ARTICLES

Affordable Housing's Finance in the Kingdom of Saudi Arabia: Potential Constraints and Solutions

Dr. Bhzad Sidawi*

Abstract:

The demand for affordable housing around the world including Kingdom of Saudi Arabia has increased in the past decades due to rise in income levels, increase in expectation, requirement for a better standard of living, and population growth. In KSA, Islamic banks, joint-stock companies, charities and government organizations such as Real Estate Development Fund REDF are struggling to meet the increasing demand for housing and in financing prospected home buyers. The present financing system seems to be constrained by a number of legal, financial, socio-economic constraints. Thus it seems incapable to meet the present and future financial demand by the growing low-income population. This paper discusses the potential constraints to the affordable housing' finance in KSA. It investigates what banks and other financial organizations are doing to overcome it and whether their plans to tackle the funding problem and ease the constraints are efficient. The study recommends that banks and other financial organizations should join efforts to overcome the problem of finance and to create legislations, mechanisms and tools that are capable to ease these potential constraints and provide sufficient and consistent funding to the low-income clients.

Introduction

In the Kingdom of Saudi Arabia, two types of housing are provided by the government, charities, and other organizations for low income people. The first is the welfare housing which is mainly free and the latter is the affordable housing. The Real Estate Development Fund, however, provides free land plots and long term loans to Saudi citizens.

* College of Architecture and planning, University of Dammam, Al-Dammam, Saudi Arabia.

Affordability can be defined as the ability of the household to purchase [own or rent] a home based on the median monthly costs. Housing can be considered as affordable if, a household pays no more than 30% of its gross income for basic housing costs. In the developed world, affordable housing is defined "housing that can be purchased by families earning between 30% to 80% of the community's median income".

The demand for affordable housing in Saudi Arabia Kingdom has increased in the past decades due a number of factors such as: the variation in income levels, the increase of population who do not have financial resources to buy a property from the traditional market. It is assumed that Saudi population will reach 33.44 million by 2020 and family size to fall to 5.3, and it estimated that 2.32 million new housing units should be built in the Kingdom. This gives a long-term average demand for new housing units of around 145,000 annually from 2005 through 2020 (NCB, 2008). Another report from SAMBA *(Saudi American Bank)* predicates that by 2020 a total of 2.62 million housing units should be built, at an average rate of 163,750 units per annum (SAIF, 2008). The Ministry of Economy and Planning's 8th Development Plan (2005-2009) showed a shortage of nearly 730,000 housing units in the kingdom in addition to the unmet housing demand of 2,7 Million housing units by the end of 7th Development Plan. This demand would be doubled by 2015 (SA housing sector outlook, 2009). However, in the Kingdom of Saudi Arabia, the housing affordability for Saudis and non Saudis would decline substantially because housing prices rises rather faster than incomes. The increase in purchasing power for Saudis is approximately 25%, against a 50% housing price rise (Struyk, 2005). Less number of citizens would afford to buy houses in the future and also to be able to get loans from banks as well. (Aldosary et al, 2007) has supported the view that there is a mass demand for affordable housing within the kingdom, particularly by middle-income Saudi families. He predicated that 906,876 affordable housing units are needed by 2025. This is based on forecasted estimation of the total population as 39.59 million. The real estate market is undersupplied with affordable low and middle-income housing and is expected to be the same case in the future. On the other hand, the financing of affordable housing in the KSA is provided by a number of government bodies, financial organizations including banks and private sector companies. The present research suggests that financial organizations are constrained by a number of barriers (including the ones mentioned above) that limit their ability to meet the present and future demands, develop a feasible strategy and create flexible lending mechanisms to tackle the financing problem. These constraints will be discussed in detail in the following sections.

2. Background to Islamic finance in KSA

Islamic law (or *Shari'ah*) sets rules for Islamic finance[(1)] (Freshfields, 2006). The main principles of Islamic finance include (i) the prohibition of taking or receiving interest (ii) capital must be used in ventures which have social and ethical purpose not just as a means to a source of continuous return, irrespective of whether the money is invested in a profitable venture or not (iii) investments in businesses dealing with alcohol, gambling, drugs or anything else that the Shari'ah considers unlawful iv) a prohibition on transactions involving *maiser* (speculation or gambling) and (v) a prohibition on *gharar*, transaction in which there is uncertainty about the subject-matter and terms of contracts - this includes a prohibition on selling something that one does not own or unlikely will be owning in the future (Freshfields, 2006). Islamic finance is considered to be based on the concept of a social order of brotherhood and communal solidarity. The participants in banking transactions are considered business partners who jointly bear the risks and profits. Islamic financial instruments and products are equity-oriented and based on various forms of profit and loss sharing (Imady and Seibel, 2006). In the Kingdom of Saudi Arabia, a number of Islamic transactions/ financing methods are used by banks and other financial institutions to invest in real estate and provide Islamic mortgage loans to clients. The major type is the *Sukuk*

(1) The basic sources of Shari'ah are the Qur'an and the Sunna, which are followed by the consensus of the jurists and interpreters of Islamic law.

(plural of *Sak*) which are *Shari'ah*-compliant bonds. Sukuk do not pay interest rather they generate a return through actual economic activities in the form of using or leasing the underlying assets. *Sukuk* are generally built around one of the following main contracts which are used by banks in KSA to provide funding to buy properties and these are:

- Al-Ijarah: The bank purchases the assets then rents them to the customer, giving him an option to either purchase the assets during the period of rent or after its completion. It is the most efficient and flexible way to facilitate high cost assets and technology related products.
- Al-Mudarabah: A profit partnership agreement between the bank and the customer, whereby the bank provides complete funding, and the customer manages the business in return for a percentage of the profits - provided there are no losses. The basis of this is good management and a solid business plan.
- Al-Musharakah: Profit and loss sharing. This is a partnership where profits are shared according to an agreed ratio, whereas the losses are shared in proportion to the capital/investment of each partner.
- Al-Murabahah: Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity (for which the loan would have been taken out) from a third party and resells it at a predetermined higher price to the capital user. By paying this higher price over instalments, the capital user has effectively obtained credit without paying interest.
- Al-Istisnaa: An agreement suited for construction projects, whereby the bank signs an agreement to construct a site or a building with the client and transfers the same to the client and then signs another agreement with the construction company responsible for the development. The bank pays them in instalments as the construction progresses.
- Istithmar: This is an investment agreement whereby individuals or companies can invest their money in Shariah-compliant projects, for example Real Estate projects. In this type, as with the other types,

the investor shares the loss and profit with the investing body or bank.

- Al-Silm: An agreement whereby money is paid in advance and the goods are received later. This is considered an important method for funding the agricultural and industrial sectors. The bank in this contract buys "the yet to be produced product'' and resells the same quality and quantity of the product bought via a parallel Al-silm contract.

The above discourse gave some exposure to the Islamic finance based on which any proposed framework for solving the constraints to the financing of affordable housing in KSA has to work.

The financing of affordable housing in the KSA is provided by a number of government bodies, financial organizations and private sector companies (NCB, 2005). These are: the public Sector, REDF, the private sector and joint-stock companies, banks, charities and Welfare organizations. There is a shortage of finance that increases annually, and it was found that REDF contributes heavily towards the funding of the purchase and development of affordable housing. This however is associated with a very slow process of loan applications which would stretch for decades. There is little contribution of the private sector and charities whereas joint stock companies are just starting to operate effectively in KSA, thus, their contribution towards the financing of affordable housing is still intangible (Sidawi, 2009).

3. Constraints on the Islamic financing in KSA

3.1. Socio-economic and cultural constraints

Socio-economical constraints can be defined as the long term Socio-economical constraints that influence the decision of the financing provider thus affect the financing flow to the client. Financial organizations such as banks and REDF are concerned about the way that the property would be used/ altered during the mortgage repayment period as this would affect it's value (Sidawi, 2009). In the Arabic/ Islamic world, it is difficult to control this issue as the tradition of transformation and internal and external alteration of the property is rooted deep in the history of Arabic and Islamic cities. (Ibn Al Rami, 1995), (Akbar, 1992) and others have found a substantial number of such transformations which occurred during these cities' evolvement and throughout its' life. There are reasons for the 'transformation/ adaptation' such as initial financial constraints faced by the client and the client's need for an additional income. This manifests into reality when the owner transforms a part of the property to a shop that can be run by the owner or let to another else in order to generate additional income to support the family (Al-Naima and Mahmood, 2007). Other reasons would include the need for more space for the growing family, the need for visual and sound privacy, the need for outdoor space for children's activities or entertainment and a general need for flexibility in design of spaces which are not incorporated in the present housing design in KSA (Al-Kurdi, 2002), (Darweesh, 2003). (Mahmud, 2007) mentioned similar reasons which are driven by lifestyle and they include (i) the adoption (by the client) of some modern lifestyle features such as the installation of a modern kitchen or bathroom (ii) the need to achieve a higher degree of privacy for some spaces (iii) to adapt the spaces to suite the owner's lifestyle by, for example, increasing the number of spaces or changing the functions of some spaces. These transformations can be considered as a part of people's socio-economic life which is practised particularly by low income people (Mahmud, 2007).

The Saudi society's culture and customer's knowledge affects indirectly the financing operations of financial organizations. Borrowing in the Saudi Society is something which is generally unacceptable and difficult to comprehend. The client's feels that the bank - which grants the loan - is in a superior position and there is no equality in the relation between the two parties. On the other hand, people do not know the difference between lending rates, have vague perception of the mortgage loan terms and conditions and whether it is free, halal (i.e. not prohibited by Islamic Shariah) or not (Sidawi, 2009). This is why banks initially went into Ijara scheme as this would keep the property ownership with the bank.

3.2. Building laws and regulations constraints

Under the present Saudi Building laws, no permission is usually required for internal works such as refurbishment, renovation etc. The property owner needs to get permission if he/ she wants to extend the property or to convert part of his/her property into commercial or other uses. The permission is also needed if the owner wants to change the elevations' configurations (e.g. to open new doors or windows), increase the built area by building an external extension or the height of the house/ villa by adding an additional floor (Ministry of Municipal and Rural affairs 2009, Personal contact 2009). However, these are difficult to police by the municipality as it is sometimes done behind the high fences of the property. In case that the violation is detected by the municipality, the long arm of the law is not brought to bear on the landlord rather the landlord reaches some type of compromise with the municipality for an amicable settlement. Another aspect of this issue is the permission to convert a part of the property for commercial use is granted without much difficulty as long is the street/ road is classified by the municipality as commercial. Nevertheless, the classification of a street/ road as residential is not permanent and could be changed into commercial if applications made to the municipality by the owners/ investors of properties in the area are approved. However, there are some other difficulties in this process as the conversion of the property/ a part of the property for commercial use needs an approval not only from the municipality but also in most cases from other parties such as the civil defence, health authorities etc (Personal contact 2009). At present, any building application submitted to the local municipality should comply with the Saudi building code (SBCNC 2009), published last year (i.e. 2009), and will be experimented for two years. In summary, the present building laws in KSA restrict the owner's freedom of exercising his/ her rights to a certain degree. On the one hand, these laws are not strictly enforced as is the case in the developed countries. These vague issues may have legal and financial implications for the banks who lend money to the client on a long term basis. Banks are concerned about the free land provision by the government. This happens because the people who got allocated the free land may not be the ones who deserved it in the first place. Many times influential people are allocated the free land plot thus leave the land undeveloped either because they do not need a dwelling house in that land or they aim to resell it at a higher price to make quick money and this leads the land plot being left as dead (Sidawi, 2009). This may have a negative impact on the value of surrounding properties.

3.3. Financial constraints

A number of financial restrictions facing the major mortgage lenders i.e. the banks and the REDF in KSA can be identified as:

a - The financial market rigidities: this includes the structure and performance of the Saudi financial market, stability level, degree of risk of recovery, pricing etc (International Monetary Fund 2006). Mortgage lenders therefore impose restrictions on the use of the property to protect themselves against any claim or possible financial loss. The global economic downfall has affected the Saudi banking system much less than the US and other Western countries. This is due to Saudi citizens not being used to purchasing mortgages, and they are used (or like) to buy properties for cash on the other hand, the Saudi banking system applies higher risk margins on mortgages than the US banking system.

b - The Islamic financing practices: The current Islamic financing practices have a number of pitfalls (Freshfields, 2006) that concern mortgage lenders and restrict their financing practices. These pitfalls exist also in the Islamic financing system in KSA though has different influence on the Islamic finance in comparison with other countries. They include the following:

- Liquidity: Sukuk liquidity is low (Al-Fayez, 2009) because of the restrictions and market rigidities imposed by current immature Islamic lending practices that limit liquidity to Islamic financing. Financial instruments which are needed to generate liquidity for Shari'ah-compliant mortgage lenders seem to be absent. Liquidity constraints imposed on lenders would curb innovation and result in adverse selection.
- Uncertainty: banks usually submit themselves to a Shari'ah

board to ensure that they act according to Shari'ah principles. A document or structure that is accepted by one Shari'ah board in one bank may be rejected by a different Shari'ah board of another bank.

- Ownership risks: In nearly all methods of Islamic financing, the lender is at some stage the owner of the financed goods. In some cases, the asset will be retained by the bank for a considerable period and therefore the legal issues surrounding ownership, such as risk, insurance and maintenance become important. Responsibility for these issues is allocated between the borrower and the financier on a transaction-by-transaction basis. In the Islamic element of a syndicated project financing, the majority of risks will be borne by the borrower, who will be responsible, for example, for insuring the financed asset and naming the financier as an insured party.
- Security/ Recourse: A bank financing a transaction may expect to receive a mortgage over an asset as security and the availability of such security will tend to reduce the price of the transaction. The law of the jurisdictions involved varies and will have to be considered in determining whether appropriate security is available. Mortgages over movable assets are forbidden and a financier can only take security if it takes a pledge of the asset, which will often defeat the aim of the financing as a pledge will require the financier to have possession of the asset. Other factors such as registration, notarisation and payment of fees may also have an effect on the attractiveness of security in the transaction structure.
- Default: Conventional financing transactions usually provide for default interest on late payment of amounts due, which is not possible in Islamic financing. In Islamic financing, the same effect can be achieved in different ways. For example, some form of discount formula can be provided for where an agreed rate of discount is applied for each day that payment is made prior to a backstop date. The backstop date is chosen to reflect the latest date in which funds might be expected to be

paid. However, if payment is made after the backstop date then the financier cannot recover any additional amount.

- Documentary complexity: The majority of the difficulties brought into a transaction by the Shari'ah-compliant elements are surmountable, even if this means that the documentation will be more complex than in a conventional financing. For example, in a structure that combines conventional debt with Islamic equity, the equity cannot be a party to the same document as the debt (for example, a participation agreement). This has been resolved in some cases by making the equity a third party beneficiary to such document.
- Other types of pitfalls are found by a recent study and they include the followings (Sidawi 2009):
  * Financial risks: opportunities to provide financing in KSA are low and there is a high financial risk. The rights of banks are not fully protected by present legislations. Banks have another problem as there are two judicial systems in KSA; the Grievance Board or Diwan al-Mazalim and the conventional judicial system and each of them may give different verdict for the same case.
  * The client characteristics: The property financing essentially depends on the salary, credit history and the value of property. The segmentation of prospected clients that based on the above mentioned criterions has produced small size segment and particularly for low-income citizens, thus the number of mortgage loan applications that can be accepted is low.
  * The problem of finding and creating Islamic financing mechanism: creation of new products in respect of the Islamic Shariah would be a problem as banks have to develop new Islamic financing mechanisms. When a new Islamic mechanism is created, the bank compares the effect of the new Islamic mechanism with the conventional one in order to assess the potential risk. As an example, the bank has created an Islamic mechanism for selling up a property on paper before construction. Therefore, when the bank is

engaged in a relationship with a building developer, the problem is to find the right Islamic mechanism that control such relationship and provide the right product to the client.

* Banks' lending history and policy: Some banks in KSA started their mortgage scheme in 2009 thus they have little financial experience and awareness of the market needs and how to respond to these needs. Other banks offer one type of mortgage loans with a maximum repayment period of 11-20 years only. Majority of the banks have limited financing activity during the past few years.

4. Discussion and conclusion

The study highlighted that funding provided to low-income people to purchase a property is inefficient and insufficient at present and would be the same case in the future unless constraints that affect the flow of financing to the low-income clients are resolved. These constraints can be categorized into banking and external (i.e. socio-economic, government, client etc) constraints. The banking constraints are these applied by banks to avoid any potential risk, protect themselves against any possible claim and to get the profits' margins that they expected during the period of repayment of the mortgage loan. It also includes their lending experience, awareness of the client's needs, the strength and flexibility of their financial activity, length of the period of their mortgage loans and number of mortgage loans they provide to low-income clients. The external constraints include the culture of the Saudi society regarding the use, alteration, and transformation of the property. The study also highlighted the problem of the education of the client regarding the financial issues. Ready-to-use Islamic financing mechanisms that are used in other Islamic countries can be examined, altered and then adopted by banks. Saudi building laws that would control the building alteration and use are not clear and it is loosely applied. In addition, there is a problem regarding the slowness of REDF procedures and insecure financial environment due to the absence of financial legislations which hinder banks to operate and flourish.

The constraints limit banks and other financial originations ability to provide finance to the low-income citizens. Banks should explore how to address the clients on going needs and requirements such as the alteration of the property or change of use in the mortgage loan contract. Banks and other financial organizations should develop proper mechanisms to overcome the above mentioned constraints. They need to introduce more types of the mortgage loans in the near future to serve various needs of their clients. It is essential to ease the conditions of funding and develop innovative and flexible mortgage packages that respond to low-income clients needs. It should take the low-income clients circumstances into account and ease or relax the mortgage loan conditions. Banks and the government have the duty to raise the financial awareness of the public. The customer should be educated about mortgage loan products and process. The customers should be taught that he/she is entering into a business transaction relation and a loan that will not be subsidized by the government.

The research recommends that financial organizations which are involved in the funding and provision of affordable housing such as government bodies, REDF, banks, investors etc should join efforts and set up a framework for collaboration and a long term strategy that is capable to tackle the housing problem. The government should set clear and well defined financial legislations that provide secure environment to banks. Free land should not be allocated to influential individuals and the government should set a regulation on the time frame in which the land has be developed. In the case of already allocated land plots which are left undeveloped the Islamic principle of *'Ihya Al-Mawat'* (i.e. revivification) of unclaimed and unused land would be a possible solution to this problem (Malinumbay & Salasal 1998). One way to apply this concept practically is to allocate plots of land to reputable giant companies which would set up the infrastructure within a specified period. Then the land would be handed to low-income citizens and the land price, which includes the infrastructure costs, would be much cheaper.

References

- Akbar, J. A. A. (1992), The Architecture of the earth in Islam (in Arabic) KSA: Dar Al-Qebla..
- Aldosary, A., Alshuwaikhat, H., Quadri, S. I., Raziuddin., M. (2007), Al Saedan Chair on Affordable Housing- revised report, KFUPM, Volume I, determining affordable housing stocks in administrative areas, Saudi Arabia Kingdom. April, 2007. Retrieved 2008 from http://www.kfump.edu.sa/crp./Saeedan/Volume%20One.pdf
- Al-Fayez, Haitham. (2009), The Saudi Sukuk Market. Jadwa Research. Retrieved October 2009 from http://www.assaif.org/content/.../3842/.../Sukuk+JADWA+Aug+2009.pdf
- Al-Kurdi, F. (2002), The labor city in Dammam: an analysis of its house forms. Advanced workshop ARAR 602. King Faisal University.
- Al-Kurdi, F. (2002), Lifestyle and house form: the case of Aramco houses under home ownership in Dhahran. Unpublished graduate dissertation, King Faisal University.
- Al-Naim A. Mashary, Mahmud Shihabuddin. Transformation of traditional dwellings and income generation by low-income expatriates: The case of Hofuf, Saudi Arabia, Cities, Volume 24, Issue 6 December 2007, Pages 422-433.
- Darweesh, L. (2003), Dweller-initiated changes and transformations in Built environment: the impact of building regulations. Unpublished MSC thesis. King Faisal University.
- Freshfields Bruckhaus Deringer. (2006), Islamic finance: basic principals and structures. Retrieved October 2009 from
- Ibn Al-Rami Muhammad Iibn Ibrahim. (1995), Al-Ilan bi-ahkam al-bunyan (in Arabic). Markaz al-Dirasat wa-al-Ilam, Dar Ishbiliy, KSA.
- Imady Omar & Seibel Hans Dieter. (2006), Principles and Products of Islamic Finance By 2006. University of Cologne, Development Research Center. Retrieved October 2009 from http://www.uni-

koeln.de/ew-fak/aef/06-2006/2006-1%20Principles%20and%20-products%20of%20Islamic%20finance.pdf
- International Monetary Fund. (2006), Saudi Arabia: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics, Monetary and Financial Policy Transparency, Banking Supervision, and Payment Systems (IMF Report No. 06/199. 2006). Retrieved October 2009 from http://www.freshfields.com/publications/pdfs/2006/13205.pdf
- Mahmud, Shihabuddin. (2007), Identity crisis due to transformation of home environment: the case for two Muslim cities, Dhaka and Hofuf, METU JFA (24:2) 37-56.
- Malinumbay, Siti Mariam Salasal, S. (1998), The concept of land ownership: Islamic perspective, Buletin Geoinformasi, Jld. 2 No.2, ms. 285 - 304, Disember, 1998. Retrieved October 2009 from http://www.inf.org/external/[ubs/ft/sce/2006/cr06199.pdf
- Ministry of Municipal and Rural Affairs. (2009), Building permission regulations. Retrieved October 2009 from http://www.momra.gov.sa/.
- Mubarak Faisal A. (2007), Cultural adaptation to housing needs: a case study, Riyadh, Saudi Arabia. Retrieved 2008 from http://faculty.ksu.edu.sa/3177/Documents/Housing%20Adaptation6.pdf
- NCB (The national commercial bank): Economics Department. Market review and outlook, 15 June 2005, Volume 15, Issue 9. Retrieved 2008 from http://www.alahli.com/pdf/er2005/15062005.pdf
- Personal contact. (2009), Discussion with the director of Dar Ghassan Architectural consultants firm, Al Dammam.
- SAIF Saudi Arabia Investment Fund. Samba, 1 quarter 2006. Saudi Arabia and the real estate sector. Retrieved 2008 from
- SBCNC Saudi building code National Committee. (2009). Saudi building code (SBC). Retrieved October 2009 from http://www.sbcnc.gov.sa
- Struyk, Raymond J. (2005), Housing Policy Issues in a rich country with high population growth: the case of Riyadh, Saudi Arabia,

Review of Urban & Regional Development Studies, Vol. 17, No. 2. pp. 140-161.
- Sidawi, B. (2009), Hindrances to the financing of affordable housing in Kingdom of Saudi Arabia. The Emirates Journal for Engineering Research (EJER) Vol. 14, No.1, 2009.