http://www.fsb.org/wp-content/uploads/r\\_110318a.pdf](http://www.fsb.org/wp-content/uploads/r_110318a.pdf)> accessed 11<sup>th</sup> November 2016.

<sup>22</sup> Financial Stability Board, 'Thematic Review on Mortgage Underwriting and Origination Practices' (*fsb.org*, 17<sup>th</sup> March 2011) < [http://www.fsb.org/wp-content/uploads/r\\_110318a.pdf](http://www.fsb.org/wp-content/uploads/r_110318a.pdf)> accessed 12<sup>th</sup> November 2016.

<sup>23</sup> C Crowe and others, 'How to deal with real estate booms: Lessons from country experiences' (2013) 9 *Journal of Financial Stability* 300.

<sup>24</sup> G Galati and R Moessner, 'What do we know about the effects of macroprudential policy?' (*papers.ssrn*, September 2014) < [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2502003](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2502003) > accessed 12<sup>th</sup> November 2016.

There are a number of advantages to using the LTV. For example, designing and employing the LTV tools might limit the exposure and vulnerability of the banking sector to volatiles in property prices, as has been proved in some jurisdictions.<sup>25</sup> Also, it has been found that high capital and liquidity requirements established by the low rate of the LTV tool can play an important role in moderating excessive volatiles in the financial cycle.<sup>26</sup> Also, studies have shown that there is a strong connection between LTV ratio and default rate, with the low LTV ratio often associated with a low rate,<sup>27</sup> while the default rate increases with high LTV,<sup>28</sup> which means that using LTV will enhance the stability of the financial market and reduce systemic risk and financial instability.<sup>29</sup> In addition, setting a higher capital and liquidity requirement by capping LTV will grant lenders protection against a decline in house prices.<sup>30</sup> In terms of the financial cycle, there is some evidence that the use of LTV might moderate excessive volatiles in the cycle.<sup>31</sup> In some jurisdictions, Hong Kong for example, it was observed that the property price growth decelerated due to the use of LTV caps.<sup>32</sup> Also, in the same jurisdiction it has been found that the use of LTV could slow the growth of lending in the property sector.<sup>33</sup> Despite the importance of using macro-prudential tools, including the LTV, in the banking sector to help contain asset bubbles, it is illogical to make this goal the main aim of the banking sector, as the Bank of England has stated.<sup>34</sup>

Studies confirm that there are a number of disadvantages in relation to the adoption of low ratio LTV (or in other words a high down payments); liquidity is significantly affected by down payment requirements, because it forces households to depress

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<sup>25</sup> G Stefan and W Peng, 'Bank lending and property prices in Hong Kong' (2005) 29 *Journal of Banking & Finance* 461.

<sup>26</sup> G Galati and R Moessner, 'Macroprudential policy – a literature review' (2013) 27 *Journal of Economic Surveys* 846.

<sup>27</sup> Y Deng, 'Mortgage default and low down payment loans: the costs of public subsidy' (1996) 26 *Regional science and urban economics* 263.

<sup>29</sup> G Galati and R Moessner, 'Macroprudential policy – a literature review' (2013) 27 *Journal of Economic Surveys* 846.

<sup>30</sup> G Engelhardt, 'Consumption, down payments, and liquidity constraints' (1996) 28 *Journal of Money, credit and banking* 255.

<sup>31</sup> C Crowe, 'How to deal with real estate booms: lessons from country experiences' (2013) 9 *Journal of Financial Stability* 300.

<sup>32</sup> A Ashvin and N Malhar, 'Safeguarding Banks and Containing Property Booms: Cross-Country Evidence on Macro prudential Policies and Lessons from Hong Kong SAR' ([papers.ssrn,12 December 2011](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1971435)) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1971435](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1971435)> accessed 10<sup>th</sup> November 2016.

<sup>33</sup> A Ashvin and N Malhar, 'Safeguarding Banks and Containing Property Booms: Cross-Country Evidence on Macro prudential Policies and Lessons from Hong Kong SAR' ([papers.ssrn,12 December 2011](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1971435)) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1971435](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1971435)> accessed 10<sup>th</sup> November 2016.

<sup>34</sup> S Victoria, 'The role of macroprudential policy' (*estaticos. expansion*, November 2009) [http://estaticos.expansion.com/estaticas/documentos/2009/11/doc\\_banco\\_inglaterra23112009.pdf](http://estaticos.expansion.com/estaticas/documentos/2009/11/doc_banco_inglaterra23112009.pdf)> accessed 12<sup>th</sup> November 2016.

consumption in order to accumulate high down payments.<sup>35</sup> In addition, adopting a low ratio LTV might lead to the exclusion of some segments of the market, such as first-time home buyers and low-income earners, due to their inability to fulfil the high capital requirement.<sup>36</sup> The potential exclusion of these segments from the financial market and hence from the property market will in turn lead to a decrease in the homeownership rate. Thus, for example, some studies attribute Germany's low homeownership rate to the low LTV and high down payment there.<sup>37</sup> Unless potential home buyers receive some help from their families or friends to accumulate the required high down payment, they have no chance of gaining access to the financial market.<sup>38</sup>

Bearing in mind these considerations, did the Saudi Arabian Monetary Agency (SAMA), which was authorised to draft the Regulation of the Real Estate Finance Law (RREFL) including article 12, take into account the possible adverse impact of capping the LTV at 70% on the first home buyer and medium segment? Initiatives by government and legislative authorities include a number of measures that aim to facilitate access to the financial system, so as to increase home ownership rates, but the wording of article 12 seems to work against the aims of those initiatives. There is a need for an analytical examination to help us understand the circumstances surrounding the drafting of article 12, and this will achieve two goals: to improve the effectiveness of the regulatory framework governing macro-prudential policy, and to mitigate the possible impact of article 12 on the housing finance market.

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<sup>35</sup> G Engelhardt, 'Consumption, down payments, and liquidity constraints' (1996) 28 *Journal of Money, Credit and Banking* 255

<sup>36</sup> D Igan and K Heedon, 'Do loan-to-value and debt-to-income limits work? Evidence from Korea' (*papers.ssrn*, March 2011) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1974849](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1974849)> accessed 10<sup>th</sup> November 2016.

<sup>37</sup> M Voigtländer, 'Why is the German homeownership rate so low?' (2009) 24 *Housing Studies* 355.

<sup>38</sup> F Ortalo-Magne and S Rady, 'Housing market dynamics: On the contribution of income shocks and credit constraints' (2006) 73 *The Review of Economic Studies* 459. It is noteworthy that the high down payment, which of course resulted from capping the LTV at a low percentage, is the main liquidity constraint for the first home buyer in the USA, despite the down payment there being between 5-20% of the purchase price of the home, for further discussion about this tool and its impact in the US see: T Jappelli and P Marco, 'Consumption and capital market imperfections: An international comparison' (1989) *The American Economic Review* 1088 & T Jappelli and P Marco, 'Saving, growth, and liquidity constraints' (1994) *The Quarterly Journal of Economics* 83.



## **5.4 Article (12), its impact and the need to reform the regulatory framework for adoption of the LTV to develop the housing finance market**

Based on the above studies, there is no doubt that the possible impacts of applying the LTV at 70% are significant and that first home buyers are likely to be excluded from access to the housing finance market as a result. In this respect, Saudi is not exceptional. The possible impact of the LTV could be worse if we take into account the political and economic circumstances of the last two years (2015-2016), which make it more difficult for Saudi first home buyers to accumulate a down payment amounting to 30% of the price of a house.

In the wake of falling oil prices in mid-2014, along with engagement in the Yemen war, both of which factors have overtaxed the general budget and caused an acute deficit, the government has adopted many austerity policies to decrease its spending, including but not limited to job cuts and reduced salaries.<sup>39</sup> In addition, enacted the Land Fees Law 2016 has increased the government's appetite to impose more taxes and fees, in order to ameliorate the budgetary shortfall caused by the above-described circumstances. For example, electric and water tariffs were increased by the company owned by the government to double their previous levels,<sup>40</sup> and taxes on rubbish removal were imposed.<sup>41</sup> Naturally, Saudi families' budgets will be impacted by these extra expenses, making it even more difficult to accumulate the 30% down payment required to buy a house.

If we assume that Saudi authorities aimed to maintain and safeguard the financial system through imposition of the LTV, article (12), the question might emerge here as to why they have not reviewed the literature on LTV, so as to become aware of its adverse impacts on the housing finance market. Also, Saudi is a member of many international organisations which are interested in the macro-prudential policy, and is supposed to

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<sup>39</sup> S Kerr, 'S Spickernell, 'Saudi Arabia begins quest for austerity as its economy sinks in plunging oil prices' (*CITY A.M.*, 25 August 2015) < <http://www.cityam.com/223040/saudi-arabia-seeks-austerity-advice-amid-plunging-oil-prices>> accessed 12<sup>th</sup> January 2016 & S Kerr, 'Saudi Arabia cuts public sector bonuses in oil slump fallout' *The Financial Times*(London, 27<sup>th</sup> September 2016) <<https://www.ft.com/content/765898e0-8482-11e6-8897-2359a58ac7a5>> accessed 12<sup>th</sup> November 2016.

<sup>40</sup> According to the Council of Ministers' resolution dated 28<sup>th</sup> December 2015.

<sup>41</sup> According to the Council of Ministers' resolution dated 16<sup>th</sup> August 2016.

receive from those organisations several publications and reports about the macro-prudential policy, including LTV, indicate to their negative impacts on the housing finance market. This leaves Saudi authorities with no excuse to ignore the adverse impact of the LTV on the housing finance market.

Saudi Arabia was one among many jurisdictions to have taken extra care with the LTV policy in order to prevent any potential systemic risks in their banking sector that might be created by lending in general, and housing finance lending in particular. Although the LTV policy received more attention in the wake of the 2007 global financial crisis, the adoption of the LTV by the Saudi supervisory authorities was delayed until 2012 to be included within the provisions of the Housing finance laws 2012, of which the RREFL is one law.

The mechanism of the drafting article 12, together with the possible adverse impact of the LTV on first-time home buyers and low to medium segments alike, raises concerns about the regulatory framework operating in the housing finance market in general and in relation to the adoption of the LTV in particular. This is due to a mismatch between the main aims of the Housing Finance Laws 2012 and their implementation in connection with the LTV. Therefore, it is worth considering that problems exist within the regulatory framework within which article 12 was drafted, and to discover these defects it is necessary to analyse both the regulatory framework and the conditions in which it operates. The aim of this analysis is to find the most appropriate regulatory framework for boosting the housing finance market's capacity to meet the demands of all community segments, while maintaining financial stability.

To perform the above analysis, it is necessary to discuss the regulatory framework for adoption of the macro-prudential policy, including the LTV, in three aspects: decision-making, the integration of policies and legislations, and accountability.

#### **5.4.1 Decision-making**

#### **5.4.2 The integration of policies and legislation**

There is an urgent need to integrate the aims of the policies and legislation which pertains to housing finance, to make the possible outcomes of application of the legislation and policies consistent with their aim. Thus preventing the kind of conflicts, as seen in article 12 and the main aim of the enactment of the housing finance laws 2012.

There is no doubt that any action has side effects, but the issue here arises when these side effects overwhelm the planned aims of the legislation or policies. Then the strategy of implementing these legislations and policies becomes problematic.

Maintaining the financial system through the LTV policy is necessary, but it would be irrational to make this the main aim of the banking sector, let alone the housing finance sector, because this measure will prevent the sector from flourishing, growing, and of course developing.<sup>42</sup> Although it can be argued that the benefits of the LTV policy tend to be sizeable when financial or housing shocks hit the economy,<sup>43</sup> it would be illogical to make it the main aim of the financial system, so as to prevent a crisis occurring

This is not to say that we need not take account of the LTV tool to protect the financial system from such crises; rather, we should not exaggerate this factor when applying this tool. It is clear that SAMA, with its new department, works apart from other governmental agencies and legislative authority, which explains the contradiction between the general aims of enacting the housing finance laws 2012, which the RREFL is one of them, and the provision of article (12) of the RREFL. Therefore, it could be argued that a comprehensive decision to develop the housing finance market cannot be expected as long as SAMA works apart from other governmental agencies and legislative authority. The lack of integration of policies and legislations, pertaining the housing finance, results from lack of cooperation between government agencies and the legislative authority. For instance, after enacting article 12 pertaining the LTV, the Ministry of Housing sensed the possible downsides of capping LTV and called a meeting between the minister of housing and the governor of SAMA in Saudi to discuss this issue and to find a solution that might mitigate the possible impact of LTV on housing finance market. However, the results of the meeting were not announced to the public or to the newspapers.<sup>44</sup> Concern over the impact of this measure caused the Ministry of Housing to announce again, according to local newspapers, its intention to cooperate with other governmental agencies to create

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<sup>42</sup> Bank of England stated in its report about the macro-prudential policy that despite the importance of using this policy in the banking sector to help contain asset bubbles, it is illogical to make this goal the main aim of the banking sector. For more information about this report see; P Tucker, S Hall and A Pattani, 'Macroprudential policy at the Bank of England' (*papers.ssrn*, June 2013) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2327434](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2327434)> accessed 12<sup>th</sup> November 2016.

<sup>43</sup> P Angelini, S Neri and F Panetta 'Monetary and macro-prudential polices' (*papers.ssrn*, March 2011) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1832349](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1832349)> accessed 10<sup>th</sup> November 2016

<sup>44</sup> The above meeting between the Housing of Minister and the Governor is announced by SAMA's website, for more information see: SAMA, 'The governor meets the Minister of Housing' (*sama.gov.sa*, 5 August 2015) <<http://www.sama.gov.sa/ar-sa/News/Pages/News08052015.aspx>> accessed 11<sup>th</sup> November 2016.

means of helping prospective first homebuyers to provide the down payment of 30% prescribed by article (12) of the RREFL, with no details.<sup>45</sup>

To achieve a good outcome from the application of the LTV and other government policies pertaining to housing finance, it is necessary to unify the Saudi Government's plans, policies and legislation as part of its decision-making mechanism, so as to avoid potential conflicts. This mechanism will guarantee the integration of government policies with legislative enactments and decrease possible conflict between them where the housing finance market is concerned. This aim can be achieved through including a member representing the so-called Economics and Development Affairs Council (EDAC) in the composition of the suggested committee, which was mentioned in the previous section, in order to convey the orientation of the EDAC towards any issue related to the housing finance market. In fact, the EDAC was established<sup>46</sup> to examine, review and make decisions on all matters associated with economic development, and to participate in drafting bills dealing with economic issues, including housing finance.<sup>47</sup> Therefore, this step would enable the proposed committee to consider and take into account other legislations and government policies relating to the housing finance market before making any decisions; and of course it would enhance integration of legislation and government policy in this field.

It might be argued that the financial stability committee needs to do its work without the political pressure that could be exercised by the EDAC. In order to achieve these goals, the proposed committee needs independence, and there needs to be an integration of government policies with legislative enactments when making decisions pertaining to the housing finance market, i.e. a member representing the EDAC should be non-voting.<sup>48</sup>

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<sup>45</sup> A Albargawi, 'Sources; saving program to confront the difficulties of making down payment' *Sabaq* (Riyadh, 13<sup>th</sup> August 2015)

<<https://mobile.sabq.org/%D9%85%D8%B5%D8%A7%D8%AF%D8%B1-%D8%AA%D9%83%D8%B4%D9%81-%D9%84%D9%80-%D8%B3%D8%A8%D9%82-%D8%A7%D8%B9%D8%AA%D9%85%D8%A7%D8%AF-%D8%A8%D8%B1%D9%86%D8%A7%D9%85%D8%AC-%D8%A7%D9%84%D8%A7%D8%AF%D8%AE%D8%A7%D8%B1-%D8%A7%D9%84%D8%B3%D9%83%D9%86%D9%8A-%D9%82%D8%B1%D9%8A%D8%A8%D8%A7>> accessed 10<sup>th</sup> November 2016.

<sup>46</sup> EDAC was established by the Royal Order no(A/69) dated 29<sup>th</sup> January 2015.

<sup>47</sup> EDAC's missions and functions were approved by the Council of Ministers in 20<sup>th</sup> February 2015.

<sup>48</sup> The above composition of the suggested committee goes beyond the classic image, which would only emphasise financial services, to focus, instead, on both social and economic representation. In fact, such diversity in the membership of committee of this sort has been adopted by some jurisdictions such as the United States, where, for example, "the President shall have due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and the geographical divisions of the country" before appointing seven governors of the Federal Reserve System. Also, it was seen in the UK that the FPC is constituted of different members representing the Bank of England, the Financial Conduct Authority, four external members appointed by the Chancellor and non-voting representation of the Treasury. For more information about the composition of financial committee in the US and the UK see; A Arora, *Banking*

Although the proposed financial stability committee should enjoy independence when making a decision on financial matters, that does not exempt it from accountability, which will be discussed below.

### 5.4.3 Accountability

Generally speaking, the central banks' authority to use the macro-prudential policy, including the LTV, needs to be balanced with clear accountability arrangements.<sup>49</sup> Therefore, it could be argued that SAMA's silence in response to criticisms of the LTV ratio can be attributed to its lack of accountability in that SAMA, according to its enacting law,<sup>50</sup> is not accountable to the public for justification of its actions.

Usually, accountability refers to two options: a hearing in Parliament, or political accountability to the Minister of Finance and thence from the minister to Parliament.<sup>51</sup>

The concept of accountability, in fact, is inherent in the concept of a democratic society that requires independence to be coupled with accountability.<sup>52</sup> Bearing these considerations in mind, accountability could take a different form, namely that of transparency or information disclosure, although the latter is one aspect of the former.

Neither the concept of accountability, entailing a hearing in Parliament, nor that of transparency, exists in the mechanism for formulating article (12) and applying LTV. It is believed that if the principles of accountability had been included in SAMA's law, the latter would have responded to criticisms of capping LTV at 70%, or at least would have given an explanation or justification for its action. The absence of published reports or research revealing the purpose of capping the LTV ratio at 70% instead of 80%, for example, supports the belief that SAMA's action on LTV lacks accountability. That gives

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*Law* (Pearson Education limited 2014)141 & Bank of England, 'Financial Policy Committee'(bankofengland.co.uk, 2012)<<http://www.bankofengland.co.uk/financialstability/pages/fpc/default.aspx>> accessed 10th November 2016.

<sup>49</sup> D Schoenmaker and W Peter, 'Macroprudential policy: The need for a coherent policy framework'(2011) 13 Duisenberg School of Finance Policy Paper 1.

<sup>50</sup> The Royal decree no (3) was issued in 15-12-1957 to enact the Charter of the Saudi Arabian Monetary Agency, which include 14 articles represent the constitution of the SAMA to control the currency in the country alongside other financial functions and tasks.

<sup>51</sup> J Haan, F Amtenbrink and S Eijffinger, 'Accountability of central banks: aspects and quantification'(1999) 209 Banca Nazionale del Lavoro Quarterly Review 169.

<sup>52</sup> V Perro and S Ruoff, 'Improving accountability in banking' (1996) Com. Lending Rev 44 & D Jakob, F Amtenbrink and S Eijffinger, 'Accountability of central banks: aspects and quantification'(1999) 52 Banca Nazionale del Lavoro Quarterly Review 169 & E Suzuki and S Nanwani, 'Responsibility of international organizations: the accountability mechanisms of multilateral development banks' (2005) 27 Mich. J. Int'l L 177.

SAMA unlimited authority to regulate and supervise the financial sector without justifying its actions or at least clarifying the aim and purpose of those actions.

In these circumstances, how are we supposed to develop the housing finance market while the sector lacks this necessary feature, accountability? In particular, there is nothing to hinder SAMA from adopting a policy, whether a monetary policy or a macro-prudential policy, aimed at maintaining the financial system regardless of the adverse impact on the housing finance market, for example. This is not to assert a need to restrict SAMA's powers; rather the idea is to combine independence with accountability to serve the public interest.

For all the above reasons, and in order to enhance the concept of accountability by placing all decisions regarding macro-prudential policy in general and those related to the housing finance market in particular under public monitoring, the suggested financial stability committee, which was mentioned in section (5.4.1) should be subjected to an accountability requirement by the CEDA. To promote the principle of accountability it is suggested that the committee be required to respond publicly to any recommendations made to it by the CEDA, explaining either the ways in which it is acting in accordance with them or its reasons for not doing so.

It might be asked why the committee is not subject to an accountability requirement by the Saudi Parliament rather than by CEDA. In fact, there is no Parliament in Saudi, despite the so-called *Shura* council playing some parliamentary roles. However, the power and strength enjoyed by CEDA are much greater than the *Shura* Council's, and its direct linkage to the King might provide a motive for the committee to do its utmost to take into account possible adverse impacts on the housing finance market and other sectors.

To summarise this section, it has shown that there were many defects inherent in the regulatory framework used in drafting article (12) in relation to the LTV. These defects ranged from the lack of experience of the new department that was authorised to draft article (12), SAMA's inability to justify its action in setting the proportion of LTV, the mismatch between the main aims of enacting the housing finance laws 2012 and their implementation as regards the LTV, to the lack of accountability, and finally to the absence of initiatives for resolving the adverse impact of the application of the LTV. Therefore, the committee suggested above is urgently needed to improve and develop the regulatory framework shaping both macro-prudential policy and the housing finance market.

The following section will show how the competent authorities in the UK avoided the issues related to the procedures leading to LTV adoption, by enhancing the principles of accountability and transparency as well as by establishing an independent committee to deal with the macro-prudential policy while taking care over its possible impacts on the housing finance sector. The section will then be followed by section six, which will examine the way the financial authorities in Hong Kong created a means of resolving the adverse impact of the LTV.

## **5.5 Housing markets and financial stability: the evolving role of the macro-prudential regime in the UK**

### **5.5.1 Background**

During the period from the 1950s until the early 2000s, the homeownership rate in the UK reached a peak in 2003, at 70.9 per cent of households in the UK.<sup>53</sup> The main factor to play a significant role in increasing the homeownership rate was the Thatcher government's policies during the 1970s, when it adopted many initiatives to assist tenants to achieve homeownership.<sup>54</sup> For instance, the Housing Act 1980 was subjected to amendments including the Right to Buy provisions, which ended the ability of local authorities to block sales to tenants. Right to Buy gives eligible council tenants the right to buy their property from their council at a generous discount ranging from 33% to 70% of the property's value.<sup>55</sup> Consequently, the number of homeowners increased from 11.9 million to 15 million between 1981 and 1989.<sup>56</sup>

Although the above statutory amendment and government policy had the notable advantage of increasing the homeownership rate, their side-effects were not realised during that period. The result of those policies and the statutory amendments was a reduction in the local contribution to house building, so that the number of social houses

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<sup>53</sup> G Meen, 'Homeownership for Future Generations in the UK' (2012) *Urban Studies* 1.

<sup>54</sup> P Collier and R Luther, 'The use of tax regulations as covert political policy variables: A case study of tax expenditures during the Thatcher years' (2003) 19 *Financial Accountability and Management* 159.

<sup>55</sup> M Loison-Leruste and D Quilgars, 'Increasing access to housing: Implementing the right to housing in England and France' (2009) *European Journal of Homelessness* 75 & P Collier and R Luther, 'The use of tax regulations as covert political policy variables: A case study of tax expenditures during the Thatcher years' (2003) 19 *Financial Accountability and Management* 159.

<sup>56</sup> J Brown, H Song and A McGillivray, 'Forecasting UK house prices: A time varying coefficient approach' (1997) 14 *Economic Modelling* 529.

built in the UK declined from around 42,700 houses per year during 1994-95 to around 21,000 in 2002-03, according to Barker's report.<sup>57</sup> In addition, some studies suggested that local authority house-building, that is, of social houses, fell dramatically to the lowest levels achieved in the post-World War II era.<sup>58</sup>

Many initiatives have been put forward to offset the huge gap in housing funding that resulted from the policy of ceasing to build social housing. For instance, the new housing projects were funded by private debt, which became the main means of funding such projects from 1989 on.<sup>59</sup> Therefore, private renting has increased since 1989 when it reached its lowest point while the significant growth in this sector has been facilitated by the development of the Buy-to-let mortgage market.<sup>60</sup>

Also, another side-effect of the government's policies and statutes amendments during the 1980s is the increased house prices. The wave of increased house prices following the decline in construction of social houses was accepted. The decline in construction of housing was one reason for the increase in house prices, alongside, as mentioned by the Barker report of 2004, the increase in the UK population, the growth in demand for housing over time, driven primarily by demographic trends and rising incomes, the weak response of housing supply to demand changes, etc.<sup>61</sup> Of course, the increase in house prices was a barrier hindering access to the housing finance market; in turn the homeownership rate declined to reach, for example, less than 67% in 2010.<sup>62</sup> In particular, younger people were noted as the main group affected by the decline in the homeownership rate.<sup>63</sup>

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<sup>57</sup> Kate Barker is a British economist was empowered by the British Government to conduct a review of issues underlying the lack of supply and responsiveness of housing in the UK, she finished the report in 2004. For more information about the Barker's report visit; K Barker, 'Review of housing supply: delivering stability: securing our future housing needs' (*ayrshire-jsu.gov.uk*, December 2003) <<http://www.ayrshire-jsu.gov.uk/download/review%20of%20housing%20supply%20-%20interim.pdf>> accessed 10<sup>th</sup> November 2016.

<sup>58</sup> P Collier and R Luther, 'The use of tax regulations as covert political policy variables: A case study of tax expenditures during the Thatcher years' (2003) 19 *Financial Accountability and Management* 159.

<sup>59</sup> C Whitehead and W Peter, 'Causes and consequences? Exploring the shape and direction of the housing system in the UK post the financial crisis' (2011) 26 *Housing Studies* 1157.

<sup>60</sup> Buy-to-let refers usually to buy property aiming to let it and it is a very long term investment, Buy-to-let constitutes a very important segment of the housing market in the UK, for more information about this market see; N Sprigings, 'Buy-to-let and the wider and the wider and the wider housing market' (2008) 2 *People, Place & Policy Online* 76.

<sup>61</sup> K Barker, 'Review of housing supply: delivering stability: securing our future housing needs' (*ayrshirejsu.gov.uk*, December 2003) <<http://www.ayrshirejsu.gov.uk/download/review%20of%20housing%20supply%20-%20interim.pdf>> accessed 10<sup>th</sup> November 2016.

<sup>62</sup> C Whitehead and W Peter, 'Causes and consequences? Exploring the shape and direction of the housing system in the UK post the financial crisis' (2011) 26 *Housing Studies* 1157.

<sup>63</sup> C Whitehead, 'International Trends in Owner-Occupation: In the Light of the Financial Crisis' (2010) 25 *Housing Finance International* 6.



In the wake of The Barker Report, the UK Government adopted initiatives to address the lack of supply of housing in the UK. For instance, in 2013 the Conservative Party, who is still currently in power, launched initiatives to solve the housing shortage, such as the ‘Help to Buy’ scheme,<sup>64</sup> and in 2015 it allocated of £3.5 billion to deliver thousands of new affordable homes across the country, a project designed to last for three years.<sup>65</sup> However, although, the UK Government initiated some change in the wake of The Barker Report of 2004, house prices were pushed up dramatically, as a consequence of the 2007 global financial crisis.

The forecast indicated that the increase would continue in the coming years. In London, for example, house prices are predicted to rise more than 30% over the next five years, according to some studies.<sup>66</sup> However, the forecast has changed slightly since Brexit, as a new forecast suggests that house prices will fall by 1% in 2017, rising again by 2% in 2018.<sup>67</sup>

Although the above initiatives, whether governmental or private, have aimed to address the lack of housing supply and to cater for the huge demand for housing finance, they include some systemic risks that might pose a threat to the financial system in the UK. Therefore, the governor of the Bank of England, Mark Carney, said that “problems with housing are the biggest risk to the UK economy”.<sup>68</sup> Such a pronouncement gives an indication of the dangerous role that the housing market might play as a threat to the economy, and particularly to the financial system in the UK. Hence further actions were expected to follow to protect the system from such a threat. This protection is represented in the macro-prudential policy, including the LTV, which the supervisory authorities resorted to in order to protect the UK economy.

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<sup>64</sup> ‘Help to buy’ was designed for those aged 16 or over who have a valid UK National Insurance number and are UK resident and do not own another property anywhere else in the world to be a first-time buyer. It works if a person saves enough money, then the government boosts their savings by 25%. So, for every £200 they save, they receive a government bonus of £50. The maximum government bonus you can receive is £3,000. For more information see: HM Government, ‘Help to buy’ ([helptobuy.gov.uk](http://helptobuy.gov.uk), August 2013) <<https://www.helptobuy.gov.uk/>> accessed 10<sup>th</sup> November 2016

<sup>65</sup> For more information about above programme visit this website: GOV, ‘£3.5 billion deal to build homes and drive local growth’ ([gov.uk](http://gov.uk), 27 June 2013) <<https://www.gov.uk/government/news/35-billion-deal-to-build-homes-and-drive-local-growth>> accessed 12<sup>th</sup> November 2016.

<sup>66</sup> A White, ‘Is another house price bubble around the street corner for London?’ *The Telegraph* (London, 2<sup>th</sup> April 2015) 5.

<sup>67</sup> I Fraser, T Wallace and R Bury, ‘House prices forecast to fall after Brexit’ *The Telegraph* (London, 22<sup>ed</sup> August 2016) 5 < <http://www.telegraph.co.uk/business/2016/08/21/house-prices-forecast-to-fall-after-brex1/>> accessed 23<sup>th</sup> November 2016.

<sup>68</sup> R Moore, ‘Britain’s housing is a human disaster. Here are 10 ways to solve it’ *The Guardian* (London, 14 March 2015) <<http://www.theguardian.com/society/2015/mar/14/britain-housing-crisis-10-ways-solve-rowan-moore-general-election>> accessed 10<sup>th</sup> November 2016.

### **5.5.2 Building a robust macro-prudential regime**

Generally speaking, there are four dimensions that distinguish the mechanism of adopting the macro-prudential policy, including LTV, within the UK jurisdiction from its counterpart in Saudi: establishing the legal basis to rely on when adopting these tools, observing the principles of accountability and transparency, identifying the sources of threat to financial stability and resilience, and finally consulting a range of participants in the housing market before making the decision about the macro-prudential policy.

The above dimensions can be revealed by examining the competent authority (which is the Financial Policy Committee (FPC)) mandated to regulate the macro-prudential policy, its functions, the powers granted to it for the exercise of its functions in this context, and the way the FPC rounds work. The aim of this examination is to enable Saudi Arabia to learn lessons to improve its regulatory framework pertaining macro-prudential policy. The following section will examine and discuss the FPC in detail.

### **5.5.3 The Financial Policy Committee (FPC)**

The FPC was established in the wake of the evolution of the financial system through enactment of the Financial Services Act (FSA) 2012. This Act restructured the previous Tripartite System, which had been responsible for financial stability since 1997 and comprised HM Treasury, the Bank of England and the Financial Services Authority.<sup>69</sup> Alternatively, the Act created new authorities to exercise the supervisory responsibilities: the Financial Policy Committee (FPC), The Prudential Regulation Authority (PRA) and The Financial Conduct Authority (FCA), which together might be considered a different

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<sup>69</sup> In fact, the Conservative Party took the first step in venturing to criticise the Tripartite system and to sway voters to attack it through its White Paper of July 2009, nearly two years after the financial crisis of 2007. Commentators, therefore, have largely criticised the Tripartite system because it failed to anticipate the financial crisis and the roles of the three bodies were not clear enough to identify who was in charge. As a result, the White Paper proposed putting the central bank at the heart of the financial system and abolishing the Tripartite system in order to give the Bank of England responsibility for macro-prudential regulation and maintaining financial stability. These criticisms and proposals resulted in enactment of a new act that restructured and recast the financial system in the UK which contained three bodies with different functions and responsibilities. For more information see; A Arora, *Banking Law* (Pearson Education limited 2014)123 & B Geva, 'Systemic risk financial stability: the evolving role of the central bank' (2013) *Journal of international banking law and regulation* 1 & E Ferran, 'The break-up of the financial services authority' (2011) 1 *Oxford Journal of Legal Studies* 1.

tripartite structure.<sup>70</sup> The FPC has the responsibility for supervising and taking necessary action to maintain financial stability in the UK.<sup>71</sup>

The FPC is considered an independent committee at the Bank of England<sup>72</sup> and contains thirteen members<sup>73</sup> from varied sources such as the Bank of England, private sector and the Treasury, thus enhancing the diversity of this committee's membership, a feature which of course will enrich any decision it makes.

The committee has two objectives and remits, primary and secondary. The former includes identifying and monitoring the systemic risks that threaten financial stability and taking any action to remove or at least reduce those risks,<sup>74</sup> while the latter involves supporting the government's economic policy.<sup>75</sup>

To understand the FPC's functions, remits, and how it exercises its function in adopting the macro-prudential policy, it might be useful to shed light on its powers and on how FPC rounds work.

### 5.5.3.1 FPC's powers

Generally speaking, UK regulators were being cautious when they limited the FPC's remit to exercise its functions. The aim was to prevent the FPC carrying on in a way that would be likely, in the regulators' opinion, to have significantly adverse effects on the

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<sup>70</sup> P Lowey and A Reisberg, *Pettet's company law: company law & corporate Finance* (4<sup>th</sup> Edition, Pearson 2012) 395.

<sup>71</sup> There are several definitions of financial stability, such as: "the primary target in preventing financial crisis and reducing the severe risks of financial problems which do occur from time to time"; however, determining the exact meaning of the financial system is not the aim of this thesis, being beyond its scope, for more information about the nature of financial stability see; R Cranston, *Principles of Banking Law* (2<sup>ed</sup> edition, Oxford University Press 2002) 118; B Geva, 'Systemic risk financial stability: the evolving role of the central bank' (2013) *Journal of international banking law and regulation* 1 & G Schinasi, 'Responsibility of central banks for stability in financial markets' (*papers.ssrn.com*, June 2003) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=879197](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=879197)> accessed 10<sup>th</sup> November 2016.

<sup>72</sup> A Arora, *Banking Law* (Pearson Education limited 2014) 141 & Shearman & Sterling, 'United Kingdom: financial regulation – new financial regulators' (2013) 28 *Journal of International Banking Law and Regulation* 77.

<sup>73</sup> The thirteen members are: the Governor, four Deputy Governors, the Chief Executive of the Financial Conduct Authority (FCA), the Bank's Executive Director for Financial Stability Strategy and Risk, five external members appointed by the Chancellor, and a non-voting representative of the Treasury, for further information see: L Cox and others, 'United Kingdom regulatory reform: emergence of the twin peaks' (2012) 95 *Compliance Officer Bulletin* 1.

<sup>74</sup> A Arora, *Banking Law* (Pearson Education limited 2014) 141 & A Haynes, 'Financial services: all change or new cosmetics?' (2014) 35 *Company lawyer* 129.

<sup>75</sup> s.2A of the Bank of England Act 1998 was amended by Financial Services Act 2012, schedule 1 which provide that the FPC is to contribute to that objective primarily by identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system.

financial sector's capacity to contribute to the growth of the UK economy in the medium and long-term.

In that case the Financial Services Act 2012 would neither authorise nor require the FPC to carry out its function.<sup>76</sup> This limitation on the FPC can be attributed to the desire of the regulator to enhance the principle of accountability of the committee, which would thus take extra care when exercising its function.

It was observed that there has been a gradation and slowness in adopting the macro-prudential policy in the UK; that might be attributed also to two main factors. The first is that, despite the FPC having responsibility for supervising and taking necessary action to maintain financial stability in the UK, it was not authorised to exercise its function if it believed that would have an adverse impact on the growth of the UK economy in the medium and long term.<sup>77</sup> The second factor is the FPC's statutory obligation to follow specific statutory principles and procedures, as set out by the FSA 2012 and other legislations, before adopting the macro-prudential policy. This requirement enabled the regulators to ensure that FPC's policies and actions would not negatively impact on the UK economy.

To fully understand the gradation and slowness in the adoption of the macro-prudential policy, it is necessary to look at the powers, including those related to the macro-prudential policy, granted to the FPC to protect the financial system and to meet its responsibilities. In fact, the FPC is endowed with two types of powers to enable it to take necessary action to protect financial stability.

### **i. Powers of Recommendation**

This provision grants the FPC the necessary power to ask both the PRA and FCA to take action to mitigate the risks emerging from the finance market.<sup>78</sup> It is a broad power which

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<sup>76</sup> Bank of England, 'Financial Policy Committee statement on housing market powers of direction' ([bankofengland.co.uk](http://www.bankofengland.co.uk/financialstability/Documents/fpc/statement021014.pdf), September 2014) <<http://www.bankofengland.co.uk/financialstability/Documents/fpc/statement021014.pdf>> accessed 10<sup>th</sup> November 2016.

<sup>77</sup> A Arora, *Banking Law* (Pearson Education limited 2014) 142 & L Cox and others, 'United Kingdom regulatory reform: emergence of the twin peaks' (2012) 95 *Compliance Officer Bulletin*. It is worth noting that the UK regulator was extremely cautious about adopting the macro-prudential policy, due to the sensitive impact of such a policy on housing market participants, in addition to which housing is considered a priority matter for the government and any policy that might have an adverse effect on housing would require extra scrutiny of either its legal, economic or social aspects. Therefore, when Parliament discussed the proposal, including the grant of powers to the FPC, MPs raised concerns about the adverse impact of such tools on the housing sector and whether or not the government had prepared for such impacts. For more information see: HC Deb 23 March 2015, vol 121 Column number: 4-12.

<sup>78</sup> A Arora, *Banking Law* (Pearson Education limited, 2014) 142-143.

can cover wide aspects of “the activities of the regulators but it cannot relate to a specific individual’s regulated entity”.<sup>79</sup> Also, there is the so-called “comply or explain” principle whereby the FPC can make a recommendation and both authorities are required to act on it as soon as reasonably practical.<sup>80</sup> On this basis the regulators have two options, either comply with the recommendation or explain why they are not doing so.<sup>81</sup>

## **ii. Powers of Direction**

This provision is very distinctive and grants the FPC the power needed to direct the PRA and the FCA to apply specific macro-prudential tools, on two conditions: the power shall be prescribed by the HM Treasury, and must be approved by Parliament.<sup>82</sup>

### **5.5.3.2 How does the FPC exercise its powers?**

The use of the above powers requires the FPC to go through many steps when applying the macro-prudential policy; however, all steps use the gradation mechanism and so do not surprise either the market or individuals. The steps are as follows:

#### **1-Increasing awareness:**

Some measures have been taken to aid public understanding of the macro-prudential tools, their functions and their impacts on the financial system and the economy in general. Such measure began before the establishment of the FPC, due to the Bank of England under the Banking Act 2009 was required to publish financial stability reports.<sup>83</sup> For instance, in November 2009 the Bank of England,<sup>84</sup> published a discussion paper

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<sup>79</sup> P Tucker, S Hall and A Pattani, ‘Macroprudential policy at the Bank of England’ (*papers.ssrn.com*, June 2013) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2327434](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2327434)> accessed 10<sup>th</sup> November 2016.

<sup>80</sup> J Perry and others, ‘The new UK regulatory landscape’ (2011) 84 *The new UK regulatory landscape* 1.

<sup>81</sup> For more information about Powers of recommendations and its functions see: A Arora, *Banking Law* (Pearson Education limited 2014) 141-143 & E Murphy and S Senior, ‘Changes to the Bank of England’ (*papers.ssrn.com*, 14 March 2013) < [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2243562](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2243562)> accessed 10<sup>th</sup> November 2016.

<sup>82</sup> Shearman & Sterling LLP, ‘United Kingdom: financial regulation – New financial regulators’ (2013) 28 *Journal of International Banking Law and Regulation* 77.

<sup>83</sup> B Geva, ‘Systemic risk and financial stability: the evolving role of the central bank’ (2013) 28 *Journal of International Banking Law and Regulation* 403.

<sup>84</sup> A Daripa and S Wright, ‘Labour’s record on financial Regulation’ (2013) 29 *Oxford Review of Economic Policy* 71.

which drew a big picture of the role of macro-prudential policy, its impacts, why it is important, and how it works.<sup>85</sup> The gradation in deploying the macro-prudential tools, as will be seen below, gives borrowers and lenders in the housing finance market some scope to anticipate the supervisory authorities' future conduct, in order to help them make a good decision before concluding a housing mortgage contract.

## **2-Determining the source of threats and using powers of recommendation:**

The FPC is required by s.9W of the Bank of England Act 1998,<sup>86</sup> as part of its accountability, to prepare and publish a financial stability report twice per calendar year. In its reports of September 2013 and June 2014, the FPC determined the source of threat when discussed the possibility of the housing market and mortgage debt posing direct threats to the financial stability of the UK.<sup>87</sup> These reports constituted the first step taken to warn of the risks that might be posed by the housing market, due to the increase housing prices, and the need to take extra action, represented by the macro-prudential policy, to mitigate these risks.

In the same reports, the FPC mentioned that the potential risks might be amplified by a cycle of rising housing prices and overextension of credit.<sup>88</sup> To address this potential risk, the FPC set up criteria on which to choose an appropriate instrument enabling the FPC to exercise its powers of Recommendation<sup>89</sup> for mitigating risks that emerge from the housing market. Then, the Governor of the Bank of England, the FPC's member,

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<sup>85</sup> G Baber, 'Peer review of financial stability: how does the United Kingdom fare?'(2014) 35 company lawyer77.

<sup>86</sup> B Geva, 'Systemic risk and financial stability: the evolving role of the central bank' (2013) 28 Journal of International Banking Law and Regulation 403.

<sup>87</sup> To see the full papers see, Bank of England, 'Financial Policy Committee statement from its policy meeting, 18 September 2013' (*bankofengland.co.uk*, 25<sup>th</sup> September 2013) <<http://www.bankofengland.co.uk/publications/Pages/news/2013/014.aspx>> accessed 13<sup>th</sup> November 2016 & Bank of England, 'Record of the financial policy committee meetings 17 and 25 June 2014'(*bankofengland.co.uk*, 1<sup>st</sup> July 2014)<<http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2014/record1407.pdf>> accessed 12<sup>th</sup> November 2016.

<sup>88</sup> Bank of England, 'Financial Policy Committee statement on housing market powers of Direction from its policy meeting, 26 September 2014' (*bankofengland.co.uk*, 2<sup>ed</sup> October 2016)<<http://www.bankofengland.co.uk/financialstability/Documents/fpc/statement021014.pdf>> accessed 12<sup>th</sup> November 2016.

<sup>89</sup> In June 2014 the FPC exercised its current powers of Recommendation to limit the share of lending at very high loan-to-income ratios to the PRA and FCA. For more information see: Bank of England, 'Financial Policy Committee statement on housing market powers of Direction from its policy meeting, 26 September 2014' (*bankofengland.co.uk*, 2<sup>ed</sup> October 2016)<<http://www.bankofengland.co.uk/financialstability/Documents/fpc/statement021014.pdf>> accessed 12<sup>th</sup> November 2016.

announced in June 2014 that the Bank would not impose draconian measures to cool the housing market unless house prices rose by more than 20% over the next three years.<sup>90</sup> Moreover, in order to prepare for further risks, in case the current powers did not mitigate the existing ones, the FPC took further steps, such as the following.

### **3-Consulting all interested parties about the FPC's housing market tools:**

This further step was taken during 2014, when the FPC decided to launch a separate consultation on the FPC's housing market tools. The consultation targeted a wide range of housing market participants, including banks, non-bank mortgage providers, homebuilders, and industry bodies. Such a step by the FPC gives us an indication of the importance of involving housing market participants in the mechanism for decision-making on macro-prudential policy, due to their experience in this field which rests on a reliable basis of information gained through operating and dealing in this area.<sup>91</sup> In January 2015 HM Treasury issued a report on the details of the outcome of the FPC's housing market tools consultation.<sup>92</sup> This step will be followed by another one using the second kind of power, namely the Power of Direction, to mitigate the threat of systemic risks to the financial system.

### **4-Setting up statutory basis for the Powers of Direction:**

Such a power rests on two conditions: it must be prescribed by HM Treasury and it must be approved by Parliament. The first condition was met by the announcement of the Chancellor of the Exchequer, expressing his intention to give the FPC "new powers over mortgage, including over the size of mortgage loan as a share of family incomes or the value of the house",<sup>93</sup> which was followed by consultation with the FPC in accordance

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<sup>90</sup> J Treanor and L Elliott, 'Bank will not act on house prices yet, says Carney' *The Guardian* (London, 26 June 2014) <<http://www.theguardian.com/business/2014/jun/26/bank-of-england-limit-large-loans-housebuyers-mortgage-lenders>> accessed 15<sup>th</sup> November 2016.

<sup>91</sup> HM Treasury, 'Detail of outcome for FPC's housing market tools consultation' (*gov.uk*, January 2015) <[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/400448/PU\\_1748\\_Consultation\\_Housing\\_Response.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/400448/PU_1748_Consultation_Housing_Response.pdf)> accessed 12<sup>th</sup> October 2016.

<sup>92</sup> HM Treasury, 'Detail of outcome for FPC's housing market tools consultation' (*gov.uk*, January 2015) <[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/400448/PU\\_1748\\_Consultation\\_Housing\\_Response.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/400448/PU_1748_Consultation_Housing_Response.pdf)> accessed 12<sup>th</sup> October 2016.

<sup>93</sup> Gov.uk, 'Mansion House 2014: Speech by the Chancellor of the Exchequer' (*gov.uk*, 12th June 2014) <<https://www.gov.uk/government/speeches/mansion-house-2014-speech-by-the-chancellor-of-the-exchequer>> accessed 12<sup>th</sup> November 2016.

with section 9L (2) of the Bank of England Act 1998.<sup>94</sup> After these procedures a draft order was laid down, based on section 9N of the same act.<sup>95</sup> The second condition was also met by Parliamentary approval in March 2015.<sup>96</sup> After setting up a statutory basis for the Powers of Direction, the FPC adopted the Powers of Direction and this did two things: to restrict bank and building societies' ability to lend out more than 15% of their mortgages portfolios to customers; and to prohibit lending customers more than four and a half times their income. However, such "measures are not nearly as draconian as they might have been had the FPC applied absolute loan to value or loan to income caps at an individual mortgage level",<sup>97</sup> as stated by the head of residential research at Savills UK.<sup>98</sup> In view of the above steps, it could be argued that such lengthy procedures indicate beyond doubt the UK regulators' concern to establish a statutory basis for every new action or power in order to give it the needed legitimacy. Also, such procedures have many advantages, such as the gradation in adoption the macro-prudential policy, and involvement of the private sector in the decision-making procedures followed in this matter, along with giving the market enough scope to brace itself for the expected tougher action.

It is evident, when comparing the Saudi regulators with their counterparts in the UK in regard to their way of adopting and applying the macro-prudential policy including the LTV that the latter were very careful from the start when they sought to provide a statutory basis before taking an action that might have an adverse impact on the UK economy. The main impetus and explanation for this care can be attributed to the existing principle of accountability, as seen above, due to the fact that the FPC is accountable to both the Chancellor and Parliament. This principle, of course, has pushed the FPC to take many steps to enable them to be sure of their concerns before raising them officially. Also, it is clear from that the UK regulators tried to consult the main participants in the housing sector and to involve them in decision-making on the macro-prudential policy, while the Saudi regulators did not do so. These efforts by the UK regulators were aimed at

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<sup>94</sup> The Bank of England Act 1998.

<sup>95</sup> Order 2015/909.

<sup>96</sup> HC Deb 23ed March 2015, vol 594, col 3.

<sup>97</sup> P Tucker, S Hall and A Pattani, 'Macroprudential policy at the Bank of England' (*papers.ssrn*, June 2013) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2327434](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2327434)> accessed 12th November 2016.

<sup>98</sup> Savills is a global real estate services provider listed on the London Stock Exchange. They have more than 700 offices and associates throughout the world, for more information about it visit their website: Savills, 'About Savills' (*savills.co.uk*) <<http://www.savills.co.uk/about-savills/>> accessed 12<sup>th</sup> November 2016.



discovering the main participants' opinions of the potential actions that might be taken by the FPC to protect the financial system.

In the Saudi context, we have not seen such a statutory basis established by SAMA and its new department; rather, SAMA has unlimited authority to do whatever it wants, on the excuse of protecting the country's financial system. There is no doubt about the good faith of the Saudi regulators in terms of protecting the Saudi economy and maintaining the financial system free from any risk that might pose a threat to the economy; however, good faith is not enough to build a good and well-structured housing finance market.

In fact, the absence of the principle of accountability might constitute a barrier hindering the development of the housing finance market in Saudi, as seen, for example, when SAMA capped the LTV at a low ratio and thus prevented many first homebuyers from getting housing finance, without undertaking some process to assess the risks emerging in the housing sector. In contrast to the FPC's experience in dealing with the macro-prudential policy, SAMA failed at the beginning to increase awareness of the effect of the macro-prudential policy, besides which it did not release any studies revealing its attitude towards this policy. Also, SAMA did not consult the main participants in the housing sector to enable them to contribute to decision-making on this policy, which would have enriched the decision that was eventually made. All these steps were taken by the FPC, enriching the implementation of this policy and giving the market and its participants enough scope to prepare for the application of the policy later on.

The supervisory authorities in the UK deserve praise for adopting statutory procedures surrounding the macro-prudential policy, as well as for ensuring that the FPC has the tools at its disposal to deal with systemic risks emerging from the housing market, should they arise in the future. This implies that the supervisory authorities are willing to take any step that might seem important later on to mitigate the adverse impact of LTV implementation, as will be seen from Hong Kong's experience.

## **5.6 Hong Kong's experience in mitigating the impact of LTV and the creative method**

### **5.6.1 Overview**

Hong Kong's long experience with LTV rules is partly the outgrowth of its success in achieving the main goal of applying macro-prudential policy, which is to maintain

financial stability and in the meantime to guard the banking system against overexposure to the property market.<sup>99</sup> The policy environment of Hong Kong's financial system and its unique mortgage market are the main determinants of the way LTV works. The mortgage market in Hong Kong is considered one of the most developed markets in Asia.<sup>100</sup> That status is attributed to its mortgage loans, which constitute approximately 25-30% of bank loans, and to governmental policies introduced to maintain stability in the housing market.<sup>101</sup>

According to some studies, residential mortgages form a high proportion of the banking sector's lending to borrowers. For example, since 1991 residential mortgages have accounted for at least 20 percent, reaching a peak of 37% in September 2002.<sup>102</sup> On the other hand, property prices have witnessed a strong cyclical pattern in the last 30 years, which endanger financial stability, especially when the banking system is exposed to the property market.<sup>103</sup> Nevertheless, Hong Kong's experience in the housing market and its mitigation of systemic risks stemming from unstable property prices have provided strong evidence for the ability of Hong Kong to deal with these risks through LTV policy, taking into account that the financial authorities have further measures available to reduce the adverse impacts of the LTV policy, as will be shown later.

### **5.6.2 The mechanism for adopting the LTV policy**

The mechanism for adopting the LTV policy was distinctive due to the gradual process of imposing this tool. It began with setting up guidelines for LTV and went on to adopt LTV as a long-term policy for the country. Finally, it shifted the policy from guidelines to compulsion, which means that all authorised financial firms are required to comply with the policy.

The gradual movement from the guidelines level to the imposition level gives us an indication that this policy enjoys the flexibility to give the financial authorities enough

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<sup>99</sup> D He, 'Hong Kong's approach to financial stability' (2013) 9 International Journal of Central Banking 299.

<sup>100</sup> K Chau, B MacGregor and G Schwann, 'Price discovery in the Hong Kong real estate market' (2001) 18 Journal of Property Research 187.

<sup>101</sup> H Zhu, 'The structure of housing finance markets and house prices in Asia' (2006) BIS Quarterly Review (*papers.ssrn*, December 2006) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1632353](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1632353)> accessed 5<sup>th</sup> November 2016.

<sup>102</sup> H Se, 'loan-to-Value as Macroprudential policy tool: experiences and lessons of Asian emerging countries' (2013) DsF policy paper 33.

<sup>103</sup> G Stefan and W Peng, 'Bank lending and property prices in Hong Kong' (2005) 29 Journal of Banking & Finance 461.

scope to tighten and loosen the LTV policy in line with economic fundamentals. Meanwhile, it shows that the financial authorities in Hong Kong did not surprise the market with unpredictable measures in relation to such a policy; rather, they introduced and gave indications of what prudential measures would be adopted by the government in future.

The most interesting feature of Hong Kong's experience in respect of the LTV policy was that it was set as an instrument to curb hot periods in the property market and to fight incredible rises in housing costs,<sup>104</sup> alongside maintaining financial stability.<sup>105</sup> The factor that distinguishes Hong Kong's experience from others is that the formulation of the LTV has taken two forms from 1997 up to the present. The supervisory authorities adopted two kinds of LTV, one to be imposed on so-called luxury properties, and the other to be imposed on normal properties. The definition of luxury properties was limited to properties coasting HK\$12 million or more, but this definition is subject to review from time to time, due to the changes in the cost of properties.<sup>106</sup>

There is a sense that Hong Kong's experience with preventive LTV policies could succeed in containing some of the risk of boom-bust cycles.<sup>107</sup> The questionable aspect of Hong Kong's experience which needs some light shed on it is: how did Hong Kong manage to mitigate the drawbacks of the LTV policy, such as liquidity constraint and exclusion of prospective first homebuyers from access to the financial market, without undermining the effectiveness of the LTV ratio as a policy tool? This point will be explained in detail in the following section.

### **5.6.3 Addressing the adverse impact of the LTV policy through the Mortgage Insurance Programme (MIP)**

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<sup>104</sup> C Crowe, 'How to deal with real estate booms: lessons from country experiences' (2013) 9 *Journal of Financial Stability* 300.

<sup>105</sup> Also, other jurisdictions, such as China and India, Korea and Singapore have adopted the LTV policy for the same purposes, namely, to combat an overheating housing market and to protect financial banking. See: Financial Stability Board, 'Thematic Review on Mortgage Underwriting and Origination Practices' (*fsb.org*, 17<sup>th</sup> March 2011) <[http://www.fsb.org/wp-content/uploads/r\\_110318a.pdf](http://www.fsb.org/wp-content/uploads/r_110318a.pdf)> accessed 15<sup>th</sup> November 2016.

<sup>106</sup> R Craig and C Hua, 'Determinants of Property Prices in Hong Kong SAR: Implications for Policy' (*imf.org*, November 2011) <<https://www.imf.org/external/pubs/ft/wp/2011/wp11277.pdf>> accessed 12<sup>th</sup> November 2016.

<sup>107</sup> M Funke and M Paetz, 'A DSGE-based assessment of nonlinear loan-to-value policies: Evidence from Hong Kong' (2012) 20.

The Mortgage Insurance Programme (MIP) was created by the supervisory authorities in Hong Kong to resolve and mitigate the liquidity constraint resulting from the LTV policy and to increase the rate of homeownership in the country, as the authorities stated.<sup>108</sup> The Hong Kong Mortgage Corporation (HKMC)<sup>109</sup> launched in 1999 a national programme (MIP) aiming to widen home ownership through facilitating access to the financial market to obtain mortgage loans. It was obvious that the LTV policy hindered many prospective homebuyers from getting housing finance loans, due to liquidity constraints resulting from the policy. Together with restricting credit growth, it was synchronised with sharply increasing house prices which made it more difficult for people to get mortgage loans. MIP programme, however, enables prospective homebuyers to gain loans at an LTV ratio of up to 90%, on condition of meeting many criteria set up by the HKMC and subject to adjustment and change from time to time.<sup>110</sup> The mechanism of MIP programme requires first that all authorised banks have to comply with the LTV policy issued by the Hong Kong Monetary Authority (HKMA).

Under this mechanism, banks can afford to offer housing finance above the LTV imposed by the HKMA without incurring any systemic risks, due to protection by MIP. For example, if the banks have to comply with the current LTV policy for Hong Kong on properties valued at HK\$7 million, the prospective homebuyer is required to make a down payment of 40% due to the LTV is 60%. However, with MIP he or she will be able to provide just 20% as down payment because the bank will provide 80% of the housing finance, 20% of the 80% being protected against borrower default through MIP managed by the HKMC.

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<sup>108</sup> For example, Hong Kong Mortgage Corporation Limited, which is owned by Hong Kong government For further information see: The Hong Kong Mortgage corporation Limited, 'Mortgage insurance program' ([www.hkmc.com.hk](http://www.hkmc.com.hk), July 2012) <[http://www.hkmc.com.hk/eng/our\\_business/mortgage\\_insurance\\_programme.html](http://www.hkmc.com.hk/eng/our_business/mortgage_insurance_programme.html)> accessed 12th November 2016.

<sup>109</sup> The Hong Kong Mortgage Corporation Limited (the Corporation), established in March 1997, is wholly owned by the Hong Kong Special Administrative Region Government through the Exchange Fund and its mission is: to promote: stability of the banking sector, wider home ownership, and development of the local debt market. For more information see: The Hong Kong Mortgage corporation Limited, 'Corporate governance' ([hkmc.com.hk](http://www.hkmc.com.hk), April 2011) <[http://www.hkmc.com.hk/eng/about/corporate\\_governance.html](http://www.hkmc.com.hk/eng/about/corporate_governance.html)> accessed 12<sup>th</sup> September 2016.

<sup>110</sup> Currently prospective applicants for this programme have to meet the criteria issued by the HKMIA, such as; all mortgagors not holding any residential properties in Hong Kong at the time of application; (ii) all applicants being regular salaried persons; and (iii) maximum debt-to-income ratio of 45%, etc. For more information about these criteria see; The Hong Kong Mortgage corporation Limited, 'Mortgage insurance program' ([www.hkmc.com.hk](http://www.hkmc.com.hk), July 2012) <[http://www.hkmc.com.hk/eng/our\\_business/mortgage\\_insurance\\_programme.html](http://www.hkmc.com.hk/eng/our_business/mortgage_insurance_programme.html)> accessed 12th November 2016.

Under MIP, the HKMC is the insurer while the bank is considered the insured party, with the housing finance borrower paying the insurance instalments.<sup>111</sup> Therefore, in the case of default, the banks which provided the housing finance will be compensated, not the borrower. Also, it must be noted here that “the banks have the full discretion to decide whether and to what extent the insurance premium will be passed on to the borrower.”<sup>112</sup> This mechanism achieves three goals in one action: helping the prospective homebuyer with the down payment, protecting the bank against default by the borrower, and finally helping the government with its plan to widen the rate of homeownership.

In order to disperse the credit exposure resulting from MIP, the latter is reinsured by private mortgage insurance companies, thus mitigating the risks that might result from the MIP mechanism.<sup>113</sup>

It might be argued that such a mechanism mitigates the effectiveness of LTV and results in unpredictable systemic risks, due to overextended credit growth, that are assumed to be consequences of this mechanism. In actual fact, economic researches and studies carried out on this mechanism, to assess its impact on the mortgage default ratio and whether or not it would dampen the effectiveness of the LTV policy, have found no correlation between MIP and mortgage default, citing the insignificant effect of MIP on mortgage default behaviour in Hong Kong during the period between the middle of 1998 and the end of 2007.<sup>114</sup> Nevertheless, another study confirmed that HKMC should maintain its prudent criteria in considering MIP applications, because these criteria, along with the guidelines issued by KHMA to the banking industry to rein in residential mortgage default, will enhance the healthy development of the mortgage market.<sup>115</sup>

The concern surrounding the role of MIP in reducing the effectiveness of the LTV policy was officially dissipated when HKMC confirmed, empirically, that “MIP’s portfolio enjoys a lower delinquency ratio than Hong Kong’s banking sector, indication that, thanks to prudent underwriting criteria, the MIP has not undermined the LTV policy but has

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<sup>111</sup> The Hong Kong institute of banks, *Banking Lending*, (John Wiley and Sons 2012)13.

<sup>112</sup> The Hong Kong institute of banks, *Banking Lending*, (John Wiley and Sons 2012)13.

<sup>113</sup> L Chiquier, O Hassler and M Lea, ‘Mortgage securities in emerging markets’ (*papers.ssrn*, 5<sup>th</sup> August 2004) < [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=625247](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625247) > accessed 20<sup>th</sup> November 2016.

<sup>114</sup> W Tam, H Eddie and Z Xian, ‘Residential mortgage default behaviour in Hong Kong’ (2010) 25 *Housing Studies* 647.

<sup>115</sup> W Tam, H Eddie and Z Xian, ‘Residential mortgage default behaviour in Hong Kong’ (2010) 25 *Housing Studies* 647.

actually improved the stability of Hong Kong's banking system".<sup>116</sup> The same study, however, has taken its view further, stating that the mechanism of MIP, rather than reducing the effectiveness of the LTV policy, as was believed, is actually enhancing the net benefits of the LTV policy and improving the stability of financial banking.<sup>117</sup> Moreover, other research economics showed that Hong Kong's experience confirmed the effectiveness of MIP in mitigating the adverse impact of the LTV policy.<sup>118</sup>

From 1999 to 2007 the loan amount approved under MIP increased from 3.23 per cent in 1999 to 13.23 in 2007, which reflects the huge demand for this mechanism. Particularly from people who could not afford a high down payment and whom this mechanism offered an alternative solution by reducing the amount of down payment without incurring additional risk for the bank.<sup>119</sup> Also, the increase in the ratio of MIP usage can be attributed to the low rate of rejection of applications for MIP.<sup>120</sup>

It is clear that the success of the MIP mechanism can be attributed both to the innovation itself which provides additional flexibility for lenders and borrowers, and to prudent underwriting criteria which determine the dimensions of mortgage loans and property values. The former has been periodically changed and adjusted many times to reflect changes in the property market,<sup>121</sup> to enable the HKMA to assess the systemic risks that might threaten banking stability. This indicates that the HKMA has access to the real estate market and property values, which helps them to make good decisions about either the LTV ratio or the eligibility criteria for MIP, because good decisions rely on accurate information.

As mentioned earlier, despite there being no statistical evidence of the relationship between the mortgage default rate and the MIP mechanism, many studies have asserted the importance of maintaining the HKMC's prudent criteria in guidelines to the banking

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<sup>116</sup> O Hwa Se, 'Loan to Value as macro-prudential policy tool: Experiences and lessons of Asian Emerging countries' (*dsf.nl*, January 2013) <<http://www.dsf.nl/wp-content/uploads/2014/10/DSF-Policy-Paper-No-33-Loan-to-Value-as-Macro-Prudential-Policy-Tool.pdf>> accessed 12<sup>th</sup> November 2016.

<sup>117</sup> O Hwa Se, 'Loan to Value as macro-prudential policy tool: Experiences and lessons of Asian Emerging countries' (*dsf.nl*, January 2013) <<http://www.dsf.nl/wp-content/uploads/2014/10/DSF-Policy-Paper-No-33-Loan-to-Value-as-Macro-Prudential-Policy-Tool.pdf>> accessed 12<sup>th</sup> November 2016.

<sup>118</sup> Hong Kong institute for monetary research, 'Effusiveness of loan-to-value ratio policy and its transmission mechanism-empirical evidence from Hong Kong' (*hkimr.org*, October 2015) <[http://www.hkimr.org/uploads/publication/426/wp-no-20\\_2015-final-.pdf](http://www.hkimr.org/uploads/publication/426/wp-no-20_2015-final-.pdf)> accessed 12<sup>th</sup> November 2016.

<sup>119</sup> W Tam, H Eddie and Z Xian, 'Residential mortgage default behaviour in Hong Kong' (2010) 25 *Housing Studies* 647.

<sup>120</sup> W Tam, H Eddie and Z Xian, 'Residential mortgage default behaviour in Hong Kong' (2010) 25 *Housing Studies* 647.

<sup>121</sup> The Hong Kong institute of banks, *Banking Lending*, (John Wiley and Sons 2012)13.

industry because of the role that they play in reducing the rate of mortgage default.<sup>122</sup> This might explain the integrity of the success of the MIP mechanism: it can be attributed to good co-operation between the HKMA, which issues the LTV policy guidelines, and the HKMC, which designs the eligibility criteria, together achieving an optimal result in practice. However, it is questionable whether good co-operation between two entities can be easily achieved, or whether a specific environment needs to exist in order to gain that result.

In fact, the good co-operation between HKMA and HKMC may be explained by their both falling under the regime of the government in Hong Kong. Despite the HKMC being considered a corporation, it is wholly owned by the Hong Kong Special Administrative Region Government through the Exchange Fund.<sup>123</sup> This governmental structure might explain the strong correlation between HKMA and HKMC in relation to the issuance of prudential regulations which achieve the main goals of both the LTV policy and the MIP mechanism, without incurring further risks that threaten banking stability.

## 5.7 Conclusion

The chapter has sought to develop the regulatory framework for regulating the housing finance market in general, and for adoption of the LTV in particular. Also, the chapter has sought to draw from the experience of two developed jurisdictions, the UK and Hong Kong in dealing with the macro-prudential policy, of which the LTV is one element.

The analytical study of the formulation and application of article (12) of the RREFL confirms that there are three consequences: the mismatch between the main aims of enacting the housing finance laws 2012 and their implementation in connection with the LTV, the lack of cooperation between the competent Saudi authorities in the housing finance market; and the absence of an alternative solution with which to address the possible adverse impacts of the LTV. These consequences in turn suggest the existence of a defect in the regulatory framework for the regulating the housing finance market. This defect was confirmed when the chapter shed light on the process of adopting the macro-prudential policy, including the LTV, in the UK and Hong Kong.

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<sup>122</sup> W Tam, H Eddie and Z Xian, 'Residential mortgage default behaviour in Hong Kong' (2010) 25 *Housing Studies* 647.

<sup>123</sup>The Hong Kong Mortgage corporation Limited, 'Corporate governance' (*hkmc.com.hk*, April 2011) <[http://www.hkmc.com.hk/eng/about/corporate\\_governance.html](http://www.hkmc.com.hk/eng/about/corporate_governance.html)> accessed 12<sup>th</sup> November 2016.

For all above considerations, five lessons can be learned from the analytical study and the experiences of the UK and Hong Kong:

1- There is no doubt that capping the LTV at 70% is a really massive challenge for first homebuyers in Saudi Arabia, a country that suffers from a low rate of homeownership with no alternative rational solution proposed by either official authorities or the private sector to facilitate for people the access to the financial market without incurring additional obligations. In fact, the situation in Saudi became more difficult with the sharp fall in oil prices, the budget's main resource, an event which will definitely impact on individuals' incomes since the government's launch, at the beginning of 2015, of austerity measures including some job cuts, abolition of bonuses and reduction in salaries:<sup>124</sup> measures that made it more difficult for individuals to save a 30% deposit. It could be argued that the austerity policy might cause house prices to fall, making homes more affordable. This argument might be true to some extent, but it is difficult to compare the impact of the austerity policy on Saudi family incomes with the effect on house prices, because the latter is potential while the former is certain. The situation of Saudi families became much worse, unfortunately, when as recently as October 2016 the Saudi government adopted additional harsh austerity policies, including but not limited to a reduction in salaries, in some cases by more than 50%, which of course will reflect negatively on the Saudi family's ability to save 30% as a deposit on the purchase of a house.

2- The UK's experience in respect of the legal procedures and gathering of information before making a decision about the LTV shows a clear divergence between Saudi and the UK. However, certain common threads exist between the UK and Hong Kong which sharply distinguish them from Saudi, such as the good cooperation between the competent authorities in housing finance market.

Both countries; the UK and Hong Kong, clearly demonstrate good cooperation between the financial authorities, that are in charge of adopting such a policy, and the government, whether the cooperation is shown by the government's willingness to participate in decision-making while enabling the financial authorities to apply the policy in question,

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<sup>124</sup> S Kerr, 'S Spickernell, 'Saudi Arabia begins quest for austerity as its economy sinks in plunging oil prices' (*cityam.com*, 25 August 2015) < <http://www.cityam.com/223040/saudi-arabia-seeks-austerity-advice-amid-plunging-oil-prices>> accessed 12<sup>th</sup> January 2016 & S Kerr, 'Saudi Arabia cuts public sector bonuses in oil slump fallout' *The Financial Times*(London, 27<sup>th</sup> September 2016) < <https://www.ft.com/content/765898e0-8482-11e6-8897-2359a58ac7a5>> accessed 12<sup>th</sup> November 2016.



including the mechanisms that they created to help people with housing finance, as seen in the UK, or by joint effort to resolve the adverse impact of the LTV, as seen in Hong Kong. Such cooperation does not exist in Saudi, where SAMA seems to work apart from other government agencies, regardless of the cost impact of its decisions. This issue can be addressed by the suggested committee.<sup>125</sup>

3- There remains the really vexed issue of how to develop the housing finance market while SAMA enjoys total independence and immunity for all its decisions, for example regarding the macro-prudential policy. Therefore, good cooperation between the government and SAMA with regard to the housing sector is required to achieve favourable results for all parties. It is recognised as obvious that, even if SAMA is independent as a matter of law, it is necessary to couple that independence with accountability. To do that, it was suggested that an independent committee, emulating the FPC's composition, be established to exercise the function of applying the macro-prudential policy, and that the committee be made accountable to the Economics and Development Affairs Council (EDAC).

4- The nature of macro-prudential policy, and in particular the LTV tool, subjects such tools to change and adjustment based on political and economic circumstances which require the financial authority to review the LTV ratio and adjust it regularly. By contrast, legislation by nature is designed to be as permanent as possible because frequent amendments and changes to the legal role would mitigate the nature on legislation. Accordingly, it is suggested that the provision of article (12) be removed, while all the provisions of RREFL for regulating the provisions associated with real estate finance, including its participants and activities, etc., be retained. With regard to the macro-prudential policy including the LTV ratio, it is suggested that guidelines be enacted as issued by the proposed committee, which will be able, according to statutory powers to be granted to it, to review and adjust the LTV ratio when it is deemed necessary.

5- Regarding the adverse impact low ratio of the LTV, it could be resolved by emulating Hong Kong's experiences in mitigating the LTV's adverse impact and applying the MIP mechanism in Saudi, as long as both jurisdictions enjoy a number of common features in terms of monetary policies and the real estate market, as mentioned at the beginning of this chapter. These similar circumstances in the two jurisdictions might pave the way for an attempt to transfer the MIP from Hong Kong to Saudi. As was seen above, the provider

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<sup>125</sup> See section 5.4.1.

of this programme is a company wholly owned by the government, while being based on the criteria eligibility issued by HKMC, and that arrangement could be applied in Saudi as long as there are no potential legal obstacles to such an attempt.

## **Chapter Six: The development of housing finance and securitisation; is there a need to reform the housing finance laws?**

### **6.1 Introduction**

This chapter aims to determine whether or not Saudi needs to launch a securitisation market, which has been broadly defined as “the transformation of an illiquid asset ... into tradable securities with a secondary market”,<sup>1</sup> in order to develop the housing finance market in the light of current economic and political circumstances. The chapter will then ask what legal changes are needed to launch a securitisation market in the country. This question can be explored through determination of three legal defects which require further examination and discussion: the failure of article (17) of the Real Estate Finance Law 2012 to establish a legal basis for securitisation, inasmuch as an entity that should perform the function of securitisation is prevented from carrying out an important process within it, namely issuing bonds; uncertainty surrounding specification within the Saudi legal system of property rights in the event of a borrower’s default; and finally the failure of the housing finance laws 2012 to identify transparency as an important criterion in securitisation. Then the chapter will offer legal recommendations for addressing the named defects.

To do this the chapter is divided into the following sections: (6.1) is the introduction to the chapter; section two (6.2) will discuss the nature of securitisation, its function and advantages; section three (6.3) analyses the securitisation’s role and causes in the global financial crisis 2007-2008 and why securitisation acquired a bad name as a result of the crisis; section four (6.4) will examine the importance of establishing a securitisation market in Saudi; section five (6.5) will examine the failure of article (17) of the Real Estate Finance Law 2012 to establish a legal basis for securitisation, since within it an entity that should perform the function of securitisation is prevented from carrying out an important process within securitisation, namely issuing bonds. However, to do this the section needs to examine the main participants in the securitisation process, their roles, and then the reasons why article (17) is considered a barrier to the exercise of securitisation in Saudi. Section six (6.6) will discuss the Saudi legal system and the

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<sup>1</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007)1.

uncertainty surrounding specification of property rights in the event of the borrower's default in the securitisation process. Section seven (6.7) will attempt to answer the question: why did the housing finance laws 2012 fail to deal with the issue of transparency in securitisation and what should they do to remedy that failure? And finally, section eight (6.8) presents the conclusion of this chapter

## **6.2 The nature of securitisation, its function and advantages**

Since the well-developed primary residential housing finance market increases homeownership and in turn contributes to both economic and political stability, the securitisation market plays a crucial role in helping the primary market to achieve those goals. The securitisation market serves the primary market in its function by separating the housing finance investment and origination functions.<sup>2</sup> Such a separation will achieve aims such as increasing the number of investors, providing liquidity, etc.<sup>3</sup>

Although security and return on the funds to be invested are very important components for the investors, the need for liquidity in the investors' portfolio is also pressing. The main features of the housing finance market do not provide the feature of liquidity for investors.<sup>4</sup> This contrasts with the provisions available for competing investments such as corporate securities, related either to equity or debt, which are supported and enhanced by a well-developed securitisation market. Also, purchasers of securities in securitisation market know that their investment can be instantaneously converted into money when they wish, taking into account the possibility of loss or gain according to the situation of the market.<sup>5</sup> This feature of corporate securities makes such markets attractive for investors, whether small, medium or even large, who are looking for security and liquidity alike.

Given to the lack of liquidity in the housing finance market, which makes investors avoid such investment, it was suggested that the housing finance market be developed and its

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<sup>2</sup> P Calem, M Courchane and S Wachter, 'Sustainable homeownership' (*papers.ssrn.com*, 19 March 2009) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1365436](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1365436)> accessed 12<sup>th</sup> November 2016.

<sup>3</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007)2.

<sup>4</sup> D Reiss, 'Subprime standardization: How rating agencies allow predatory lending to flourish in the secondary mortgage market' (2006) 33 Florida State University Law Review 986.

<sup>5</sup> B Richard, 'Fannie Mea and the secondary mortgage market' (1971) 66 Northwestern University Law review 1.

position improved through creation of an effective securitisation market which would enhance the ability of the market to cater to the desire of investors to gain liquidity at any time. Such development and improvement depend on finding a way to enable converting housing finance (mortgage) into units that can be traded to satisfy the investors' wish for both liquidity and security.<sup>6</sup>

It might be noted from the above explanation that the essence of securitisation is mainly premised on conversion of home mortgage into liquidity. The mechanism of conversion occurs in the secondary mortgage market, which is defined<sup>7</sup> as the 'ability of mortgage investors, in an organised fashion either to dispose of mortgage in their portfolios through sale or to convert such mortgages into securities acceptable to other segments of the investing public, directly or indirectly',<sup>8</sup> in many stages and involves many participants, as will be shown later, in contrast to the primary mortgage market whose transactions take place between borrowers and lenders.<sup>9</sup>

The creation of a securitisation has a significant impact on housing finance transactions through the advantages provided to the main participants in the securitisation: lenders, borrowers, investors and even the government.<sup>10</sup> For example, the securitisation market grants banks an advantage that does not exist in the primary housing finance market, where lenders have the ability to originate loans but then sell them to more appropriate long-term investors.<sup>11</sup> The former advantage entails another, which is the lenders' ability to remove loans from their balance sheet<sup>12</sup> to lower the capital requirement introduced by

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<sup>6</sup> O Jones and L Grebler, *The secondary mortgage market: its purpose, performance, and potential* (Real Estate Research Program Graduate School of Business Administration Division of Research University of California 1961) 35.

<sup>7</sup> Although there is no consensus on the definition of a secondary mortgage market, writers hover over the essence of the term, as mentioned above. Given that the discussion of this topic is beyond the scope of this chapter, it might be useful to have a look at the following references for further discussion: G Beyer, *Housing and Society* (Macmillan 1972) 39 & L Kimmel, 'Money and credit their influence on jobs, prices and growth' (1962) 339 *The Annals of the American Academy of Political and Social Science* 229.

<sup>8</sup> B Richard, 'Fannie Mea and the secondary mortgage market' (1971) 66 *Northwestern University Law review* 8.

<sup>9</sup> L Grebler, 'Introduction to Housing Issues in Economic Stabilization Policy' (1960) *Housing Issues in Economic Stabilization Policy* 1, for more discussion above point see: W Dennis and T Pinkowish, *Residential mortgage lending: Principles and practices* (Thomson/South-Western, 2004) 35.

<sup>10</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007) 2.

<sup>11</sup> D Reiss, 'Subprime standardization: How rating agencies allow predatory lending to flourish in the secondary mortgage market' (2006) 33 *Florida State University Law Review* 986.

<sup>12</sup> E Lee, 'Basel III: Post-financial crisis international financial regulatory reform' (2013) 28 *Journal of international banking law and regulation* 433.

the Basel Committee and to expand room for more loan activities and lending.<sup>13</sup> In addition, securitisation provides liquidity for lenders, which makes the mortgages much less risky since the liquidity lowers the risk surrounding the potential for borrower's default.<sup>14</sup> Issuing new loans due to the liquidity resulting from a securitisation is likely to increase income from loan origination fees through making new loans.<sup>15</sup> With respect to the risk, the securitisation provides another advantage for the lenders as originators, by reducing the lenders' risk in holding the loans, even long after they were originated.<sup>16</sup>

The securitisation also extends its advantages to borrowers, since the lower risk resulting from the flow of liquidity into the primary market, which would otherwise be excluded from that market, means that lenders can charge a lower margin on loans that they issue. This is certain to reflect positively on borrowers and in turn increase the affordability of homeownership due to the reduction in the cost of borrowing.<sup>17</sup> Moreover, the funds resulting from securitisation are likely to enhance and at the same time facilitate access to the housing finance market due to the amount of liquidity that would cater to some extent to the huge demand for housing finance loans.<sup>18</sup>

The most surprising finding in terms of the benefits provided by securitisation market is, as mentioned by some studies, its contribution to society at large, in that by increasing access to capital it increases opportunities for homeownership, which in turn tends to enhance political stability.<sup>19</sup> Separation of the mortgage origination and investment functions may allow for greater stability in the banking system due to the opportunity provided by securitisation for the originators of a mortgage to dispose of it and gain liquidity instead, reducing the risk associated with potential borrower default.<sup>20</sup>

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<sup>13</sup> For the latest capital requirements introduced by Basel III see: A Blundell-Wignall and P Atkinson, 'Thinking beyond Basel III' (2010) 33 OECD Journal: Financial Market Trends 9.

<sup>14</sup> M Aalbers, 'The financialization of home and the mortgage market crisis' (2008) 12 competition & change 148.

<sup>15</sup> R Malloy, 'The secondary mortgage market – A Catalyst for change in real estate transactions' (1986) 39 Southwestern Law Journal 991.

<sup>16</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007) 3.

<sup>17</sup> J Rosenthal and O Juan, *Securitization of credit: Inside the new technology of finance* (John Wiley & Sons 1988) 44.

<sup>18</sup> D Reiss, 'Subprime standardization: How rating agencies allow predatory lending to flourish in the secondary mortgage market' (2006) 33 Florida State University Law Review 986.

<sup>19</sup> For further discussion of other grounds for a securitisation market and its benefits, see generally: D Seider, 'The Future of Secondary Mortgage Markets: Economic Forces and Federal Policies' (1984) 3 Housing Finance Review 319.

<sup>20</sup> For further discussion of other grounds for a securitisation market and its benefits, see generally, Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007) 5

### 6.3 Analysing Securitisation's role in the causes of the global financial crisis 2007-2008

Securitisation sometime involves a very risky institution called sub-prime lending, or sometimes sub-prime mortgages, which came into existence in the early 1980s in the US. This risky institution, sub-prime lending, serves borrowers who would not meet the criteria for getting housing finance, or in other words who have poor credit histories; by enabling borrowers to get the housing finance they require but that they would not obtain under normal lending conditions.<sup>21</sup> Usually, borrowers with poor credit histories are able to get housing finance loans through the mechanism of sub-prime lending at a higher interest rate, to offset the lenders' exposure to the risk of borrower default.<sup>22</sup>

From the mid-1990s, sub-prime lending flourished and became an important fiscal innovation, enabling the US government to expand the homeownership rate while providing an alternative financial solution for lenders seeking to expand their operations.<sup>23</sup> To understand the expansion in sub-prime lending in the US it might be useful to glance at its growth during the 1990s and up to 2006. For instance, in 1997, it was expected that approximately 5% of all mortgages originated were sub-prime, a percentage that increased to 20% in 2005. Also, the total dollar amount of the sub-prime mortgage loans originated in 2001 was \$57 billion, increasing in 2006 to \$375 billion,<sup>24</sup> while estimates suggest that the value of sub-prime lending was over \$600 billion in 2006.<sup>25</sup>

The most significant government contributed to the success of this fiscal innovation, the most noticeable element playing a crucial role in this field is the pair of government-

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& D Seider, 'The Future of Secondary Mortgage Markets: Economic Forces and Federal Policies' (1984) 3 Housing Finance Review 319.

<sup>21</sup> M Jackson and M Shelly, 'Sub-prime lending, its deficiencies and the Government responses' (2008)10 Journal of International Banking Law and Regulation 523.

<sup>22</sup> A Cutts and R Van Order, 'On the economics of subprime lending' (2005) 30 The Journal of Real Estate Finance and Economics 167.

<sup>23</sup> For more information about the role played by securitisation during the period 1990s until 2006 in expanding the homeownership rate and helping the lenders to expand their operations, see: D Awrey, 'Complexity, innovation and the regulation of modern financial markets' (*papers.ssrn*, 2011) <[https://papers.ssrn.com/sol3/Papers.cfm?abstract\\_id=1916649](https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=1916649)> accessed 25<sup>th</sup> November 2016; H Reden, 'Regulation of Securitised Products post the Financial Crisis' (2013) 2 UCLJLJ 112 & B Bavoso, 'Financial innovation and structured finance: the case of securitisation' (2013) 34 Company Lawyer 3.

<sup>24</sup> Y Demyanyk and O Hemert, 'Understanding the subprime mortgage crisis' (2011) 24 Review of financial Studies 1848.

<sup>25</sup> The Australian Law Reform Commission, *Review of Privacy – Credit Reporting* (Law Com No32, 2006).

sponsored housing enterprises, Fannie Mae and Freddie Mac, which are the giants of the home mortgage industry and were the first and are still by far the biggest purchasers of mortgages on the securitisation market in the US.<sup>26</sup> Established by Congress in 1938 and 1970 respectively to develop the housing finance market, their mission was to increase opportunities for homeownership by means of enhanced market liquidity.<sup>27</sup> They operate in two distinct lines of business, mortgage-backed securitisation, which will be defined later, and retained mortgage portfolios. Fannie Mae and Freddie Mac purchase and transform sets of whole mortgage loans into mortgage-backed securities (MBS) which are then sold to capital market investors (Fannie Mae and Freddie Mac investors-held MBS).<sup>28</sup> At the same time Fannie Mae and Freddie Mac guarantee these MBS against the risk of default, in return for which they obtain an annual guarantee fee. In 2007 both entities owned or guaranteed about 40% of outstanding home mortgage debt in the United States.<sup>29</sup>

The above figures and information give us an indication of the role played by securitisation, especially sub-prime lending, in increasing access to the housing finance system to obtain housing finance, which in turn promoted homeownership. However, the increase in house prices as a consequence of the excessive lending caused by the expansion of originated sub-prime mortgages helped to build up the bubble in the housing market. Rising house prices, in turn, enhanced the appetite of lenders to lend to more people with poor credit histories in the expectation that if those borrowers defaulted, the lenders could offset their losses by selling houses without incurring any actual loss.<sup>30</sup> However, this expectation was not accurate because huge numbers of sub-prime borrowers failed to fulfil their financial obligations, the reason for which will be explained later. Consequently, investors resorted to selling houses to satisfy the debt, but the issue

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<sup>26</sup> A Boyack, 'Laudable Goals and Unintended Consequences: The Role and Control of Fannie Mae and Freddie Mac' (2010) 60 Am. UL Rev 1489.

<sup>27</sup> R Malloy, 'The secondary mortgage market – A Catalyst for change in real estate transactions' (1986) 39 Southwestern Law Journal 991.

<sup>28</sup> D Jaffee, 'The interest rate risk of Fannie Mae and Freddie Mac' (2003) 24 Journal of Financial Services Research 5.

<sup>29</sup> J Forrester, 'Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners' (2007) 72 Mo. L. Rev 1077.

<sup>30</sup> A Orkun, 'Securitisation, the Financial Crisis and the Need for Effective Risk Retention' (2013) 14 European Business Organization Law Review 1.



here was that the housing bubble burst when house prices were exposed to collapse, so that lenders faced the loss of their credit and loans.<sup>31</sup>

A number of researches and reports pointed to the role played by securitisation in the run-up to the global financial crisis 2007.<sup>32</sup> It could be argued that securitisation acquired a bad name as a result of the financial crisis in 2007/2008, due to three main factors: weak underwriting standards in the securitisation of sub-prime mortgages; the technical sophistication and complexity of securitisation, which led to misunderstanding of the risk inherent in this fiscal innovation; and finally, the complaint that Credit rating agencies (CRAs) are financially incentivised to give a particular securities issue a good ranking because they are paid by the issuer of the securities.

The first reason, the deterioration in underwriting standards, was observed following the adoption of several processes related to monetary policies in order to withstand the 2001 recession caused by the destruction of the World Trade Centre in New York on September 11, 2001.<sup>33</sup> For example, in the wake of the destruction of the World Trade Centre, stock market turmoil around the whole world motivated the US Federal Reserve and its counterparts to inject billions of American dollars into the banking system to facilitate lending and reassure the markets.<sup>34</sup> At the same time the US Federal Reserve reduced interest rates in order to enhance economic growth. With ample liquidity and low interest rates reaching 1% in 2003, the environment was conducive to increased operations and expanded activities by lenders. These circumstances, helped potential borrowers with poor credit histories to finally have a chance to obtain a mortgage through sub-prime securitisation techniques. These encouraging conditions for lending and borrowing led both lenders and borrowers to take riskier decisions, helped by the deterioration in underwriting standards for sub-prime mortgages. While the borrowers gained credit at high interest rates to offset their poor credit histories, it was recorded that mortgage brokers, who originated sub-prime mortgages, provided mortgage loans by the sub-prime

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<sup>31</sup> In May 2007, it was reported that 7.5 million sub-prime mortgages were outstanding in the US, accounting for nearly 14% of all first mortgages. M Jackson and M Shelly, 'Sub-prime lending, its deficiencies and the Government responses' (2008)10 *Journal of International Banking Law and Regulation* 523.

<sup>32</sup> For example, see; V Bavoso, 'Financial innovation and structured finance: the case of securitisation'(2013) 34 *Company Lawyer* 3 & H Reden, 'Regulation of securitised products post the financial crisis' (2013) 2 *UCL journal of Law and Jurisprudence* 112.

<sup>33</sup> M Jackson and M Shelly, 'Sub-prime lending, its deficiencies and the Government responses' (2008)10 *Journal of International Banking Law and Regulation* 523.

<sup>34</sup> A Orkun, 'Securitisation, the Financial Crisis and the Need for Effective Risk Retention'(2013)14 *European Business Organization Law Review* 1.

mortgage mechanism without requiring adequate documentation of the income and assets available to service the mortgages.<sup>35</sup>

In fact, the above practice of mortgage brokers represents a form of the weakened underwriting standards which might be considered among the many factors contributing to the global financial crisis 2007 during the run-up to it. The only explanation for mortgage brokers incurring the underlying risks involved in these actions is the belief that those risks could be disposed of by selling those sub-prime mortgages to Fannie Mae and Freddie Mac which were pushed, at that time, by Congress and the Bush Administration to accumulate sub-prime mortgages and so increase the homeownership rate.<sup>36</sup> In turn, when the giant intermediaries Fannie Mae and Freddie Mac bought these subprime mortgages, they securitised them and sold some in the securitisation market while holding others in their own portfolios.<sup>37</sup>

Although the above practice weakened underwriting standards by granting potential borrowers the chance to obtain a mortgage despite poor credit histories, it also exposed them to another issue which is a predatory lending. Predatory lending can be described as providing a loan to a borrower with no capacity to repay it,<sup>38</sup> a course of action that has played a significant role in generating the global crisis 2007.

The predatory lending represents in the imposition of high fees on sub-prime mortgages which sometimes in conjunction with repeated refinancing of a loan within a short period of time have led to increased risk of foreclosure.<sup>39</sup> The prime borrowers, sometimes, may not have had the capacity to assess clearly the risk involved in the sub-prime mortgage which exposes them to predatory lending. That risk resides in the fact that interest rates in some kinds of sub-prime mortgages can increase substantially after an initial period of between one month and two years from the start of the agreement, without the borrowers recognising the threat. This substantial increase in interest rates, of course, affects sub-

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<sup>35</sup> W Poole, 'Causes and consequences of the financial crisis of 2007-2009' (2010) 33 Harv.J.L.&Pub 421.

<sup>36</sup> M Barr, 'Access to Financial Services in the 21st Century: Five Opportunities for the Bush Administration and the 107th Congress' (2002) 16 Notre Dame JL Ethics & Pub. Pol'y 447.

<sup>37</sup> For more information about the historic background of the giant intermediaries Fannie Mae and Freddie Mac and their role the development of the housing finance market in the US :R Malloy, 'The secondary mortgage market – A Catalyst for change in real estate transactions' (1986) 39 Southwestern Law Journal 991.

<sup>38</sup> G Elliehausen and M Staten, 'Regulation of subprime mortgage products: An analysis of North Carolina's predatory lending law' (2004) 29The Journal of Real Estate Finance and Economics 411.

<sup>39</sup> G Ho and A Pennington-Cross, 'The impact of local predatory lending laws on the flow of subprime credit' (2006) 60 Journal of Urban Economics 210.

prime borrowers' creditworthiness as the monthly instalments will increase, leaving them unable to fulfil these new financial obligations.<sup>40</sup>

The legislators, however, have recognised this issue and attempted to curb predatory lending through the federal Home Ownership and Equity protection Act (HOEA) which classified the mortgage loan with high interest rates and fees as potentially a form of predatory lending. Although the HOEA has incorporated consumer protection provisions, including but not limited to disclosure requirements of the mortgage contracts, the sub-prime mortgage borrowers are still exposed to predatory lending.<sup>41</sup>

The second source of securitisation's bad name is its complexity and sophistication. The rationale for weakened underwriting standards, despite the risks involved, was that this kind of investment was attractive for lenders due to the high yield it offered, while the underlying risks were transferred to investors who were also looking for high yields. Unfortunately, investors based their decision to buy such securitisations on the triple-A ratings which were granted by the Credit rating Agencies CRAs. The CRAs' primary function is to assess the creditworthiness of a company and its debt obligations through issuing credit ratings in order to help investors judge the credit risks before investing in the markets,<sup>42</sup> at face value of these securitisations regardless of the risks they entailed.

The financial crisis 2007 has confirmed that investors failed to appreciate risks and acted irrationally when they invested in securitisations which met their criteria for investment and their appetite for ever-higher yields.<sup>43</sup> The crisis also confirmed that investors over-relied on credit rating agencies which provided triple-A ratings for all securitisation products even those belonging to sub-prime borrowers.<sup>44</sup> The irrationality of investors' actions was criticised by the G20s' declaration at the Summit of the financial markets and

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<sup>40</sup> G Dell'Araccia, D Igan and L Laeven, 'Credit booms and lending standards: Evidence from the subprime mortgage market' (2012) 44 *Journal of Money, Credit and Banking* 367.

<sup>41</sup> For further information about HOEA, its function and its provisions in dealing with the predatory lending see: L Keyfetz, 'The Home Ownership and Equity Protection Act of 1994: Extending Liability for Predatory Subprime Loans to Secondary Mortgage Market Participants' (2005) 18 *Loy. Consumer L. Rev* 151.

<sup>42</sup> A Pinto, 'Control and responsibility of credit rating agencies in the United States' (2006) 54 *The American Journal of Comparative Law* 341.

<sup>43</sup> A Orkun, 'Securitisation, the Financial Crisis and the Need for Effective Risk Retention' (2013) 14 *European Business Organization Law Review* 1.

<sup>44</sup> The role played by Credit rating agencies in run-up the global financial crisis is controversial, this chapter will address some aspects of their role in the crisis, however, for more information about their role in the crisis see; H Tom, 'The role of credit rating agencies in the current worldwide financial crisis' (2009) 30 *The Company Lawyer* 61; M Mullard, 'The credit rating agencies and their contribution to the financial crisis' (2012) 83 *The Political Quarterly* 77 & J Lower and A Resiberg, *Pettet's company finance* (Fourth ed, Pearson educational limited 2012) 395.

the world economy: ‘during a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yield without an adequate appreciation of the risks and failed to exercise proper due diligence ... weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system’.<sup>45</sup>

The third reason why securitisation has a bad name lies in the CRAs’ role in the economic meltdown of 2007. Although there are nearly 150 local and international credit rating agencies worldwide, the largest CRAs, which are dominant in this industry, are Moody’s, Standard & Poor’s, and Fitch.<sup>46</sup> These giant agencies’ wide experience and professionalism qualified them as the most powerful players in many business transactions, leading to complaints about the CRAs’ unlimited power in the markets.<sup>47</sup> For instance, the New York Times columnist Thomas L. Friedman described in 1996 the power enjoyed by one of the three giant agencies in these words: “There are two superpowers in the world today in my opinion. There’s the United States and there’s Moody’s bond rating service. The United States can destroy you by dropping bombs, and Moody’s can destroy you by downgrading your bonds. And believe me, it’s not clear sometimes who’s more powerful.”<sup>48</sup> This remark might epitomise the major complaints about the superpower status enjoyed by the CRAs, and it became clear at the time that there were grave fears about the effectiveness of the principle of accountability in relation to these entities which seemed set to dominate the financial world.

The business of CRAs is “the issuance of credit ratings for the purposes of evaluating the credit risk of issuers of debt and debt-like securities”.<sup>49</sup> In other words, the CRAs’ primary function is to assess the creditworthiness of a company and its debt obligations through issuing credit ratings in order to help investors judge the credit risks before investing in

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<sup>45</sup> Financial stability board, ‘Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience’ (fsb.org, 2008) <[http://www.fsb.org/wp-content/uploads/r\\_0804.pdf?page\\_moved=1](http://www.fsb.org/wp-content/uploads/r_0804.pdf?page_moved=1)> accessed 25<sup>th</sup> November 2016.

<sup>46</sup> L White, ‘Markets: The credit rating agencies’ (2010) 24 *The Journal of Economic Perspectives* 211.

<sup>47</sup> E Devine, ‘The collapse of an Empire-Rating Agency Reform in the Wake of the 2007 Financial Crisis’ (2011) 16 *Fordham J. Corp. & Fin. L* 177.

<sup>48</sup> Interview by Jim Lehrer with Thomas L. Friedman, *New York Times* Columnist, on *The News Hour*, PBS Television (Feb. 13, 1996).

<sup>49</sup> M Elkhoury, ‘Credit rating agencies and their potential impact on developing countries’ (2009) *UNCTD Compendium on Debt Sustainability* 165.

the markets.<sup>50</sup> Therefore, it could be argued that CRAs play a very important role in both financial and capital markets. Nevertheless, it might be argued that their role in financial markets is controversial and has raised some concerns regarding their complex relationship with the main players in the markets, namely issuers of corporate securities, investors, and banks. Therefore, the CRAs have been subjected to the criticisms before and after the financial crisis 2007, as will be shown below.

Prior to the economic meltdown in 2007, the CRAs were attacked in general criticisms incorporating the following points. First, imperfect competition has resulted from the size of the largest CRAs (Moody's, Standard & Poor's and Fitch) which enjoy the largest share, 95%, of the market, while other credit rating agencies share the rest.<sup>51</sup> The second criticism is the slow reaction of the CRAs in adjusting their ratings to changes in corporate creditworthiness. For instance, the giant energy corporation Enron's creditworthiness was confirmed by the CRAs on November 2001; then on December 2001 Enron was failed for bankruptcy.<sup>52</sup> Finally, it was argued that the mechanism of CRAs' function made it liable to the charge of lack of independence, due to their practice of selling ratings to firms that hire them to rate their creditworthiness.<sup>53</sup> This conflict of interest presents a big challenge, making CRAs vulnerable to criticism, as will be shown later.

After the global financial crisis 2007, however, the CRAs have faced censure based on the prevailing belief that they played a significant role in generating the crisis. In general, the criticisms can be placed in two categories:

1. **Conflict of interest:** it is evident from the nature of the CRAs' business that the mechanism of their function reveals a lack of independence and potential conflict of interest because they are paid by their clients to provide ratings of issuers of securities. This complex relationship between CRAs and their clients raises concerns that CRAs might be encouraged to issue a high rating in order to avoid displeasing the clients,

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<sup>50</sup> A Pinto, 'Control and responsibility of credit rating agencies in the United States' (2006) 54 *The American Journal of Comparative Law* 341.

<sup>51</sup> J Lower and A Resiberg, *Pettet's company law: company law & corporate finance* (Fourth ed, Pearson educational limited 2012) 424.

<sup>52</sup> The massive accounting and auditing scandals of Enron has put the CRAs under huge criticisms and has led many to question about their competence and the value of their ratings, for more information about Enron scandal and the role played by CRAs in it see; C Frost, 'Credit rating agencies in capital markets: A review of research evidence on selected criticisms of the agencies' (2007) 22 *Journal of Accounting, Auditing & Finance* 469.

<sup>53</sup> J Lower and A Resiberg, *Pettet's company law: company law & corporate finance* (Fourth ed, Pearson educational limited 2012) 424 & C Frost, 'Credit rating agencies in capital markets: A review of research evidence on selected criticisms of the agencies' (2007) 22 *Journal of Accounting, Auditing & Finance* 469.

who pay for this rating. In fact, this concern was noted prior to the global financial crisis 2007. In response to this criticism CRAs have defended themselves by saying that they pay more attention to their business, which depends on their reputation, while the amount they receive from a particular issuer is small in comparison to overall income.<sup>54</sup>

A clear example emerged from the global financial crisis 2007, showing the extent to which the complex relationship between CRAs and their clients might influence their professionalism and at the same time strengthen the concern over potential conflict of interest. The US Securities and Exchange Commission's (SEC) civil fraud case against Goldman Sachs produced a record of emails exchanged over 16 months which revealed that Standard & Poor's and Moody's were pressurised into giving Abacus 2007<sup>55</sup> a much better rating than the CRAs knew they deserved.<sup>56</sup> The CRAs rated the securities that were issued by Goldman AAA and then sold to investors who were misled by this rating before the disaster occurred and the incorrect rating was discovered.

2. **Slow interaction to downgrade the securities:** it was observed prior and post the global financial crisis 2007 that CRAs failed to recognise the decline of the issuers' creditworthiness before the market did. The CRAs usually downgraded the issuers' ratings after the markets recognised that their creditworthiness had deteriorated.<sup>57</sup> For example, in fall and winter 2006-2007 a wave of early payment defaults on mortgage based securities (MBS) which were rated by CRAs spread throughout the US markets, but the CRAs did not begin large-scale revision of the creditworthiness of those securities, and downgrading of the rating where necessary, until the summer of 2007, after the global financial crisis had occurred.<sup>58</sup>

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<sup>54</sup> A Pinto, 'Control and responsibility of credit rating agencies in the United States' (2006) 54 *The American Journal of Comparative Law* 341.

<sup>55</sup> SEC alleged that Goldman misled their investors about the role played by the hedge fund Paulson & Co in the construction of a collateralised debt obligation called Abacus 2007, whilst also concealing that Paulson's was, through separate transactions with Goldman, betting against Abacus 2007. For further information about this case see: J Lower and A Resiberg, *Pettet's company law: company law & corporate finance* (Fourth ed, Pearson educational limited 2012) 426.

<sup>56</sup> G Tett, 'E-mails throw light on murky world of credit' *The Financial Times* (London, 25 April 2010) < <https://www.ft.com/content/a9da1aa4-508b-11df-bc86-00144feab49a> > accessed 12<sup>th</sup> November 2016.

<sup>57</sup> J Lower and A Resiberg, *Pettet's company law: company law & corporate Finance* (Fourth ed, Pearson educational limited 2012) 427.

<sup>58</sup> J Rosner, 'Toward an understanding: NRSRO failings in structured ratings and discreet recommendations to address agency conflicts' (2009)14 *Journal of Structured Finance* 435.

For all the above considerations, securitisation acquired a bad name in the aftermath of the global financial crisis 2007 due to the role it played in the run-up to the crisis, which required regulators to regulate some aspects of securitisation that posed a threat to the financial system. Therefore, the Saudi legislator needs to take great care when considering launching such a market in the country. This raises the question: why does Saudi really need to launch a securitisation market despite its risks and complexity?

#### **6.4 The importance of establishing a securitisation market in Saudi**

The development of the housing finance market requires an increase in the number of investors and of course in the amount of capital in the market that is available to cater for the demand for housing finance operations. These features, if realised in the development of the housing finance market, will increase competition which in turn will lead to more choices and lower costs for borrowers. Homeownership will become cheaper and more affordable so that the rate of homeownership will increase.

The remarkable increase in housing demand following the positive state of the Saudi economy, as well as the booming numbers of people both locally and nationally, make Saudi an attractive housing market for national and foreign real estate developers, investors, financial institutions and multinational construction companies. Also, the enactment of the housing finance laws 2012 has opened the door for banks and financial institutions to increase their operations in housing finance to cater for the huge popular demand in this area.

However, the circumstances have changed and placed some obstructions against that door. The fall in oil prices, which are considered the main source of the government's budget, alongside engagement in the Yemen war,<sup>59</sup> have imposed fundamentally high costs, having a significant impact on the governmental budget, and thus, of course, on the Saudi economy. Therefore, the Saudi government is currently forced to borrow from national and international lenders in order to meet its fiscal obligations.<sup>60</sup> It must be noted here that the increase in government borrowing is likely to increase the ratio between

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<sup>59</sup> BBC, 'Saudi Arabia launches air strikes in Yemen' ([bbc.co.uk](http://bbc.co.uk), 24<sup>th</sup> March 2015) <<http://www.bbc.co.uk/news/world-us-canada-32061632>> accessed 25<sup>th</sup> November 2016.

<sup>60</sup> N Parasie, 'Saudi Arabia set to secure \$10 Billion loan to address budget shortfall' *The Wall Street Journal* (New York, 20<sup>th</sup> April 2016) <<http://www.wsj.com/articles/saudi-arabia-set-to-secure-10-billion-loan-to-address-budget-shortfall-1461148491>> accessed 13<sup>th</sup> November 2016.

government debt and the gross domestic product (GDP), which in turn will expose the government's rating to the risk of downgrade by credit rating agencies.<sup>61</sup>

Due to all the above geopolitical and economic circumstances, the securitisation market emerges as a good solution for developing the housing finance market so as to cater to the desires of both the Saudi government and the financial market. There are three main reasons for this.

The first reason supporting the idea of establishing a securitisation market in Saudi is the Saudi government's intention to become a regulator of the housing finance market, rather than a financier, to avoid incurring any fiscal obligation. The above geopolitical and economic circumstances have forced the government to adopt austerity policies to deal with the potential deficit in its budget and to carry out its plans and policies internationally and nationally. The austerity policies include, for example, ceasing to offer interest-free housing loans to those who have been waiting for more than 15 years to gain such loans from Real Estate Development Fund (REDF). The government's reason for this step lies in its intention to transform REDF from an entity providing interest-free loans to a company owned by the government which provides housing finance loans with interest.<sup>62</sup>

It could be argued that the government might be committing a sin when the REDF provides housing finance loans with interest. However, this argument is not quite correct, since the government is likely to avoid committing *Riba*, which is considered a sin and forbidden under the general teachings of Islamic law, by applying some of the Islamic finance transactions that offer borrowers the desired finance but avoid *Riba* such as: *Ijarah muntahia be tamlieak*.<sup>63</sup>

These austerity policies and others – especially Saudi Vision 2030, which explicitly signals the government's intention to pave the way for the private sector to perform many functions formerly the preserve of government – might be considered a gesture indicating that the government aims to be a regulator rather than a financier and thus to avoid incurring any fiscal obligation. In light of these circumstances, securitisation emerges as a good solution of a tool serving the private sector by catering to its need for liquidity and

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<sup>61</sup> Credit rating agencies are independent companies that rate a creditworthiness of debtor's ability to pay back debt and give that information to large-scale investors, whether governments or companies. For further discussion of the role of the credit rating agencies see: L White, 'Markets: The credit rating agencies' (2010) 24 *The Journal of Economic Perspectives* 211.

<sup>62</sup> Alriyadh, 'Specialists: transforming the Real Estate Development Fund to financial institution will facilitate housing solution' *Alriyadh* (Riyadh, 17 October 2015) <<http://www.alriyadh.com/1088831>> accessed 5<sup>th</sup> November 2016.

<sup>63</sup> Chapter Three, section 4.



to some extent offering cheap housing finance loans for borrowers, while enabling the government to avoid further fiscal obligation.

The Saudi Government's intention to become a regulator rather than a financier of the housing finance market, was explicitly signalled by the Saudi Vision 2030; this indicated the Saudi Government's desire to copy the American model of housing finance (in that the US government became a regulator rather than a financier). In particular, the legislative authority in Saudi explicitly stated when drafting the housing finance laws 2012 that the laws were inspired by US's experience in dealing with the housing finance market and especially with the securitisation market.

The example of the US in the housing field and outsourcing of securitisation revealed that the government's role became that of regulator rather than financier, which of course prevents it from assuming the burden of additional fiscal obligations. There, the government's policy was to create a legal and regulatory environment that enabled the private sector to flourish while its own role in providing housing for people remained really modest.<sup>64</sup> The US government's intervention in housing was minimal where it was believed that the best way to increase homeownership was through paving the way for the private sector to contribute in this field while retaining the government's role to legislate and control the sector.

Such a successful experience in the housing finance sector, which did not incur fiscal liabilities for the US government, supports the idea of introducing securitisation in Saudi, particularly in present circumstances, when the government faces fiscal difficulties due to the collapse of oil prices. The latter problem has expanded to create another issue hindering housing finance activities, and of course revives consideration of the launch of securitisation: namely, liquidity constraint,<sup>65</sup> as will be explained below.

The second reason supporting the idea of establishing securitisation in Saudi is the lack sources of liquidity due to current economic circumstances which increase the cost of borrowing and place much pressure on liquidity. The oil price collapse has led to a drop in the government's revenue which reduced its deposits in national banks, tightening

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<sup>64</sup> The US government's intervention in housing was minimal where it was believed that the best way to increase homeownership was through paving the way for the private sector to contribute in this field while retaining the government's role to legislate and control the sector. For further discussion see; A Shlay, 'Low-income homeownership: American dream or delusion?' (2006) 43 *Urban Studies* 51.

<sup>65</sup> S Kerr, 'Gloom descends on Gulf as oil price slump hits economy' *The Financial Times* (London, 23rd December 2015) <<https://www.ft.com/content/52dbea30-a7cd-11e5-9700-2b669a5aeb83>> accessed 25<sup>th</sup> November 2016.

liquidity and forcing lenders to raise borrowing costs.<sup>66</sup> A study on the impact of the decline in oil prices on the Saudi economy, published by the International Monetary Fund (IMF), showed that “a 1 percent decline in oil prices leads to a 0.3-0.4 percent decline in credit growth, a 0.1-0.2 percent decline in deposit growth, and higher nonperforming loans”.<sup>67</sup> Historically, it has been observed in terms of the relationship between deposits and oil prices that lower oil prices reduce income and deposit flows, whether from the government, business or individuals. Therefore, the Saudi Arabian Monetary Agency (SAMA) has taken further steps to ease the rules on bank lending, in order to stimulate growth in liquidity, by permitting banks to lend the equivalent of 90% of their deposits, up from the former policy which gave permission to lend just 85%: thus easing liquidity constraints, as mentioned.<sup>68</sup> However, the sustained low level of oil prices seems to have had a huge negative impact, even beyond what was expected, as seen by the Fitch rating service agency having recently downgraded 7 Saudi banks, “because of a weakening operating environment, resulting in lower loan growth, impacting earnings and profitability and asset quality, ultimately leading to a reduction in capital ratios”.<sup>69</sup> An increase in oil prices is not the only way to resolve liquidity constraint, despite being considered a significant remedy for the Saudi economy, because such a solution is subject to complicated political and economic circumstances which make it difficult to rely on it. This requires us to think outside the box to create a mechanism that will raise finance without resorting to deposits that suffer from scarce liquidity. Saudi’s history in particular shows us that the government has adopted some financial means of addressing the liquidity shortage; for example, late in 2002 the Saudi Telecom Company was 30% privatised, creating a huge government fund.<sup>70</sup>

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<sup>66</sup> D Almashabi and G Carey, ‘Saudi Arabia Follows Fed with Rate Increase as Oil Slumps’ *Bloomberg* (New York city, 17 December 2015) <<http://www.bloomberg.com/news/articles/2015-12-16/saudi-arabia-raises-reverse-repurchase-rate-to-0-5-from-0-25->> Accessed 12<sup>th</sup> November 2016.

<sup>67</sup> H Abusaaq and others, ‘Saudi Arabia selected issues’ (*imf.org*, October 2015) <<https://www.imf.org/external/pubs/ft/scr/2015/cr15286.pdf>> accessed 12<sup>th</sup> November 2016.

<sup>68</sup> M Nair, ‘Saudi Arabia said to ease lending rules to boost liquidity’ *Blomberg* (New York city, 14 February 2016) <<http://www.bloomberg.com/news/articles/2016-02-14/saudi-arabia-said-to-ease-rules-on-bank-loans-to-boost-liquidity>> accessed 12<sup>th</sup> November 2016.

<sup>69</sup> Fitch ratings, ‘Fitch downgrades 7 Saudi Arabian Banks; Revises outlook of 4 others to negative’ (*fitchratings*, 20<sup>th</sup> April 2016) <<https://www.fitchratings.com/site/fitch-home/pressrelease?id=1002896>> accessed 12<sup>th</sup> November 2016.

<sup>70</sup> For more information about the factor that have been adopted to resolve liquidity constrains see; M Al-Jasser and A Banafe, ‘Globalisation, financial markets and the operation of monetary policy: the experience of Saudi Arabia’ (*bis.org*, March 2005) <<http://www.bis.org/publ/bppdf/bispap23u.pdf>> accessed 12<sup>th</sup> November 2016.

The liquidity shortages represents a big challenge for the lenders to expand their operations in lending, therefore, in some economic circumstances, lenders, including banks and financial institutions, face issues surrounding deposits, because depositors may prefer to place their money in mutual funds and other investments that pay higher interest rather than keep it in local banks and financial institutions that pay less interest. This practice by depositors can expose lenders, whether local banks or financial institutions, to liquidity shortages which of course will minimise their capacity to lend.<sup>71</sup> Such practice from depositors and other economic circumstance that cause to the liquidity shortage might limit the capacity of lenders to expand their operations in lending. In the light of these considerations, the securitisation could emerge to address these liquidity shortages. For example, in the late 1960s, the huge demand for mortgages in the US, combined with limited liquidity, encouraged banks and financial institutions to develop securitisation to provide cheaper funding and enable them to raise finance faster without the need to rely on deposits.<sup>72</sup>

The third and last reason supporting the idea of establishing a securitisation market in Saudi is the high cost of borrowing in Saudi.<sup>73</sup> The high cost of borrowing might be attributed to the systemic risks regarding the borrowers which might lead to an increase in the rate of default. However, this argument might be acceptable if the banks had no assurances when they concluded housing finance agreements, but the current operation reveals that Saudi banks, required by SAMA, look for all these assurances, including but not limited to: a high down payment equal to 30%, verification of the customers' credit histories, and the requirement for a full valuation of a property. These assurances are enough theoretically to reduce the systemic risks and of course to grant the required credit

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<sup>71</sup> R Malloy, 'The secondary mortgage market – A Catalyst for change in real estate transactions' (1986) 39 *Southwestern Law Journal* 991.

<sup>72</sup> E Loutskina, 'The role of securitization in bank liquidity and funding management' (2011) 100 *Journal of Financial Economics* 663 & R Malloy, 'The Secondary Mortgage Market a Catalyst for Change in Real Estate Transactions' (1986) 39 *Sw. LJ* 991.

<sup>73</sup> The researcher, through using banks' official websites' in the UK and Saudi, has compared the cost of mortgage borrowing, taking into account the need to provide similar details, as follows: the annual income is £30,000, monthly commitments £300, property value £150,000, deposit £27,000, mortgage term 25 years. The results of this comparison were collected from the Halifax Bank in the UK which offers the mortgage borrower, roughly, up to £106,444, with monthly payments between £547 and £613, the total repayment coming to £174,000. For more information see : Halifax bank, ' mortgage calculator'(halifax.co.uk)<<http://www.halifax.co.uk/mortgages/mortgage-calculator/calculator/>> accessed 12<sup>th</sup> November 2016. *AlJazira* Bank in Saudi offers the following numbers based on the same details: loan up to £106,039.70, monthly payments of £658.36 and the total repayment amounting to £197,508. For more information visit: *AlJazir*, 'Housing finance calculator'(baj.com.sa)<<http://www.baj.com.sa/ar/personal-banking.aspx?page=home-finance-calculator&id=63&sub=61>> accessed 12<sup>th</sup> November 2016.

at low cost; however, the borrowing cost is still high and is likely to prevent those wishing to own a home from gaining access to the housing finance market.

It could be argued, therefore, that the explanation for the high cost of borrowing can be found in Saudi monetary policy and its effects on the cost of borrowing, as will be discussed below.

Generally speaking, Saudi monetary policy is for openness of the economy and the country has a pegged exchange rate system whereby the Riyal, which is the currency of Saudi, is effectively pegged to the US dollar.<sup>74</sup> This means that Saudi Arabia's financial market is highly integrated with the US market and that therefore SAMA, as the country's central bank, follows the US Federal Reserve's interest-rate moves whether they increase or decrease.<sup>75</sup> Such a policy influences the so-called Saudi Interbank Offered Rate (SIBOR), which represents the interest rates at which banks offer to lend unsecured funds to other banks in Saudi.<sup>76</sup> This in turn increases the cost of borrowing between banks and of course is reflected in the cost of providing loans to both businesses and individuals. Therefore, when SAMA announced in December 2015 that it was raising the interest rates for the first time since 2009,<sup>77</sup> matching the US Federal Reserve's move,<sup>78</sup> the result was an increase in the SIBOR. In other words the borrowing cost between local banks operating in Saudi will be increased, which of course reflects on the borrowing cost, which is supposed to increase as a consequence of increasing SIBOR.<sup>79</sup> A study published

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<sup>74</sup> The Saudi Riyal has been pegged with the US dollar since 1981. For further information see: M Al-Jasser and A Banafe, 'Monetary policy instruments and procedures in Saudi Arabia' (*bis.org*, 25<sup>th</sup> July 1999) <<https://www.bis.org/publ/plcy05j.pdf>> accessed 25<sup>th</sup> November 2016.

<sup>75</sup> For more discussion of the Monterey policy in Saudi, see: M Al-Jasser and A Banafe, 'Globalisation, financial markets and the operation of monetary policy: the experience of Saudi Arabia' (*bis.org*.2005)<<http://www.bis.org/publ/bppdf/bispap23u.pdf>>accessed 12<sup>th</sup> November 2016.

<sup>76</sup> For further information about SIBOR see: B Chong, Ming-Hua Liu and K Shrestha, 'Monetary transmission via the administered interest rates channel' (2006) 30 *Journal of Banking & Finance* 1467.

<sup>77</sup> SAMA, 'SAMA decided to increase SIBOR ratio' (*sama.gov.sa*, 16<sup>th</sup> December 2015)<<http://www.sama.gov.sa/ar-sa/News/Pages/News16122015.aspx>>accessed 12<sup>th</sup> November 2016.

<sup>78</sup> For more discussion about the Federal Reserve's action to increase the interest rates, see: A Yuhas, G Wearden and S Thielman, 'Federal Reserve hikes interest rates seven years after financial crisis – as it happened' *The Guardian* (London, 16<sup>th</sup> December 2016)<<http://www.theguardian.com/business/live/2015/dec/16/federal-reserve-us-interest-rates-janet-yellen-live>> accessed 12<sup>th</sup> November 2016.

<sup>79</sup> N Alhamri, 'Economist; the demand for liquidity and increase the interest rates the main cause of rose the SIBRO' *Alriyadh* (Riyadh, 17 February 2016) <<http://www.alriyadh.com/1129346>> accessed 12<sup>th</sup> November 2016.

by SAMA revealed that the rise in the SIBOR would, theoretically, have negative impacts on consumption and investment which should decline due to the high cost of finance.<sup>80</sup>

The mechanism of borrowing additional funds to increase mortgage lending activities might explain the role played by SIBOR in increasing the cost of borrowing in Saudi. Usually, most mortgage lending institutions, including banks, borrow capital in the short-term credit markets to increase mortgage lending through the SIBOR mechanism; however, they hold such loans in their portfolios as long-term investments.

The issue with the former action is that it encourages higher interest rates in a short-term credit market, and this exposes lenders to the risk that any return might be less than the cost of their capital. To address this issue the securitisation market can help reduce the cost of borrowing by offering lenders alternative sources of liquidity without the need to borrow through SIBOR.

The US experience in the secondary mortgage market in general and in securitisation in particular has played a significant role in reducing the cost of borrowing, by offering mortgage lenders an alternative mechanism for creating funds without resorting to borrowing at high interest rates.<sup>81</sup>

For all the above reasons, it could be said that the launching securitisation in the light of above circumstances might help the improvement of the housing finance activities to address the liquidity shortage and lower the capital adequacy requirements. However, from legal perspective, the housing finance laws of 2012, which pave the way to establishing securitisation, are supposed to begin with fundamental legal issues about securitisation. In particular, much ink has been spilt over the causes and shortcomings surrounding the financial crisis 2007, attracting attention from scholars and policy makers alike and leading us to wonder whether the Saudi legislator has resolved such issues through the provisions of the housing finance laws 2012.<sup>82</sup> The question emerges here as

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<sup>80</sup> G Algahtani, 'Impact of rising interest rate on Saudi economy' (*sama.gov.sa*, May 2015) <<http://www.sama.gov.sa/enUS/EconomicResearch/WorkingPapers/IMPACT%20OF%20RISING%20INTEREST%20RATE%20ON%20SAUDI%20ECONOMY.pdf>> accessed 12<sup>th</sup> November 2016.

<sup>81</sup> The history of the US secondary mortgage market shows some similarities with current fiscal circumstances in Saudi, in that, at the initial launch of the secondary mortgage market in the US during the 1930s, the US economy was suffering an economic depression. This, alongside liquidity constraint, had a negative impact on homeowners' ability to meet their payment obligations. For more information see; R Malloy, 'The secondary mortgage market – A Catalyst for change in real estate transactions' (1986) 39 *Southwestern Law Journal* 991.

<sup>82</sup> Many studies and reports which emerged in the wake of the financial crisis pointed to the causes and shortcomings underlying the crisis. Some blamed credit rating agents as the main sources of the crisis, while others highlighted risk retention and the need for regulations to reform it. For more information see; M Mah-Hui, 'Old wine in new bottles: Subprime mortgage crisis-Causes and consequences' (2008) 3

to whether or not the legislative and government initiatives to launch a securitisation market are enough to design a well-developed market, avoiding the main causes of the run-up to the global financial crisis 2007.

Around four years have passed since the enactment of the Real Estate Finance Law 2012 (REFL),<sup>83</sup> which included provisions that pave the way for the establishment of a securitisation market, followed by the announcement to make a partnership between the Public Investment Fund (PIF) in Saudi and the Boston Consulting Group to help design a government-owned entity similar to America's Fannie Mae and Freddie Mac, with the purpose of developing a securitisation market for home loans.<sup>84</sup> However, this chapter argued that such legislation and government initiatives are not sufficient to launch and develop a well-structured market due to three issues that remain unaddressed: the failure of Article (17) of the Real Estate Finance Law 2012 to establish a legal basis for securitisation, specification of property rights in the event of borrower default, and finally the lack of legislation addressing transparency in securitisation. The aim of discussing these issues is to develop a healthy environment for housing finance, which would provide low cost borrowing while protecting the rights of all parties and mitigating the risks of securitisation, as well as learning from others' experience and avoiding their mistakes.

### **6.5 The failure of Article (17) of the Real Estate Finance Law 2012 to establish a legal basis for securitisation**

Before shedding light on article (17) of the Real Estate Finance Law, it is necessary to understand the process of securitisation and the main participants in the process. Securitisation plays a significant role in the secondary mortgage market, attracting much attention and observation from economists and legislator alike, as it is considered an

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Journal of Applied Research in Accounting and Finance 3 & R Duchin, O Ozbas and B Sensoy, 'Costly external finance, corporate investment, and the subprime mortgage credit crisis' (2010) 97 Journal of Financial Economics 418.

<sup>83</sup> Articles 11 & 12 of (Real estate finance law (REFL)) allowed real estate finance entities to refinance either through Real estate refinance companies in accordance with the provisions of the REFL, or securities, in accordance with the Capital Market Law, while article (17) stated "SAMA shall license one or more companies to engage in real estate refinance activity in accordance with the Law".

<sup>84</sup> Z Fattah, S Bianchi and D Almashabi, 'Saudi Arabia Said to Plan Fannie Mae-Style Mortgage Company' *Bloomberg* (New York City, 18<sup>th</sup> November 2015) <<http://www.bloomberg.com/news/articles/2015-11-18/saudi-arabia-said-to-plan-fannie-mae-style-mortgage-company>> accessed 12<sup>th</sup> November 2016.

engine which starts off the secondary mortgage market. Securitisation entails “the process of repackaging larger sized and illiquid instruments into smaller and more liquid instruments that can be traded”.<sup>85</sup> In fact, the mechanism of securitisation involves many stages and participants, as will be examined below.

The operation goes through five stages, beginning with the primary mortgage market and ending with the secondary market, while participation in this operation involves some or all of the following parties: borrowers, primary lenders,<sup>86</sup> mortgage-backed security (MBS) issuers (originators),<sup>87</sup> servicers,<sup>88</sup> guarantor,<sup>89</sup> and investors.<sup>90</sup>

To simplify the mechanism of securitisation one might say that it combines individuals’ loans into a pool and then uses them as collateral for bonds. To explain it in greater detail: in the first stage, the primary lenders originate housing finance loans to fund their customers. The main challenge for the lenders at this stage is how to market their loans in the secondary mortgage market when they intend to sell the loans, in view of the fact that not every loan would be purchased in the secondary market and the lenders would thus be exposed to the risk of ‘Pipeline’ – which refers to the notion that not all loans will come to fruition.<sup>91</sup> A prolonged period of time required to sell the loans will cost lenders,

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<sup>85</sup> D Sylvie, ‘Removing loans from banks’ balance sheets – an overview of the techniques, the markets and the regulatory issues’ (1992) *Journal of International Banking Law* 1.

<sup>86</sup> Primary lenders are those who originate and fund the mortgage to the consumer. According to the former description only banks and mortgage lending companies will be considered primary lenders based on the banking laws and housing finance laws 2012 in Saudi.

<sup>87</sup> The loans issued by primary lenders will be purchased by MBS originators who will pool and group loans then securitise them and finally sell them in the secondary mortgage market. The largest MBS originators in the US are entities owned by the government, Fannie Mae and Freddie Mac, while Ginnie Mae issues MBSs backed by government guarantees, or issues mortgages. For further information about these entities and their role, see: P Wallison and C Calomiris, ‘The last trillion-dollar commitment: The destruction of Fannie Mae and Freddie Mac’ (2009) 15 *Journal of Structured Finance* 71 & C Peterson, ‘Fannie Mae, Freddie Mac, and the home mortgage foreclosure crisis’ (2009) 10 *Loyola University New Orleans Journal of Public Interest Law* 149.

<sup>88</sup> A servicer is an intermediary between individual mortgage borrowers and the MBS issuer. Usually a servicer collects payments due on the underlying assets and, after collecting a servicing fee, pays them over to the security holders or their trustee. There are many additional functions that a servicer can perform, such as: balance inquiries, periodic statements, payment verification, and tax statement preparation, while, if the borrower defaults, the servicer is expected to carry out foreclosure functions. For further discussion of the servicer’s functions see: A Levitin and T Twomey, ‘Mortgage servicing’ (*papers.ssrn.com*, 15 December 2010) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1324023](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1324023)> accessed 12<sup>th</sup> November 2016.

<sup>89</sup> As the term implies, the guarantor is an entity that guarantees that the investor will receive all due cash flow under the MBS agreement even in the case of borrower default, for further information see: V Mints, ‘Securitization of mortgage loans as a housing finance system. To be or not to be’ (2007) 22 *Housing Finance International* 23.

<sup>90</sup> Besides the above main participants, the rating agencies play a significant role in the securitisation process by assessing the credit quality of certain types of instruments, such as bonds, and assigning a credit rating, for further information about their role in securitisation market see: M Pryke and C Whitehead, ‘An overview of mortgage-backed securitisation in the UK’ (1994) 9 *Housing Studies* 75.

<sup>91</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007) 6.

as these loans will remain in their portfolios and expose them to many risks, such as borrower default and change in interest rates, which will negatively affect the value of the loans. Another issue requiring some attention is that the lender has to consider whether it wishes to provide ‘servicing’,<sup>92</sup> which is considered a highly profitable source of revenue especially for the largest lenders who have the ability, skills and capacity to perform such a function. However, small lenders who lack the abilities to perform these services have the right to sell the rights of doing services to other entities who can do so.<sup>93</sup> The former stage means the end of the role of primary participants in the securitisation process except for the function of loan servicing if applicable, which would be implemented by the primary lenders as mentioned above. The loans issued by lenders will be bought by MBS issuers who will combine them and then collect a pool of homogeneous mortgages and finally sell them to investors in the secondary mortgage market, who will be entitled to receive proportional shares of all cash flows the mortgages generate.<sup>94</sup>

In order to protect the investors’ rights to receive the cash flow that they are owed under the MBS issuers, there is an entity called the guarantor, whose function is to guarantee the rights resulting from securitisation, particularly when the MBS issuers become unable to meet their obligations.<sup>95</sup> However, the MBS issuers have to take extra care at the earlier stage regarding the structure of the MBSs that will be issued, since there are many ways to structure such loans,<sup>96</sup> involving the amount of credit risk that investors will have to bear and so on.<sup>97</sup>

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<sup>92</sup> The above servicing includes provision of monthly statements, call centres, collection and so on. For more information see: A Levitin and T Twomey, ‘Mortgage servicing’ (*papers.ssrn.com*, 15<sup>th</sup> December 2010) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1324023](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1324023)> accessed 12<sup>th</sup> November 2016.

<sup>93</sup> For more information on the above subject see: A Colletta, ‘Asset securitization: Evolution, current issues and new frontiers’ (1990) 69 *Tex. L. Rev* 1369 & Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007) 7.

<sup>94</sup> D Jaffee, ‘The interest rate risk of Fannie Mae and Freddie Mac’ (2003) 24 *Journal of Financial Services Research* 5.

<sup>95</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007) 28.

<sup>96</sup> Within the US secondary mortgage market there are various ways to structure an MBS, such as mortgage-passthrough securities (MBS) and mortgage-backed bond (MBB). For more information about their function and structure, see: D Vink and A Thibeault, ‘ABS, MBS and CDO compared: an empirical analysis’ (2008) 14 *The Journal of Structured Finance* 27; Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R, 2007) 4 & E Schwartz and W Torous, ‘Prepayment and the Valuation of Mortgage-Backed Securities’ (1989) 44 *The Journal of Finance* 375.

<sup>97</sup> D Vink and André Thibeault, ‘ABS, MBS and CDO compared: an empirical analysis’ (2008) 14 *The Journal of Structured Finance* 27.



The above-described operation of securitisation reveals that the main participants in such a mechanism are: borrowers, primary lenders, MBS issuers (originators), investors and guarantor, despite there being other participants whose role is not crucial in designing securitisation, such as mortgage brokers and legal advisors.<sup>98</sup> Within the Saudi market, most securitisation participants are found, such as borrowers, primary lenders, and investors, while the MBS issuers and guarantor, whose roles in the securitisation market are significant, will be established sooner as stated by the government.

However, it might be useful to mention the recommendation by the US Department of Housing and Urban Development that emerging markets should take account of the fact that the MBS-issuing entities were supposed to be owned by the government.<sup>99</sup> The purpose of this recommendation is to enhance confidence in such an emerging market, and so to boost capital by attracting investors nationally and internationally.

It seems that the Saudi regulator has taken into account the above recommendation when starting to establish the MBS issuer. Article (17) of the Real Estate Finance Law has paved the way for licensing of a company to carry out real estate refinance activities. Accordingly, the Saudi government has noted the defect stemming from the absence of MBS issuers from the Saudi market and launched talks with the Boston Consulting Group to create an entity which will take the form of a company with the possibility of being transformed into a joint-stock company, owned by the government. This company would resemble Fannie Mae and Freddie Mac<sup>100</sup> in the US, and would be granted the function of refinancing mortgages. So, these talks will result in the establishment of an entity exercising the functions of the MBS issuer.

With regard to a guarantor and whether or not it exists in the Saudi market, in fact, there is no need to establish a specific entity to perform the role of guarantor in securitisation, because that role can be played by the entity exercising real estate refinancing activities, as the latter is supposed to be designed on the model of the American Fannie Mae and Freddie Mac, whose role, based on the US securitisation market, is to act as a guarantor

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<sup>98</sup> For more information about the main participants in securitisation see: P Jean-Charles, 'Asset Securitization: A Comparative Study between the United States and Belgium' (1996) *Int'l Bus. LJ* 341 & R Malloy, 'The secondary mortgage market – A Catalyst for change in real estate transactions' (1986) 39 *Southwestern Law Journal* 991.

<sup>99</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007) 5.

<sup>100</sup> Z Fattah, 'S Bianchi and D Almashabi, 'Saudi Arabia Said to Plan Fannie Mae-Style Mortgage Company' *Bloomberg* (New York City, 18<sup>th</sup> November 2015) <<http://www.bloomberg.com/news/articles/2015-11-18/saudi-arabia-said-to-plan-fannie-mae-style-mortgage-company>> accessed 12<sup>th</sup> November 2016.

alongside their main function as MBS issuers.<sup>101</sup> Accordingly, there is no need to establish a specific entity to act as guarantor.

Although article (17) has cleared the way to establishment of a securitisation market in Saudi, it contains a legal defect that hinders the creation of a well-structured market. Article (17) stated that “SAMA shall license one or more companies to engage in real estate refinance activity in accordance with the Law, this Regulation, the Finance Companies Control Law and its Implementing Regulation, provided that: a- The license be restricted to real estate refinance activities. b- The capital of the real estate refinance company be not less than five billion riyals”. According to this article, the potential entity will be allowed to exercise real estate refinance activities which consist of buying mortgages from the lenders and holding them in its portfolio. This function is deemed the first part of the MBS issuers’ function, but the second part – pooling and combining loans and then issuing bonds backed by a pool of homogeneous mortgages – is not allowed.

In other words, the MBS issuers have two functions: the first is to purchase loans originating from primary lenders, while the second function is to aggregate the loans into pools, secure them, and then sell them into the secondary market. A company could be licensed under article 17 to carry out the functions of MBS issuers. However, according to the terms of article 17 the company would be allowed to exercise the role of loan purchase, but not allowed to aggregate loans in to pools before selling them on the secondary market. Therefore, article 17 presents a legal obstacle and there is a need to amend this article to enable the potential company to conduct the two roles in full.

However, it could argued that there is no need for the second role to be sanctioned by article 17, as long the role that facilitates the combined purchase and pooling of loans for sale on the secondary mortgage market is mentioned in the Memorandum and Articles of Association of a company, then the latter could exercise this function legally. This argument might be accepted if the Saudi legislators had not already confirmed restrictions as stated in article 17, which imply that any agreement that goes against the law is classed as illegal. However, there is no indication of the purpose of these restrictions or whether they are temporary or permanent.

The last point takes us to another argument: might the regulator have intended to restrict the function of the company to solely refinancing real estate activities, without pooling loans and reselling them to the secondary market? This argument might succeed if the

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<sup>101</sup>S Schwarcz, ‘Securitization Post-Enron’ (2003) 25 Cardozo L. Rev1539.

function of securitisation were just to refinance real estate loans, whereas its actual function, as mentioned above, is to convert illiquid assets into tradable assets through the securitisation mechanism. Therefore, there is a need to reform article (17) so as to grant the real estate refinance companies another function with respect to pooling loans and reselling them to the secondary mortgage market.

To summarise this section, the government has taken further steps to establish an entity owned by the government similar to Fannie Mae and Freddie Mac in the US, to develop a securitisation market for housing finance loans. However, the wording of article (17) raises concern about the possibility of establishing a well-developed securitisation market while the MBS issuers are not allowed to exercise one of its main functions Saudi.

## **6.6 The Saudi legal system and the uncertainty surrounding specification of property rights in the event of the borrower's default in the securitisation process**

The assignment of receivables,<sup>102</sup> which is considered the central structure of securitisation, might lead to an overlap of liabilities, obligations and rights resulting from the securitisation unless a legal structure is created to maintain such rights and obligations.<sup>103</sup> As seen above, the originator of mortgage loans (lender) sells them to the MBS issuer that purchases them for sometimes a discounted sum, while the MBS issuer's function is to raise funds through issuing bonds.<sup>104</sup> The complementary functions, such as servicing, are probably carried out by the lender, who will attempt to maintain the relationship with the borrower. The transforming of receivables and the rights derived therefrom aim to make sure that the lender is not in a position to reach them, particularly in the case of insolvency.<sup>105</sup>

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<sup>102</sup> Usually 'Receivables' refers to the company's balance sheet that represents instalment loans being repaid over time by borrowers. For more information see: F Fabozzi and V Kothari, 'Securitization: the tool of financial transformation' (*papers.ssrn*, 2007) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=997079](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=997079)> accessed 12<sup>th</sup> November 2016.

<sup>103</sup> V Bavoso, 'Financial innovation and structured finance: the case of securitisation' (2013) 34 *Company Lawyer* 3.

<sup>104</sup> F Fabozzi and V Kothari, 'Securitization: the tool of financial transformation' (*papers.ssrn*, 2007) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=997079](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=997079)> accessed 12<sup>th</sup> November 2016.

<sup>105</sup> V Bavoso, 'Financial innovation and structured finance: the case of securitisation' (2013) 34 *Company Lawyer* 3.

The Saudi legislator has treated the above issue with extra care in article 21 of the Regulation of the Real Estate Finance Law when stating that the mortgage assets and the rights derived from them may be assigned to the Real Estate Refinance Company (RERC) in refinancing transactions, without the prior consent of the borrower so that all rights assigned to the third party in the secondary market are protected in case of the lender's insolvency.<sup>106</sup> Such wording means that a transfer by assignment would establish a new relationship between borrower and assignee, who is in this case MBS issuer, which is the RERC under Saudi jurisdiction.

In actual fact, the Saudi legislator deserves praise when it succeeds in avoiding the legal uncertainty that might arise concerning the rights of the buyer, the MBS issuer, in the case of insolvency of the lender,<sup>107</sup> due to the statement of article (21) that the transfer shall not be revoked or otherwise rescinded in the event of the bankruptcy of the transferring real estate finance entity. In addition, the former article asserted that the transferred rights shall not be deemed part of the transferor's assets, provided the MBS issue has paid the agreed amount in full to a transferring real estate finance entity. However, potential concern might arise from another feature of the Saudi legal system and threaten the right of the buyer (the MBS issuer) when the borrower defaults, as will be explained below.

Logically, should the borrower default, the MBS issuer, who bought the receivables, can sell the pledged property, which was financed as a collateral, to pay off the debt. However, there is doubt about the application of this process under Saudi jurisdiction; at least the application might face legal challenges that mitigate the structure of securitisation, and in turn might alienate investors and lenders alike from participating in such a market because of the ownership of the financed property being retained by the lender not the borrower.

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<sup>106</sup> Article(21) of the Regulation of the Real Estate Finance Law stated; "If the Real Estate Refinance Company has paid the agreed upon amount in full to a transferring real estate finance entity, such transfer shall not be revoked or otherwise rescinded in the event of the bankruptcy of the transferring real estate finance entity. The transferred rights shall not be deemed part of the transferor's assets".

<sup>107</sup> The above concern arises from the concept of the sale of loans because there is debate hovering over the former term. Is it considered a true sale or should it be recharacterised as a security? The first conceptualism would protect the SPV from the substantive consolidation, which refers to "the threat of originator's creditors' potential claim, in the context of insolvency, to seek consolidation of the assets of the two companies; the originator and the SPV"; while, if the sale is characterised as a security, "the assets would remain on the originator's balance sheets". This debate and risk are common in the US jurisdiction. Although this debate is beyond the scope of this chapter, it is worth seeing the following references for more information: V Bavoso, 'Financial innovation and structured finance: the case of securitisation' (2013) 34 *Company Lawyer* 3 ; D Sylvie, 'Removing loans from banks' balance sheets – an overview of the techniques, the markets and the regulatory issues' (1992) *Journal of International Banking Law* 1.

As mentioned in Chapter Three,<sup>108</sup> the banks operating in Saudi resort to Islamic finance transactions as a consequence of the decision of the Supreme Judicial Council (SJC) which denies them their greatest security, namely mortgage. The rationale for preventing banks from recording mortgages in their interest was that all loans provided by these banks are usurious, and are thus not *Sharia*-compliant, according to the SJC. In nearly all forms of Islamic finance transactions, the lender is at some stage the owner of the financed goods and of course, as a result, deems the bank the owner of the financed asset for a considerable period of time until the debt owed is fully paid. Accordingly, it is assumed under Saudi jurisdiction that the main participants in securitisation are: the originator of the loan, who will retain the ownership of the financed property as security for the loan, as explained in detail in Chapter three; the borrower, who gained the loan from the originator and will be considered the renter of the financed property until the debt owed is fully paid, when ownership will be transferred to him; and the MBS issuer, which under Saudi jurisdiction is the RERC.

To enable the MBS issuer, in the case of borrower default, to gain the right to sell the financed property to satisfy the debt, there are two possible scenarios:

- 1- Given that the ownership of the financed property is under the authority of the lender (the loan originator), the MBS issuer may take legal action against the lender for recovery of any loss, under a claim based on the ownership of the financed property being deemed collateral to secure the loan in the case of borrower default. From this perspective, the MBS issuer is well advised to gain a copy of the loan agreement between the borrower and lender to support such a claim. However, the lender might argue that he abided by all liabilities and rights resulting from the assignment of receivables, which represent instalment loans that borrowers are repaying over time, including but not limited to the shifting of the debts from his balance sheet<sup>109</sup> to the MBS issuer. In addition to this, he assigned to the MBS issuer the right to receive all or a proportionate share of payment when made by the borrower through him.

Also, the lender might offer the defence that the default arose from the borrower and that he is only an intermediary between the borrower and the MBS issuer. On this basis the MBS issuer needs to raise a claim against the borrower, rather than

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<sup>108</sup> Chapter Three, section 4.

<sup>109</sup> Usually loans must be transferred without recourse to the originator of the loans; for more information on this issue, see: S Schwarcz, 'The future of securitization' (2009) 41 Connecticut law review 1313.

the lender, who has already fulfilled all liabilities resulting from the transaction. In fact, the lender's defence might be endorsed by the new and direct contractual relationship established by the securitisation between the borrower and the MBS issuer, as assignee, which requires the MBS issuer to raise the claim against the borrower rather than the lender.<sup>110</sup> In these circumstances, the MBS issuer might be forced to resort to the second scenario.

- 2- The MBS issuer might raise a claim against the borrower who defaults on paying the debt owed. From a legal perspective, the claim is absolutely correct, because the transaction of securitisation has established a new relationship between the MBS issuer and the borrower, which gives the former the right to raise such a claim against the latter, requiring the transfer of all liabilities, loan assets and rights through securitisation from the originator to the MBS issuer. Following assurance of the legality of the claim, however, the main goal which to satisfy the due debt might not be achieved because the borrower is likely to argue that the ownership of the financed property is not registered in his name, and that therefore the MBS issuer needs to raise a claim against the lender who retains the ownership of the financed property to satisfy the due debt.

The potential outcome of the above scenarios carries more risks for the buyers (MBS issuer) and exposes them to legal uncertainty in case of the borrower's default; in particular, both scenarios are likely to occur due to all parties having a legal basis to support their arguments. Consequently, there is a need for a solution to protect the interests of the buyers (MBS issuer) and at the same time to maintain the structure of securitisation because there is uncertainty surrounding specification of property rights in the event of the borrower's default in the securitisation process.

Generally speaking, the existence of a few problematic issues and legal defects in the Saudi jurisdiction may cause loss of confidence in such a market, which in turn may spoil this fiscal innovation's reputation for trustworthiness, even before it is used. As Professor Tamar Franklin said: "Regulation provides the industry with the stamp of 'good housekeeping' that guards investors' interests",<sup>111</sup> and would of course reduce the very high costs of unpredictable outcomes due to the existing legal uncertainty in the jurisdiction. Thus, lawmakers have to carefully consider this issue and strike a balance

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<sup>110</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007) 34.

<sup>111</sup> T Frankel, 'Regulation and Investors' Trust in the Securities Market' (2002) 68 Brook. L. Rev 439,440.

between importing fiscal innovations to be applied in Saudi, and accommodating national legal issues, such as the SJC's decision, in order to create a hybrid form that will convince the investors, in particular those who will participate in the securitisation market as MBSs, that their rights will be protected in all situations including that of borrower default.

To fill the above gap and address the issue, the primary task of the legislator is to put the RERC (MBS issuer) in a position to gain access to the financed property in the event of borrower default, without exposing him to conflict with the lender (the housing finance loans originator) who holds ownership. The solution lies in creating bankruptcy remoteness between the lender and the RERC, which retains ownership of the financed property.<sup>112</sup>

The equitable remedy provided by such a solution is embodied in the proposal discussed and examined in Chapter Three,<sup>113</sup> and recommended as a means of resolving the issues arising from the SJC's decision. Such an equitable remedy guarantees that the borrower's default would not impact on the RERC's interest in selling the financed property to satisfy the debt.

As mentioned there, in order to develop the housing finance market and enhance confidence, the government is advised to establish, under article (155) of the companies law, a special purpose vehicle SPV owned by the government, to hold the collateral, that is, the property being financed, and keep it at the same distance from lender and borrower. This new collateral structure will dissipate the concerns arising from the above two scenarios because the receivables and liabilities, which are at the centre of the securitisation mechanism, being transferred to the MBS issuer while ownership remains under the authority of the borrower. This collateral structure in fact enables the MBS issuer to raise a claim against the borrower, who retains ownership of the property being financed, without potential conflict with the lender, as will be seen below.

The mechanism of the housing finance transaction with this company owned by the government will enable the borrower to retain ownership of the property being financed in order to grant him proper protection in this bargain, while the lender's rights and interests in the property being financed will be secured through mortgaging the property in favour of the proposed SPV. In this case, the MBS issuer will have the right to raise a claim against a borrower if he fails to pay the instalments required by the housing finance

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<sup>112</sup> V Bavoso, 'Financial innovation and structured finance: the case of securitisation'(2013) 34 Company Lawyer 3.

<sup>113</sup> Chapter Three, section 5.

agreement, because he retains ownership of the property being financed alongside all rights arose from the housing finance transaction between the borrower and lender have been assigned to the MBS issuer (article 21).

In these circumstances, it seems there is no potential way for the borrower to defend himself against such a claim by alleging that the ownership is not under his authority. In the light of the above-mentioned new mechanism for housing finance transactions, the ownership will remain under the authority of the borrower. In addition, the new mechanism will prevent conflict between the MBS issuer and the lender because under this mechanism the ownership is no longer under lenders' authority, and there is no need for MBS issuer to make a claim against him.

To summarise this section, the MBS issuer might be exposed to the risk of loss of its interests in the case of borrower default, due to the ownership of the financed property being retained by the lender. Therefore, establishing a bankruptcy remoteness entity would maintain the rights of all parties to the securitisation and address the above concern.

## **6.7 Why did the housing finance laws 2012 fail to deal with transparency in securitisation?**

The Saudi legislator has paid good attention to the promotion of transparency in the primary mortgage market, since the market would fail without it. For instance, SAMA was obliged to “publish data related to the real estate finance market and to determine principles for disclosure of finance costs and method of calculation to enable consumers to compare prices”.<sup>114</sup> In addition, the Saudi legislator attempted to standardise, whenever possible, and to get as much information as possible to the market, because it was believed that would help to establish the culture of transparency, which of course will ultimately lead to the success of the market.<sup>115</sup>

For instance, the lender is obliged to include specific information and data in the contract that would be concluded with borrowers.<sup>116</sup> The former step is considered standard in the real estate finance contract to be concluded between lender and borrower, and is deemed a sophisticated step on the part of the legislator in this field. Nevertheless, it could be

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<sup>114</sup> Article 2 of the Real Estate Finance Law.

<sup>115</sup> Article 10 of the Real Estate Finance law.

<sup>116</sup> Article 10 of the Real Estate Finance Law.



argued that the provisions of the housing finance laws 2012, which were supposed to regulate securitisation, did not give securitisation the same level of care as the primary housing finance market is given in to the matter of transparency. This which of course might have a negative impact on the potential securitisation market when it is established in Saudi. As mentioned at the beginning of this thesis, the members of both the government and the *AlShura* Council,<sup>117</sup> which are both considered the legislative authority in Saudi, announced, in the wake of enactment of the housing finance laws 2012, that the laws had taken account of the causes contributing to the global financial crisis 2007-2008, in order to prevent such a crisis occurring in Saudi.<sup>118</sup> However, the absence of provisions in the housing finance laws 2012 to regulate transparency in securitisation might impair the former claim, inasmuch as the lack of transparency in the securitisation market was deemed a factor, among others, that contributed to the global financial crisis 2007. This leads us to wonder whether further legal reform is needed to legislate the aspect of transparency for the purpose of averting the circumstances that contributed to the global financial crisis 2007. To answer this question it might be useful to shed light on the role played by lack of transparency in generating the global financial crisis and the initiatives were adopted to develop this principle prior to and post the crisis.

Usually, the originator of the loan (lender) is required to promote a more comprehensive understanding of the risks involved in securitisation, by providing both the MBS issuers and investors with the information needed to enable them to carry out their due diligence on the properties, rather than relying blindly on the judgement of CRAs, for example.<sup>119</sup>

The means to this end lies in transparency, defined by the Bank of International Settlements as “sufficient information on the underlying assets, the structure of the transaction and the parties involved in the transaction, thereby promoting a more

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<sup>117</sup> *AlShura* Council has regulatory authority of Saudi Arabia such as; lay down statutory laws and regulations, discuss and approve the international treaties in addition to shares the legislative authority with the Council of Ministers; for more information about the *AlShura* Council’s function see; F Al-Fadhel, ‘Legislative Drafting and Law-Making Practices and Procedures under Saudi Arabian Law: A Brief Overview’(2012)1 *IJLDR* 95.

<sup>118</sup> Securitisation coupled with the global financial crisis 2007 due to the role played by it, as has been explained in detail in this chapter; for a brief background about the role played by this innovation in the global financial crisis see; V Acharya, ‘The financial crisis of 2007-2009: Causes and remedies’ (2009) 18 *Financial markets, institutions & instruments* 89.

<sup>119</sup> J Ackermann, ‘The subprime crisis and its consequences’ (2008) 4 *Journal of Financial Stability* 329.

comprehensive and thorough understanding of the risks involved”,<sup>120</sup> which would enable the investor to assess the risks involved in securitisation.

The global financial crisis 2007 confirmed investors’ over-reliance on credit rating agencies (CRAs), which are paid by the loans originator,<sup>121</sup> due to the investors not being in a position to assess the value of the securities because of the lack of transparency. Two explanations are available: either the insufficiency of the information prevented the investors from properly assessing the risks involved in securities, or the complexity and overload of the information hindered the investors from assessing the securities and forced them to rely on the CRAs.<sup>122</sup>

Post the financial global crisis 2007, it was adopted the principle of disclosing all relevant information in order to address information asymmetry.<sup>123</sup> The aim of this mechanism is to put the investors in a position to fully assess the risks of securitisation. Therefore, this issue was naturally not discussed post the global financial crisis 2007, because “most of the risks giving rise to the collapse of the market for securities backed by subprime mortgages were disclosed”.<sup>124</sup>

However, it was questionable whether the full disclosure put the investors in a position to perform their role with due diligence and to assess the risks in the securities, or whether it failed to achieve its aim, thus forcing investors to rely on CRAs to help them in valuing the securities and assessing the systemic risks. In fact, the full disclosure backfired in terms of its main goal by leading to information overload, with investors unable to understand the risks involved in the securities due to the huge amount of information, by contrast with the limited skills of the investors.<sup>125</sup>

The concept of full disclosure is based on the idea that investors and other securities market participants are perfectly rational, and that, in addition, more disclosure is always better than less.<sup>126</sup> However, Herbert Simon has a different viewpoint, which is that

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<sup>120</sup> Bank for International Settlements, ‘Criteria for identifying simple, transparent and comparable securitisations’ (*bis.org*, July 2015) <<http://www.bis.org/bcbs/publ/d332.htm>> accessed 12<sup>th</sup> November 2016.

<sup>121</sup> M Pagano and P Volpin, ‘Securitization, transparency, and liquidity’ (2012) 25 *Review of Financial Studies* 2417.

<sup>122</sup> H Reden, ‘Regulation of securitised products post the financial crisis’ (2013) 2 *UCL journal of Law and Jurisprudence* 112.

<sup>123</sup> M Pagano and P Volpin, ‘Credit ratings failures and policy options’ (2010) 25 *Economic Policy* 401.

<sup>124</sup> S Schwarcz, ‘Disclosure's failure in the subprime mortgage crisis’ (2008) *Utah Law Review* 1109.

<sup>125</sup> E Avgouleas and R Kolb, ‘Financial regulation, behavioural finance, and the global financial crisis: In Search of a new regulatory model:Lessons’ in R Kolb(ed), *The Financial Crisis: Causes, Consequences, and Our Economic Future* (Hoboken, N.J. : Wiley 2010) 55

<sup>126</sup> H Simon, ‘A behavioural model of rational choice’ (1955) 69 *The quarterly journal of economics* 99.

people are boundedly rational because they have limited cognitive abilities with which to process information.<sup>127</sup> Therefore, when faced with complicated and sophisticated tasks, such as securitisation, people tend to economise on cognitive effort through either heuristics or "short cuts".<sup>128</sup> Based on Simon's insight, in cases involving vast quantities of information, people tend to adopt a decision strategy requiring less cognitive effort.<sup>129</sup> In fact, Simon's insight might explain the desire of investors to rely on the CRAs in the securitisation process due to information overload forcing them to adopt a strategy requiring less cognitive effort.

The full disclosure, in fact, might be considered incomplete and sometimes counterproductive, as it is meaningless to disclose information that is not used. Such a principle requires analysis of the disclosed information to approach a degree of certainty about the investment, whereas investors do not have the ability to perform this function. Even if they managed to do it they might not be able to realise the legal consequences of the securities products.<sup>130</sup>

Investors usually seek CRAs' experience in valuing the securities due to their inability to assess the risks involved in the securities products. Although the CRAs employed numbers of qualified experts in securitisation, they failed in this function and played a crucial role in generating the crisis through badly underestimating the risks in the new securities products and giving these products the highest grade "without adequately examining the assumptions underlying such ratings and without considering whether changed circumstances surrounding the issuance of novel securities should have caused the revision of such assumptions".<sup>131</sup> Therefore, over-reliance on the CRAs caused the investors not to scrutinise the risk involved in the securities products they were

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<sup>127</sup> H Simon, 'A behavioural model of rational choice' (1955) 69 *The quarterly journal of economics* 99 & T Paredes, 'Blinded by the light: Information overload and its consequences for securities regulation' (2003) 81 *Washington ULQ* 417.

<sup>128</sup> T Paredes, 'Blinded by the light: Information overload and its consequences for securities regulation' (2003) 81 *Washington ULQ* 417.

<sup>129</sup> H Simon, 'A behavioural model or rational choice' (1955) 69 *The Quarterly Journal of Economics* 99.

<sup>130</sup> S Schwarcz, 'Information asymmetry and information failure: disclosure problems in complex financial markets' in S Schwarcz (ed), *Corporate Governance and the Global Financial Crisis: International Perspectives* (Duke 2011) 99.

<sup>131</sup> T Hurst, 'The role of credit rating agencies in the current worldwide financial crisis' (2009) 30 *Company Lawyer* 61.

purchasing, and thus exposed them to credit risks.<sup>132</sup> This failure requires us to seek the reasons beyond it and ask whether information overload played a role in it.

The complexity and overload of information undermine the disclosure paradigm of securitisation which requires parties to disclose all relevant information. The complexity is derived from the nature of securitisation, as seen above, which makes investors unable to determine the risks.<sup>133</sup> Therefore, the full disclosure did not resolve that complexity, confirming the need to establish a new concept with which to address such complexity and give investors a degree of certainty when they invest in securities. This viewpoint is supported by the testimony of one of the most famous CRAs, Moody's, that announced in 2008 that the complexity of the market makes CRAs unable to determine where the risk lies.<sup>134</sup> Professor Schwarcz believes that the complexity of transactions even affects institutional investors, who are expected to have the abilities needed to assess the suitability of securities products; therefore, the complexity of the transaction rendered the full information insufficient for the market and the participants alike.<sup>135</sup>

The complexity of information remains the main challenge facing securitisation in developed markets such as the US and Europe. Nevertheless, many initiatives have been taken to mitigate complexity, with the aim of enhancing confidence and, at the same time, simplifying securitisation to enable securities market participants to determine the risks. It is noteworthy that the purpose of these initiatives was not to serve as a substitute for investors' due diligence but instead to help the investors and the securities market participants to assess the systemic risks. The Basel Committee on Banking Supervision (BCBS), for example, and the International Organisation of Securities Commission (IOSCO), both of which organisations include Saudi Arabia as a member, have attempted to identify the meaning of simple, transparent and comparable securitisations, to

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<sup>132</sup> G Caprio, A Demirgüç-Kunt and E Kane, 'The 2007 meltdown in structured securitization: searching for lessons, not scapegoats' (*papers.ssrn*, 2008) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1293169](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1293169)> accessed 12<sup>th</sup> November 2016.

<sup>133</sup> A Orkun, 'Securitisation, the Financial Crisis and the Need for Effective Risk Retention' (2013) 14 *European Business Organization Law Review* 1.

<sup>134</sup> R Barley, 'Ability to track risk has shrunk "forever" -Moody's' *Reuters* (London, 6<sup>th</sup> Jan 2008) <<http://www.reuters.com/article/moodys-risk-idUSL0455354520080107>> accessed 12<sup>th</sup> November 2016.

<sup>135</sup> Professor Schwarcz pointed to two levels of reasoning that explain the insufficient disclosure, for more information about them see: S Schwarcz, 'Disclosure's failure in the subprime mortgage crisis' (2008) *Utah Law Review* 1109.

contribute to a more accurate assessment of the systemic risks in securitisation.<sup>136</sup> They have also set up criteria for these principles, which are non-exhaustive and non-binding, to help investors with their due diligence on securitisation so as to determine the risks and value the investment.<sup>137</sup>

Also, the European Central Bank (ECB) has developed eligibility criteria, with two goals: to determine the asset that will be permitted as collateral, and to enhance standardisation and transparency in the securitisation market in order to enhance investors' confidence.<sup>138</sup> The demand to structure the disclosed information has stimulated the ECB to develop templates, which are designed to ensure compliance with data protection and confidentiality regulations, while requiring specific information to be standardised and disclosed.<sup>139</sup> The ECB's initiative is intended to improve transparency, clarify the information for investors and other securities market participants, and keep CRAs up-to-date with information related to their credit and cash flow models.<sup>140</sup> Such initiatives indeed minimise complexity by ensuring that only relevant information is disclosed, avoiding the information overload that produced the complexity.

When an attempt is made to apply the above principles of transparency in the Saudi jurisdiction, it is observed that the Saudi legislator remains outside the latest developments in this field, despite the enactment of the housing finance laws 2012 in the wake of the global financial crisis 2007. This is not meant to undermine the initiatives adopted by the Saudi legislator in the housing finance market, but to shed light on areas that need to be developed.

Accordingly, the Saudi legislator, firstly, needs to avoid relying solely on full disclosure as the main means of enhancing transparency, inasmuch as the application of this idea has not achieved its goals in cases where the investors and other securities market

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<sup>136</sup> Bank for International Settlements, 'Criteria for identifying simple, transparent and comparable securitisations' (*bis.org*, July 2015) <<http://www.bis.org/bcbs/publ/d332.htm>> accessed 12<sup>th</sup> November 2016.

<sup>137</sup> Bank for International Settlements, 'Criteria for identifying simple, transparent and comparable securitisations' (*bis.org*, July 2015) <<http://www.bis.org/bcbs/publ/d332.htm>> accessed 12<sup>th</sup> November 2016.

<sup>138</sup> H Reden, 'Regulation of securitised products post the financial crisis' (2013) 2 UCL journal of Law and Jurisprudence 112.

<sup>139</sup> For more information visit ; European central bank, 'Loan-level data templates' (*ecb.europa.eu*, 17<sup>th</sup> June 2013) <<https://www.ecb.europa.eu/paym/coll/loanlevel/transmission/html/index.en.html>> accessed 12<sup>th</sup> November 2016.

<sup>140</sup> The ECB has published many reports about above topic for more information visit; European central bank, 'Loan level initiative' (*ecb.europa.eu*, April 2013) <<https://www.ecb.europa.eu/home/search/html/index.en.html?q=loan-level%20data>> accessed 12<sup>th</sup> November 2016.

participants, as seen above, were unable to assess the systemic risks in securitisation. This is not an argument for ignoring full disclosure, but rather for following the latest development on enhancing transparency in securitisation.

Therefore, the Saudi legislator, secondly, is advised to boost the transparency environment before establishing the securitisation market, by adopting the latest developments in the field. Such a task will be easier than anticipated, due to Saudi Arabia's membership of many financial organisations and institutions such as IOSCO and the Board of the International Organisation of Securities Commissions. These organisations have already developed a number of mechanisms and methods for enhancing transparency, which Saudi can utilise and employ in its system.

## **6.8 Conclusion**

The chapter has drawn attention to the process of securitisation by pointing to its nature, function, advantages and main participants. It has observed the impact of securitisation in increasing homeownership through offering borrowers low-cost loans while lenders, such as banks, benefit from a reduced risk of weighted credit exposures, as securitisation offers them the flexibility to remove from the balance sheet the securitised assets, loans and receivables owed to the originator. This in turn enhances the banks' efficiency, enabling them to increase their activities in housing finance lending; in other words, removal of securitised assets from balance sheets will improve the trade books ratio.<sup>141</sup>

The underlying question remains whether such an innovation under Saudi jurisdiction can deliver economic and social outcomes. If on the one hand securitisation would be a means of addressing the results of the oil price collapse, such as liquidity shortages and the new government's austerity policies, on the other hand the difficulties presented by the Saudi legal system, which have been highlighted by this chapter, raise the possibility of securitisation producing unexpected results or at least not leading to the desired results. Although Saudi has recently created the legal framework needed, the housing finance laws 2012, to make securitisation possible, its development could be hindered by a number of regulatory constraints inherent in the Saudi legal system.

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<sup>141</sup> A Orkun, 'Securitisation, the Financial Crisis and the Need for Effective Risk Retention'(2013)14 European Business Organization Law Review 1.

The establishment, for instance, of an entity to perform the function of securitisation is not enough as long as that entity is prevented from carrying out an important process within securitisation, namely issuing bonds. This consideration suggests that it would be unwise to adopt the concept of securitisation but divest it of its main function.

The right of the MBS issuer to sell the pledged property to satisfy the debt in case of borrower default is not clear under Saudi jurisdiction. There is a need to address this issue to enhance confidence in securitisation, particularly as such a market is considered emergent in the Saudi context, and needs to be made more attractive to participants in order to acquire additional funds and investors. Therefore, it is suggested that a bankruptcy remoteness entity be established to maintain the rights of all parties to securitisation and to enhance confidence in the market while stimulating investors to participate in it.

Saudi's membership of a number of international financial organisations, such as the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commission (IOSCO), which are interested in securitisation, could facilitate identification of the level of transparency of disclosure in securitisation, since the obligation of the securitisation market to disclose all information does not promote understanding of the risks that securitisation involves, as seen throughout this chapter. It is clear that international organisations' recommendations offer a general framework for legislators, based on the principle that determining and standardising the information to be disclosed might promote understanding of the risks posed by securitisation, while still avoiding information overload that does not achieve the main goal of disclosure. Therefore, the Saudi legislator is advised to amend the provisions of the Real Estate Finance Law regarding transparency to bring them into line with the latest developments in this field.

For all these considerations, and to build a well-structured securitisation market from a legal perspective, the following legal changes are needed:

- 1- Amending para a. of article (17) of the Real Estate Finance Law to grant the licensed company the function of pooling and selling loans to complete the process of securitisation.
- 2- Establishing a special purpose vehicle (SPV) owned by the government to hold the collateral, that is, the property being financed, and keep it at the same distance from lender and borrower, as explained in detail above.

- 3- Adding a new article to the Real Estate Finance Law to oblige the main participants in securitisation to identify the information that will be disclosed in securitisation in order to promote the level of transparency and to facilitate understanding of the risks that securitisation involves.

In summary, it is believed that the establishment of a well-structured securitisation market could not occur in current circumstances, but would require a certain degree of legal guidance in order to maximise the market's efficacy. Hence, the Saudi legislator is strongly advised to take into account the above recommendations to achieve the highest level of desired results of applying securitisation in the Saudi jurisdiction, while preventing a repetition of the global financial crisis 2007 in Saudi.



## Chapter Seven: Conclusion

### 7.1 Summary

This thesis has sought to explore ways in which Saudi Arabian laws for housing finance might be improved, so as to encourage the development of the housing finance market. However, the task was not easy because the development of housing finance in Saudi Arabia is a moving target that, in recent times, has been influenced by significant economic and political upheaval, such as the collapse of oil prices and the *Saudi Vision 2030*. These circumstances have made the task of development and improvement very difficult. This situation has, in turn, created a new challenge in relation to the development of housing finance, in the form of a general liquidity shortage, which has changed the Saudi government's priorities, particularly in relation to the housing finance market. However, the thesis accommodates such influences, and takes into account possible economic, political and legal circumstances that might impact on suggestions made for the development of the housing finance market.<sup>1</sup>

The research aimed to achieve the following objectives: to suggest a mechanism to enhance the efficiency of the main participants in the housing finance market, namely, the lender and borrower, and to provide them with adequate protection; to make suggestions to facilitate access to the housing finance market and to build up a strong regulatory framework for regulating that market; and, finally, to address potential legal barriers to the provision of cheap liquidity in the market. The research confirmed that, in spite of the enactment of the Housing Finance Laws (2012) which were enacted with the similar above objectives, four issues still present significant obstacles to the development of the housing finance market, and some are the result of the provisions of the Housing Finance Laws (2012).

It was necessary at the beginning of the research process to determine what barriers hindered the achievement of the above objectives, in order to clear the way for the thesis to examine and analyse these barriers and to propose solutions. To do this, Chapter Two of the thesis reviewed the interventions made by the government and legislative authorities in the development of the housing finance market during the last thirty years to address two housing shortage phases, the first between the 1970s and the mid-1980s,

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<sup>1</sup> Chapter Two, Section 2

and the second beginning in the late 1990s and which persists to this day. The thesis confirmed that interventions and initiatives undertaken by both the Saudi Government and legislative authorities succeeded in addressing the first housing shortage only. The thesis asserted that despite significant measures and initiatives taken during the last ten years, including the enactment of the Housing Finance Laws (2012), which aimed to build up a well developed housing finance market, these measures were unable to address the second housing crisis, and the public were let down by modest outcomes.<sup>2</sup>

The thesis identified four factors that work as barriers to achieving the desired objectives, and these barriers could be the subject of legal reforms. The first barrier is the lack of protection granted to participants in the housing finance market as a result of the Supreme Judicial Council's (SJC) decision to deprive lenders and borrowers of a mortgage mechanism to secure their interests in financed property. Furthermore, an increase in land prices has led to negative effects in the housing finance market, mainly due to the rise in the cost of borrowing. This hinders first-time buyer access to housing finance. The only solution advanced by the Saudi Government and legislative authorities to address this issue was the enactment of the Land Fees Law (LFL) (2016). Therefore, it was necessary to analyse this law and its provisions to see whether or not the law tends to precipitate either a decrease in the market value of land, or an increase in its supply. The third factor is the high value down payment required under Article 12 of the Regulation Real Estate Finance Law (RREFL), which restricts first-time homebuyers' access to the housing finance market. Fourthly, and finally, the thesis examined the legal changes needed to enable the establishment of a securitisation market for the purpose of providing cheap liquidity in the housing finance market, and to address liquidity constraints in Saudi Arabia that have been caused by the oil price collapse.

Bearing these considerations in mind, the thesis then explored the improvement of the legal infrastructure. It suggested measures which might enhance the effectiveness of the housing finance market, so as to provide an efficient, healthy and practical commercial environment for housing finance market participants, and to facilitate access to the market for potential first-time homebuyers by lowering lending costs and providing the desired level of protection.

There has long been a need for Saudi Arabia to develop and improve its housing finance market, not only to meet current domestic demand and to rectify the second era of acute

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<sup>2</sup> Chapter Two, Section 2.

housing shortage, but also to strengthen the housing finance market to a point where it can cater for the demand for housing finance in any circumstances. This is especially so in light of the absence of successful government initiatives designed to address the housing crisis, a factor which confirms the view that no lasting solution can be found without the support and engagement of the private sector.<sup>3</sup> Therefore, the importance of this thesis derives from the belief that it is consistent with the Saudi Vision 2030, which explicitly conveys the Saudi Government's intention to pave the way for the private sector to flourish within the housing sector.<sup>4</sup> An analysis and assessment of the improvement of legal infrastructure, as provided in this thesis, is vital for the future development of the housing finance sector in Saudi Arabia, and this thesis has sought to help the Saudi Government in its task of creating an attractive environment for private sector investment, to assist in the government's role to facilitate access to the housing finance market for potential first-time purchasers, and to maintain the financial system in the country.

The thesis benefits from the use of a combination of theoretical, doctrinal and contextual approaches to enrich its content and to establish a strong foundation on which to propose possible avenues for reform, to achieve the above described objectives. Although the thesis focused on the situation within Saudi Arabia, in that cases and data examined rules and legislations pertaining to the housing finance market and financial system of KSA, some lessons were learned from three other jurisdictions: namely, the UK, Hong Kong and the US, and these issues were dealt with in Chapters Four, Five and Six respectively. Finally, as mentioned at the beginning of this thesis, the barriers selected for consideration are not the only challenges that exist to the development of the housing finance market in Saudi Arabia.<sup>5</sup> Other legal challenges are apparent in every aspect of this field. However, the constraints of a doctoral research project forced the researcher to limit the scope of the thesis to those barriers that were considered to be major hindrances to the development of the housing finance market, and these barriers were chosen due to their importance.

## **7.2 Research Findings**

As noted above, Chapter Two reviewed the initiatives undertaken by the Saudi Government and legislative authorities to develop the housing finance market and to address the housing shortage of the last thirty years. Chapter Two then identified four

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<sup>3</sup> Chapter Two, Section 1.4.

<sup>4</sup> Saudi Vision, 'A development digital infrastructure' (*vision2030.gov.sa*, April 2016) < <http://vision2030.gov.sa/en/node/97> > accessed 13<sup>th</sup> November 2016.

<sup>5</sup> Chapter One, Section 5.

barriers to the development of the housing finance market which remain unaddressed, despite government and legislative initiatives initiated in response to the housing crisis.<sup>6</sup> These barriers, in fact, constitute the substance of the research questions, and, accordingly, were dealt with in its chapters.

### **7.2.1 The Findings of Chapter Three**

Chapter Three analysed the impact of the decision of the Supreme Judicial Council (SJC) on the development of the housing finance market. This decision deprives lenders and borrowers of the mortgage mechanism by which to secure their interests in financed property. The chapter also asked whether or not the provisions of the Housing Finance Laws (2012) overturned that decision. Finally, the chapter aimed to put forward an alternative solution to bridge the gap produced by the SJC's decision.

Although there have been many attempts to overturn the SJC's decision during the last thirty years, the analytical study conducted as part of this thesis confirmed that the decision remains immune to amendment and overturning by the Saudi regulators and the legislations, including the Housing Finance Laws (2012), as long as the initiative to amend or overturn does not emerge from the Supreme Court. Chapter Three asked whether Islamic finance transactions (IFTs) could be used as a solution, and if so, are banks correct in asking to use such transactions to secure their interests in properties being financed, even though borrowers lack the same degree of protection, and the risks surrounding these transactions appear to have undermined such protection as is afforded to lenders, particularly when compared to that offered by a mortgage.<sup>7</sup> The analytical study carried out in Chapter Three found that IFTs may be suitable in some instances, primarily with regard to religious matters, but in terms of acting as substantial protection, like that provided by a mortgage, these transactions are susceptible to failure.

The analytical study illustrated three risks involved in using IFTs which might impair the protection provided to the borrower and the lender. These are: the risk of re-characterisation of these transactions, due to the fluctuation between sale and lease contracts; the lack of protection granted to the borrower; and, finally, the absence, in these transactions, of priorities given to the lender in case of borrower insolvency. Borrowers

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<sup>6</sup> Chapter Two, Section 5.

<sup>7</sup> Chapter Five.

in particular are not given the same protection afforded to lenders by IFTs, and may find themselves, in some circumstances, losing what is likely to be their most valuable asset. The risk of the re-characterisation of such transactions may expose lenders to the risk of a lease contract being re-characterised as a sale agreement, and this outcome would, of course, be highly detrimental to lenders who are anxious to see their interests protected. Chapter Three sought to develop a collateral security structure to plug the gap left by the decision of the SJC, and at the same time address the risks involved with IFTs.<sup>8</sup> The solution lies in the concept of the *Adel*: a trusted and honourable person selected by both the lender and borrower to hold the collateral. This concept is derived from Islamic law, and is similar to that of the trustee in the western sense, and the main function of the *Adel* is to hold the collateral. The chapter developed the concept of the *Adel* and proposed the establishment of an entity similar to the Special Purpose Vehicle (SPV), owned by the government, which would be trusted by both borrowers and lenders in the housing finance market. The SPV would be a third party in all housing finance contracts. The borrower would retain ownership of the property to be financed to grant him adequate protection in this bargain, while the financed property would be mortgaged in favour of the SPV to secure the lenders' rights.

The adoption of the above collateral security structure may enhance confidence in the housing finance market on both sides, and this will benefit both lenders and borrowers alike, as well as encouraging the market to adopt fresh financial innovations to make it easier to obtain housing finance, such as securitisation. The collateral security structure is also somewhat novel, and this might open the gate for Islamic countries that are presented with a similar dilemma to adopt such measures, in order to avoid committing sin, *riba*, and to provide the housing finance agreement with the desired level of protection.

### **7.2.2 The Findings of Chapter Four**

Although the rise in land prices has significantly affected the ability of first-time buyers, financiers and developers to obtain housing finance, the only solution advanced to address this issue has been enactment of the Land Fees Law (LFL) (2016). Chapter Four sought

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<sup>8</sup> M McMillen, 'Islamic Sharia –compliant project finance: collateral security and financing structure and financing structure case studies'(2001) 24 *Fordham International Law Journal* 1184.

to determine whether the LFL, which imposes a levy constituting 2.5% of land values annually, tends to precipitate either a decrease in the market value of land or an increase in its supply. In addition, the chapter attempted to shed light on two legal concerns: the lack of fairness resulting from the wording of the LFL, along with a possible overlap of liabilities and obligations stemming from the LFL and *zakah*.

It was evident that the political will had a significant effect when the law-making process was accelerated to enact the Land Fees Law 2016.<sup>9</sup> Although the enactment of the LFL was considered a significant achievement by the legislative authority, due to its success in taxing individuals based on a demand from the individuals themselves,<sup>10</sup> the LFL cannot be considered the best solution to resolve the increase in land prices problem, because of the questionable effect the LFL has on land values, especially relating to the application of land taxation.<sup>11</sup> In addition, the lack of clarity surrounding the aim of the LFL might impair its application and make its objectives questionable, in so much as that aim has been inconsistently presented (varying between decreasing the market value of land and increasing its market supply). The chapter indicated that the relevant economic research failed to confirm that land taxation would definitely lead to either a decrease in the market value or an increase in the market supply of land.<sup>12</sup> Therefore it could be argued that there is a disparity between the aims of the LFL, and this might reflect negatively on the results of its application in the future.

Taking into account all the above considerations, to achieve the aim of developing the housing finance market there is a need to establish an independent committee of respected economists in order to study land value in Saudi Arabia. Their job would be to determine the main elements that affect land value, and then to prepare a report similar to Barker's report of 2004.<sup>13</sup> This recommendation, if followed, should make it possible to determine what elements can contribute to an increase in land value, and to propose measures to counteract this trend.

The chapter then moved on to examine two legal concerns that emerge from the wording of the LFL: the lack of fairness, and the possible overlap of liabilities and obligations resulting from both the LFL 2016 and *zakah*. With regard to the first concern, it was

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<sup>9</sup>Chapter 4, section 2.

<sup>10</sup>Chapter Four, Section 2.

<sup>11</sup>Chapter Four, Section 4.4.2.

<sup>12</sup>Chapter Four, Section 3.

<sup>13</sup>Chapter Four, Section 2.

confirmed that exempting lands of less than 5000m<sup>2</sup> from the LFL's liabilities is unfair, due to the absence of legal or economic justification for this exemption. In practice, according to the LFL, landowners who own larger pieces of land can avoid liabilities by disposing of lands so that they only own land less than 5000m<sup>2</sup>, leaving the final consumer to bear the land taxation.<sup>14</sup> Thus, by implication, this actually worsens the situation.<sup>15</sup> We can assume that the law aims to increase land supply by encouraging landlords to develop their land and then sell it on the market. But this, of course, will lead to an increase in land supply. Chapter Four raises concerns that the exemption of land under 5000m<sup>2</sup> might encourage landowners to change their behaviour and decrease the size of their land portfolio in order to evade taxation liabilities. Such a development would represent a failure to achieve the goals of the law.

Accordingly, the chapter concludes that the law's enactment discloses an eagerness to appease citizens who demand the levying of taxes on extensive landholdings, and, therefore, it fails to impose the levy on the basis of justice and equity. Instead it adopts a short-term approach to what may be a long-term problem. Thus, there is a need to realize the goals of equity and justice in the LFL by amending its provisions to cover all land, as there is no legal or economic reason to support the allocation of tax on the basis proposed by the LFL.

The second concern raised in Chapter Four concerns the possible overlap of liabilities and obligations stemming from LFL and *zakah*, the latter being an Islamic instrument similar to tax. When the legislative authority redrafted the LFL 2016, it amended the level of the charge set by the law from \$24 to 2.5% of the land value annually, and changed the name of the law from the land taxation law to the land fees law. Both changes were made in order to achieve the *Islamisation* of the LFL and to avoid opposition from the Council of Senior *Ulama* (CSU), which is an official institution in charge of issuing religious opinions in Saudi Arabia (they believe that taxation is contrary to Islamic law). Chapter Four explored the idea that *Islamisation* can be achieved by simulating the level of *zakah*, and imposing a 2.5% levy of land value annually, thus bringing the law much closer to *zakah* and meeting the standards of the CSU.<sup>16</sup>

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<sup>14</sup> Chapter Four, Section 3.

<sup>15</sup> Chapter Four, Section 4.

<sup>16</sup> Chapter Two, Section 5.

The argument asserted that the payment imposed by the law is regarded as *zakah* despite the LFL being called the land fees law. The concern arising from the above mentioned change is that the wording of the LFL has confused Muslim landowners in Saudi Arabia, and they do not understand whether or not, if they paid 2.5% as the liability imposed by the new law, they are still required by Islamic law to pay 2.5% of the land value as *zakah*. This confusion has arisen due to the similarities between the liabilities and obligations resulting from the LFL and *zakah*. To avoid such confusion it is necessary to make the wording of the provisions of the LFL 2016 solid, accurate and coherent. Therefore, the chapter recommends that the LFL be amended in two ways. Firstly, the name of the LFL should be changed from the 'land fees law' to a 'land *zakah*' in order to avoid the impression of a potential overlap between the two instruments, and possible resulting dual liabilities and obligations incurred by individuals. A second recommendation aims to avoid possible evasion of LFL by landlords: once the name of the law is changed to 'land *zakah*' the registration of land in the name of non-Muslims can take place, because this kind of ownership would not be caught by *zakah*, because of the non-Muslims' exemption from the obligations set by *zakah*. For this purpose, it was recommended that the LFL be amended to include a provision imposing fees equal to 2.5% of the land value annually on land owned by non-Muslims.

### **7.2.3 The Findings of Chapter Five**

Chapter Five confirmed that the development of the housing finance market has been hindered by article (12) of the Regulation Real Estate Finance Law (RREFL) which capped the Loan to Value (LTV) at the low ratio of 70% (this stipulates a high down-payment requirement equal to 30% of the total house purchase). The chapter sought to achieve two aims: the first was to develop the regulatory framework for the management of the housing finance market in general, and for the adoption of a macro-prudential policy, of which LTV is one element, in order to avoid a conflict between the general aims of the Housing Finance Laws (2012), of which the RREFL is one law, as is and the application of article (12). The second aim was to determine how to mitigate the adverse impact on the housing finance market of applying LTV.

To achieve these aims, the chapter explored the practices of two developed countries (the UK and Hong Kong) when adopting and applying a macro-prudential policy, including LTV, in order to gauge the extent to which Saudi Arabia can draw on their experiences.



It was evident that capping the LTV at the low ratio of 70%, as imposed by article (12), may be suitable for certain policy areas (primarily banking and financial matters which require protection from excessive lending), but in the context of housing finance, its application is liable to conflict with the main aims of the Housing Finance Laws (2012), namely to facilitate housing finance access, as announced by both the Saudi Government and the *Shura* Council.<sup>17</sup> This conflict between the application of article 12 and the main aims of the Housing Finance Laws (2012) was the main research finding of Chapter Four. It was discovered that there is a disparity between the aims of the laws and the results of applying those laws.

The enactment and application of article (12) of the RREFL demonstrates the vexed issue of a lack of cooperation between government agencies, including the financial authorities and the legislative authority, which of course represents a significant barrier to the development of the housing finance market. The chapter analysed the formulation and application of article (12) of the RREFL and confirmed that the article has three consequences: a mismatch between the main aims of enacting the Housing Finance Laws (2012) and their implementation in connection with the LTV; a lack of cooperation between Saudi financial authorities in the housing finance market; and the absence of an alternative solution to address the possible adverse impact of the LTV. These consequences suggest the existence of a defect in the regulatory framework for regulating the housing finance market in general, and in the adoption of a macro-prudential policy in particular.

The chapter then outlined the critical analysis undertaken to determine the defects in the regulatory framework in relation to three aspects: decision making, the integration of policies and legislations, and accountability. The critical analysis observed that the Saudi Arabian Monetary Agency (SAMA), which was authorised to draft the RREFL, works apart from other government agencies and the legislative authority. In addition, the analysis confirmed SAMA's inability to justify its drafting in relation to the 70% LTV cap, along with its failure to publish studies and research on the LTV to increase public's awareness about its function and adverse impact. Finally, it was found that SAMA enjoys unlimited authority to regulate and supervise the housing finance market, mainly due to the absence of the principle of accountability, and this might explain why SAMA did not respond to criticisms about its decision to cap the LTV at the low ratio of 70%. In contrast,

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<sup>17</sup> Chapter Five, Section 4.

the experience of the UK and Hong Kong demonstrates that Saudi regulators have not adopted the proper legal format for applying the LTV policy, and this is quite apart from the negative impact that capping the LTV at 70% has on first-time homebuyers.

The UK's experience, in respect of using legal procedures and gathering information before making a decision about adopting a macro-prudential policy, clearly demonstrates good cooperation between their financial authorities, and the government. This good cooperation is shown by the UK Government's willingness to participate in decision making while enabling the financial authorities to apply the policy in question, including mechanisms that have been created to help people with housing finance. The principle of accountability is relied on in the UK jurisdiction, and both UK Parliament and the UK Government have refrained from granting unlimited authority in this field to the competent authority in charge of dealing with macro-prudential policy, namely the Financial Policy Committee (FPC). This is to avoid any possible adverse impact on UK economic growth, which, of course, requires limits to be placed on the FPC's authority.

In light of the UK's experience, and to avoid a conflict between the aims of legislative and government policies regarding the housing finance market in Saudi Arabia, it is suggested that an independent committee be established which emulates the composition of the (FPC), in order to exercise the function of drafting and applying the macro-prudential policy. However, there is an urgent need to ensure that the proposed committee be accountable to the Economic and Development Affairs Council (EDAC) in order to promote a culture of transparency and to enhance confidence in the housing finance market. In the adoption of critical financial system reform, the suggested committee will be required to allow cooperation between all financial authorities and the Saudi Government in the area of housing finance, as seen in the UK.

Also, it is suggested that the provision of article (12) be removed, while all the provisions of RREFL for regulating the provisions associated with real estate finance, including its participants and activities, etc., be retained. With regard to the macro-prudential policy, including the LTV ratio, it is suggested that guidelines be enacted by the proposed committee.

With regard to the adverse impact of the LTV, especially on first-time homebuyers, the experience of Hong Kong was explored. The analysis revealed that Saudi authorities have failed to create or use a mechanism to mitigate the detrimental effect of LTV's on housing finance activities. Hong Kong's experience provides a very good example of how

effective cooperation between financial and governing authorities can work in relation to the housing finance market. In addition, the financial authorities in Hong Kong were successful in mitigating the adverse impact of applying an LTV, while still protecting financial stability. In the light of the similarities between Hong Kong and Saudi, the Saudi financial authorities are advised to copy Hong Kong's model for dealing with an LTV through the application of a Mortgage Insurance Programme (MIP), which serves to increase home ownership rates, to mitigate the detrimental effect of the LTV, and, finally, to maintain the financial system .<sup>18</sup>

#### **7.2.4 The Findings of Chapter Six**

Why does Saudi need to launch a securitisation market in the context of the development of the housing finance market? If, indeed, this need exists, will there be a consequent need to reform the Housing Finance Laws (2012) so as to build up a well-developed securitisation market? These questions were central to the discussion undertaken in Chapter Six.

It is clear that the Saudi housing market lacks certain financial innovations, such as the mechanism of securitisation, and it depends largely on conventional fiscal tools, despite the known advantages provided by securitisation in both the housing and banking sectors. Chapter Six examined the need to establish a securitisation market in Saudi Arabia in light of current circumstances such as the collapse of oil prices, which has resulted in a liquidity crisis (a negative financial situation characterised by a lack of cash flow) and, in turn, this has had a negative effect on the housing finance market. It was held that, besides the aim of addressing the liquidity crisis, the establishment of a securitisation market is needed to contribute to the development of the housing finance market through reducing the cost of borrowing, providing cheap liquidity, and reducing the risk to lenders of holding housing finance loans for a significant length of time.

The chapter also found that the Housing Finance Laws (2012) have paved the way for the establishment of a securitisation market in Saudi, via a number of rules and principles. However, the examination and analysis conducted in Chapter Six revealed that, in the current circumstances, it would be unwise to establish securitisation market due to the legal changes that are needed.

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<sup>18</sup> Chapter Five, Section 5.6.3.

At the beginning of the development process it is crucial for legislators to widen their understanding of securitisation in order to introduce a proper legal system that is derived from the experience of other jurisdictions, but adapted to suit to the interests of the Saudi nation and be compliant with the domestic legal system. The provisions of the Housing Finance Laws (2012), however, do not represent such a system, because they fail to address a number of issues. This is in spite of assurances made by Saudi legislators that the laws offer protection for all participants and take account of the factors that contributed to the global financial crisis of 2007-2008.<sup>19</sup> An examination of the former claim found that if we wish to introduce securitisation in Saudi Arabia, to develop the housing finance market within a framework that is coherent, rational and workable, then a new raft of legal reforms and governmental initiatives are required.<sup>20</sup> It is difficult to argue that Saudi legislators succeeded in introducing comprehensive legal form when they provided neither the desired protection for the participants using securitisation, nor avoided the factors which precipitated the financial crisis of 2007, as they claimed to have done.

The securitisation market, by its nature, is not like other markets; it requires a high degree of confidence, protection for market participants, a high level of transparency, and a full understanding of its intricacies in order to deliver optimal economic and social outcomes. These characteristics cannot be provided by the Housing Finance Laws (2012), due to the three legal changes that are needed, as shown by the examination conducted in Chapter Six. It was found that the main player in securitisation, the mortgage backed security (MBS) issuer, is prevented, by article 17 of the Real Estate Finance Law (one of the Housing Finance Laws (2012)) from exercising the key function of pooling and grouping loans, and then selling them in the secondary mortgage market. Therefore, it is unlikely to attract the participation of national financial institutions, including banks, in the market, let alone international institutions, when they are excluded from the main advantage offered by securitisation. Thus it is questionable why Saudi legislators adopted such a restriction without a clear reason, whereas other markets, whether developed or emerging have declined to do so.<sup>21</sup> This action gives the impression of a failure to understand the securitisation process, which is reflected in the drafting of article 17. The

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<sup>19</sup>Chapter Six, Sections: 3, 4.

<sup>20</sup>Chapter Six, Section 7.

<sup>21</sup> Integrated Financial Engineering, *Mortgage securitization: lessons for emerging markets* (PD&R 2007) 39..

Saudi legislative authority is advised, therefore, that any potential entity established under article (17) (to act as MBS issuer) should be granted the functions of pooling and selling loans to complete the process of securitisation.<sup>22</sup>

The Housing Finance Laws (2012) lack another critical characteristic, namely the protection of the rights of the MBS issuer in the event of the borrower's default in the securitisation process. It was shown that the Real Estate Refinance Company (RERC), (which will act as the MBS issuer based on article 21 of the REFL), would lose its rights in cases of borrower default, due to the ownership of the financed property being retained by the lender.<sup>23</sup> The legislator should consider a solution that does not conflict with Islamic law, yet can achieve the desired level of protection for all parties. One solution is to create bankruptcy remoteness between the lender and the RERC (MBS issuer). This guarantees that any borrower default would not impact the RERC's interest in selling the financed property to satisfy the debt without exposing the RERC to conflict with the lender. Although creating such an entity would be a new development under Saudi jurisdiction, it would serve the purpose of enabling the securitisation process to achieve its main goals. There is no indication of any potential barriers to this solution, either from a legal perspective or from the perspective of Islamic law, and this reinforces the possibility of its adoption by the Saudi legislators.

Finally, although it is clear from the evidence provided that a lack of transparency played a crucial role in generating the global financial crisis of 2007, this matter was not given enough attention in the drafting of the Housing Finance Laws (2012), and in particular the REFL.<sup>24</sup> However, this lack of transparency cannot be addressed through insisting on the disclosure of all relevant information in the securitisation market. This is mainly because of the potential for a resulting information overload, which caused some problems during the financial crisis of 2007.<sup>25</sup> Therefore, it is asserted that promoting a culture of transparency is essential, because the requirements in securitisation have shifted from a trend towards the disclosure of all related data to the standardisation of transparency and the disclosure of specific information, in order to avoid information overload. Accordingly, there is a need to reform the REFL by adding a new article to the

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<sup>22</sup> Chapter Six, Section 5.

<sup>23</sup> Chapter Six, Section 6.

<sup>24</sup> Chapter Six, Section 7.

<sup>25</sup> Chapter Six, Section 7.

law to oblige the main participants in securitisation to identify information that will be disclosed for securitisation, rather than disclosing all information, in order to promote a satisfactory level of transparency and to facilitate an understanding of the risks that securitisation involves. The chapter then recommended that the Saudi authorities take advantage of their membership of financial organisations and institutions, such as the International Organisation of Securities Commission and the Board of the International Organisation of Securities Commissions, which have already developed a number of mechanisms and methods for enhancing transparency in securitisation. The initiatives of these international organisations aim to minimise complexity by ensuring that only relevant information is disclosed, and, thus, avoiding the disclosure of all information.

### **7.3 Conclusion**

It evident that any efforts or procedures aimed at addressing the housing shortage and enhancing the effectiveness of the housing finance market in Saudi Arabia will lack the confidence of the public, due to the modest consequences of prior initiatives.<sup>26</sup> In addition, the policies and initiatives regarding housing and housing finance invite concerns as to their eventual implementation and effects, because they indicate a lack of any coherent vision, as seen in the LFL (2016) and the application of the LTV article (12) of the RREFL. This thesis, therefore, offers a strong theoretical basis, coupled with the practical recommendations to provide methods to improve and develop the housing finance market. This thesis is the most detailed and systemic response to the development of housing finance in Saudi Arabia undertaken, because it covers several aspects whilst also taking into account the general principles of Islamic law and the Saudi legal system.

It would seem that this thesis is the first to deal with the development of the housing finance market in Saudi Arabia. Surprisingly, so far, there has been no significant research devoted to reviewing the housing finance market so as to provide a framework to develop the housing finance market from a legal perspective. However, having completed this investigation, it is hoped that this thesis will contribute to the field, and build a foundation on which clear guidelines can be constructed, and be used for further research into the subject.

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<sup>26</sup> Chapter Two, Section 4.



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