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REAL ESTATE, THE DIRECT CONTRIBUTOR TO THE DEBT CRISIS

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Naveed Siddiqui
CEO of Capitas International

By Sindhu Nair

Naveed Siddiqui is an expert in startup finance business. He has to his credit launches of numerous Shariah-compliant investment products. His expertise in introducing the first national Shariah-compliant commercial real estate financing platform in the US endorses his position. He is the CEO of Capitas International, doing what he does best, launching multiple Islamic mortgage and specialty finance businesses.

He talks to *Qatar Today* on the financial climate of the country.

The crisis and its end?

Siddiqui believes that the crisis is still not over. He feels that the undercurrents are still prevailing.

"Currently, there are a number of dynamics we need to be aware of around the world as well as here in the GCC. The sovereign debt pressures we are seeing in the EU are signs that, aside from the private sector, governments have over-extended themselves beyond their means. The crisis in Greece is a clear example of this. In the US, while the issues close to the subprime crisis have leveled off the outlook for the commercial real estate sector, a major component of bank lending remains negative. The rating agency Fitch recently stated that exposure to commercial real estate will require US banks to take more losses in 2010 – which will limit the amount of credit they will extend to the market."

The GCC countries are in no way immune to these global dynamics, he says.

"GCC economies have had to make tough decisions to handle the financial crisis. As a case in point, Qatar provided liquidity to banks to help them with their troubled assets. In Saudi Arabia, the government had to take the surplus generated from its oil exports to increase its budget. Its large indigenous consumer base and religious tourism sector helped to sustain the Saudi economy. However the government had to step in to avoid even tougher economic times."

He is of the opinion that the financial crisis has brought a major correction to

asset values around the globe.

"We won't return to the types of economic activity – the affluence, high levels of spending, and over flow of credit – we saw some years back and we shouldn't be expected to since most of that activity lost focus on the fundamentals of markets and finance. We need a more measured approach to growth that is sustainable and brings risk-managed business transactions to creating equally sustainable demand.

The real scenario

While some markets around the globe are slowly regaining their footings, the real estate sector still seems to be wavering. The reason, according to Siddiqui, was because the growth was infused artificially.

"It grew beyond the limits of what was sustainable from a demand perspective. There was an oversupply of liquidity credited to undeserving obligors who never had the capacity to repay. Thus, there was no risk strategy focused on the sustainability of the sector. All the players – developers, financiers and regulators – were unfair to markets that grew too high, too fast and may still be falling from that height."

We have to see where the RE market was before the crisis to consider how and when it will recover, he says.

"The RE sector was a direct contributor to the debt crisis. There was too much development for an end market which was over-extended through undeserved credit to drive transactions in the real estate sector. To top it off, that development was financed by debt packages underwritten on the assumption that the property will appreciate over time. At its most fundamental level, the RE market is based on absorption – you need people and companies to occupy the space that's built. That requires a real, local market with proven demand."

But some of the immediate effects of the RE downturn in the GCC have been addressed. And a case in point, according to Siddiqui is Qatar, whose government infused large sums of money into the banking sector to help it temporarily cover its exposure to the large real estate projects it financed.

Even with such measures someone has to absorb these assets, he says.

"It will take time to recover in markets such as Dubai and even in Qatar where there was a significant amount of over development."

"It will take time to recover in markets such as Dubai and even in Qatar where there was a significant amount of over development. In Qatar, for example, recovery will happen when local market demand absorbs the stock of available real estate. These local markets will be created through new business generations which will lead to an increasing demand for commercial property and housing for larger employee bases.

"The market with the most robust local market is Saudi Arabia. They will lead the recovery, with its pent up demand for at least 150,000 residential units per year over the next 10 years."

Loan application versus disbursement

The loan applications far outpace the loan disbursements in GCC. Siddiqui analyses the reasons behind this.

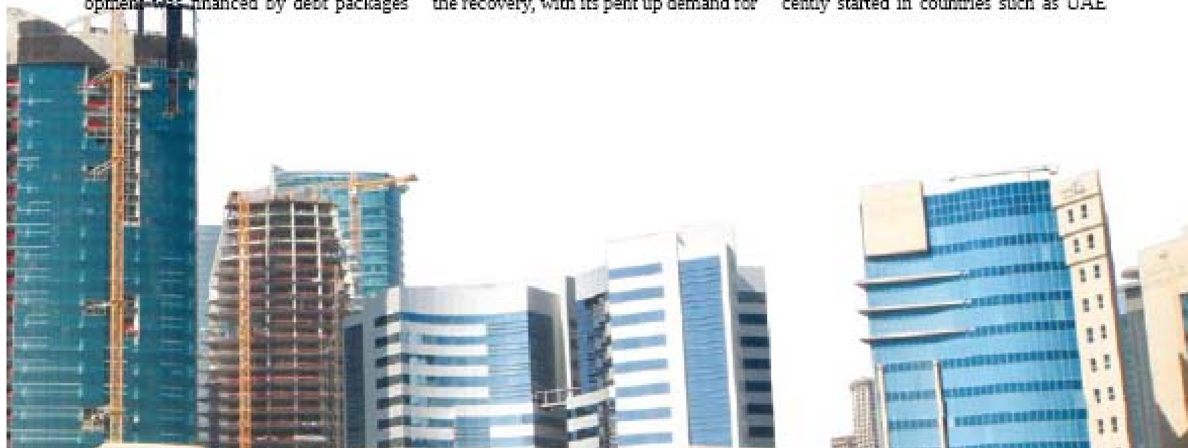
"First, banks haven't made mortgage finance a priority, so they remain unfamiliar with the nuances of mortgage finance. They are more accustomed to selling short-term credit products to customers for higher, short-term returns. Aside from the banks, there is also a shortage of dedicated mortgage providers in the market. So customers who are looking for financing are not properly serviced by banks and the number of mortgage providers in the market isn't enough to service the demand.

Second, says Siddiqui, there is a lack of standardised underwriting and credit in the market.

"Existing lenders don't know how to properly measure the risk of the clients or the assets they are financing. For example, if a financier wants to assess the quality of a home for financing, they would want to collect market information such as vacancy, rental rates, construction completions, property sales in the same area, and more. These types of data aren't systematically recorded in many of the GCC markets or are just beginning.

"In addition, when a financier wants to assess the credit worthiness of a borrower it is very difficult to verify their income and balance sheet information."

Consumer credit reporting has only recently started in countries such as UAE



INSURANCE PRODUCTS *AND THE LACK THEREOF IN GCC*

Siddiqui talks about this lack which was identified in one of Capita's reports.

"The point about insurance products in our reports is relevant specifically to the real estate and housing sectors. In more developed housing markets, the finance industry has evolved mechanisms to manage its exposure to risk beyond the basic underwriting methods which assess the three 'Cs' of underwriting a loan to a borrower (collateral, capacity, and character)."

Specifically, various insurance products such as life insurance, property insurance, mortgage insurance, and hazard insurance are used to manage risk in home financing scenarios. For example, property insurance is generally a requirement for residential mortgages in the US to protect against possible loss due to significant damages to the property. Mortgage insurance is often obtained to offer partial or full protection against loss in the event of a default. Often, mortgage insurance will only be required for financings where the customer exceeds standard funding ratios and an extra layer of protection is needed to qualify the customer for a financing programme. Mortgage insurance may become especially important in the GCC until foreclosure laws are more clearly established.

"The insurance market will no doubt grow in response to the stimulus of the mortgage market. We believe that much of this development will happen in the Takaful sector which is a critical part of the growth of Islamic finance. In the meantime, an immediate solution can be affected by the public sector, by offering certain key mortgage related products such as Takaful-based property and mortgage insurance."

and Saudi Arabia. Qatar is in the process of establishing a consumer credit bureau.

"In these markets credit reporting does not provide the type of history available in more developed housing markets. This makes lenders even more cautious to provide financing."

"Third, from a legal perspective mortgage laws in most GCC countries have only recently been drafted or are still being considered. Questions remain on the enforcement of vital laws such as foreclosure rights or transfer of title. Overall, there is a perception that in default scenarios, there is limited protection for creditors.

Finally, mortgage markets have to be sustained by an expanded base of institutional investors or an active secondary market that creates liquidity for mortgage assets. More effective underwriting and greater transparency at the origination level is necessary to encourage secondary market development and growth. Governments can take a leading role in this by facilitating the creation of mortgage liquidity centers to create uniform standards and boost investor confidence in the sector," he says.

Project Finance

According to reports from earlier this year there is an estimated long-term project pipeline of $2.8 trillion in the GCC. This included projects in the construction, petrochemicals, Oil and Gas and infrastructure sectors. GCC witnessed a significant reduction in project finance of almost 50% to roughly $20 billion in 2009 from $40 billion the previous year, according to an S&P report. Securing project finance is a difficult proposition now. This has led some sponsors who have excess liquidity to finance projects themselves without trying to access global capital markets.

And the way forward, according to Siddiqui's regulation.

"In general, the sector needs to be better regulated overall. Specifically, governments need to establish active bond and sukuk markets. These will play a vital role in long-term project financing in the region. Improved corporate governance standards and the strengthening of investor protection rights should also improve the appetite for GCC debt whether corporate, sovereign, or project. Finally, there needs to be a joint effort between the public and private sectors. Public Private Partnerships (PPPs) will play a role in allowing all stakeholders to put forward their interests."

Two markets, Dubai and Qatar

Siddiqui compares two markets, in the real estate scenario.

"In Dubai, there is limited local demand for real estate. All of the end occupants are expatriate individuals/companies. This makes for a very challenging market to operate in for real estate finance. At its peak, most of the financing for real estate in Dubai was being issued to expatriates or speculators. The effect of the speculation has been well documented – prices increased artificially in a short amount of time. To top all of this, Dubai borrowed heavily to finance these developments which never really had a proven demand. Financiers didn't assess absorption trends and kept lending against the assumption that they could expect assets to increase in value. It was banking that ignored the fundamentals of credit risk management.

"In Qatar, there are some similarities. For example, local demand is limited. So there are oversupply risks there as well. But in contrast, because of its vast natural resources, Qatar has a base to develop local industry. Qatar can develop various industries related to the oil and gas sector as well as technology and education that will spur local business creation. This will be critical to create long-term employment opportunities that can be filled by locals or expats. So if the businesses are local and they are creating jobs, you have the potential to create a proper supply-demand dynamic for real estate."

In conclusion, he says that Qatar's wealth will allow it to support its development needs internally, rather than borrow on the scale that Dubai did ■