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# HOUSING FINANCE

## An analysis of the Prospects For Increased Activity

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HOUSING FINANCE

An Analysis of the Prospects

For Increased Activity

## I. INTRODUCTION

The past four years have witnessed a remarkable development of Egypt's capital markets. The assets of the banking sector have increased 286 percent in the 1976-80 period. At the same time the investment needs identified by the nation's plans and political processes suggest that even more remarkable performance will be required in the twenty years remaining until the end of the century.

Housing is one of these investment needs. The 5-year National Housing Plan for 1978-82 is extremely ambitious and has called for housing programs equalling 24 percent of total national investment. This compares with an 11 percent rate for the 1973-76 period. To even approach these levels it seems clear that the nation's private sector must become a more active participant in the mobilization of resources for investment in housing.

The purpose of this report is to describe the Cairo housing finance system through all phases of shelter development, i.e. from the project concept stage through final sale or lease of units; to assess the strengths and constraints on institutional and other sources of housing finance; to identify and assess the points within the finance systems where AID funds could be used to leverage an increase in the flow of funds toward the production of affordable, non-subsidized shelter for households in the lower half of Cairo's income distribution. The emphasis of this mission was to understand the role of the formal private sector in the process in order to help AID assess the usefullness of assistance that would bring about greater formal private sector participation in the attack on Egypt's housing needs.

In summary form, the scope of work called for:

- review of previous analysis,
- description of the dynamic of public and private sector production,
- estimation of the order of magnitude of various types of financing,
- evaluation of the techniques of financing and the impact of government laws and regulations,
- assessment of the roles of the various institutions and the constraint on the mobilization of resources, and
- assessment of the role played by construction materials financing.

This analysis has drawn extensively on two earlier AID supported studies of the condition of housing finance in Egypt, the work of the Joint Housing Team for Finance, completed in August 1977, and the study carried out by Richard T. Pratt Associated Inc., in 1979. The two AID funded studies contain a great deal of information relating to the operating practices of specific institutions, which has not been repeated here. Also influential were the analyses of domestic resource mobilization and growth prospects for the 1980's carried out by an IBRD team in 1980 and a study of capital markets undertaken by the IFC and not yet fully completed.

Of principal importance to the development of this analysis was the participation of more than 20 Egyptians and expatriates representing institutions operating in both the public and the private sectors. In some instances, they have been kind enough to review the conclusions and recommendations contained herein. In no case do these conclusions represent official positions. Without the input from these distinguished individuals, however, the real workings of the housing finance process would never have been known. (A list of persons interviewed is contained in the Annexes).

A. Conclusions

1. Shift in Government Policy

The dynamic of the formal housing finance process in Egypt cannot be understood without careful analysis of the nation's political course and the economic consequences.

As the government has charted a course between the needs of the domestic economy and the effects of its close ties to the international economy, it has become apparent that the budget outlay required to meet domestic investment needs is increasing at a rate which can only be supported by enormous increases in government resources. In response, GOE planning and policy has been directed at reducing the reliance on direct government intervention and at mobilizing private sector resources.

In the mid-1970's, the GOE launched the Al-Infitah (open door) policy in an effort to produce a more market-oriented economy. The program has been moderately successful and has been aided by four factors: income from Suez Canal operations, petroleum exports, workers remittances and foreign investment.

These factors have combined to flood the economy with foreign exchange, reducing balance of payments concerns and opening the door, at least a crack, to free market concepts and techniques. In 1980, the banking system recorded a positive net foreign asset position of $5 billion. Four years earlier the net position has been negative.

At the same time, domestic resources have been particularly important in the development of national investment, accounting for 67 percent of total new investment in 1980, a reversal of the situation in 1974. Private sector investment increased from 5.2 percent of GDP in 1973 to 9.4 percent in 1979.

This revitalization of national investment has motivated a more active analysis of the nation's capital markets and the legislative and fiscal reforms which must complement efforts to expand the private market's service to the national economy.

An important impact of the foreign exchange activity has been the investment of workers' remittances in housing. In 1980, the three million Egyptians working abroad remitted $2.8 billion. Though a sophisticated capital market has not yet reappeared in Egypt, and private sector business continues to be characterized by a cash-and-carry approach, remittances have, in some degree, served to broaden the distribution of the wealth required to make investments in the shelter sector. The analysis of the nation's capital markets and the potentials for resource mobilization indicate that the propensity to save from remittances is much greater than that from disposable income.

2. <u>More Policy Revision is Necessary</u>

The moderately successful program to attract foreign resources clearly offers intriguing possibilities for investment in housing, though a number of obstacles must be cleared away before such investments can be attracted with ease. The attempt to lure foreign investment has not yet resulted in a broadly spread allocation of these new resources throughout the economy. The primary impact appears to have been investment in commercial banking (and, therefore, trade financing), petroleum extraction and commercial real estate. Investments in manufacturing appear to be growing at a more gradual pace.

One of the principal obstacles is presented by the government's wage and price policy. The GOE has long recognized a responsibility to hold down prices on essential items so that they do not get out of line with incomes, also set by the government because the five million public sector employees dominate the labor force. Rent control is one of the byproducts of this policy.

Increasingly, the market prices of basic foodstuffs, construction materials and other essential items, influenced by international markets, have left incomes behind, creating renewed pressure for government support and cutting into the disposable income which might otherwise, be available for housing expenditures.

The importance of this context for housing finance should not be underestimated. It affects investor decisions relating to the term of risk they are willing to accept. Developers build only for those who can pay cash. It affects credit policy as even variable rate or graduated payment options are chancy because income increases are directed by GOE decisions. And it affects the pressures on government to intervene.

In sum, the Egyptian economy is a long way from shaking loose of tight central government controls and the psychology that goes with them. Credit Foncier management estimates that 80 percent of formal housing investment is government inspired and supported. The National Housing Plan itself suggests that 90 percent of investment during the 1981-85 period will have some link to government programs. Finally, the broad sweep and the speed of government intervention in the early 1960s has not been forgotten by private sector investors. Yet the nation's post-war history gives evidence of familiarity with a br ader range of options and, the set of institutions that could handle a more efficient direction of national resources toward housing exists. To make longer term risk more acceptable to investors and to permit incomes to relate more closely to actual costs would be among the primary objectives of any new housing policy.

B. Recommendations (Summarized)

1. Joint Program Objectives

In a long term context a joint program might focus on:

- encouragement of savings.
- extension of the risk financial institutions are ready to take on mortgage loans.
- expansion of the retail eff--ts of thrift and mortgage lending instititions and a concurrent increase in the flexibility of operations.
- establishment of a mortgage loan purchasing institution (the beginning of a secondary mortgage market.)

At present, the atmosphere is not conducive to implementation of broad scale reforms such as rationalization of rents and interest rates and reduction of the GOE role in shelter finance and construction. The approach recommended herein would lead to a better environment for such reform through gradual expansion of the formal, non-governmental mortgage loan market. This means improving the retail aspects of the housing finance system. Agressive retail banking should be able to capture new resources and generate demand for mortgage loans at market rates.

2. Joint Program Contents

The Credit Foncier would appear to be the most logical institition with which to work as it is now involved in the Helwan project. The Housing Development Bank may be interested in such an approach as well, though it does not presently have the facilities and operating experience that would serve as the foundation for an agressive retail program.

The home improvement loan program now in the first stages of development in Helwan may produce an experience that could be duplicated elsewhere, at least in Cairo. This program might be expanded to include standard mortgage lending and a linked savings program. It has been suggested that if a savings account were required prior to consideration of a borrowing relationship then savers might accept savings interest slightly below prevailing market rates giving the lender a better opportunity to set a workable margin even if some foreign loan funds were used as seed capital. In addition, loan interest rates could be lowered somewhat to expand the potential market for the program.

In sum, the basic premise behind this program is that the availability of funds will generate demand, even at prevailing market rates, and that the linked savings and loan program would represent a fine-tuning to reach a lower income group. Joint program funds would be used to open modest branch facilities (rent, furniture, communications and calculating equipment) and to capitalize the lending program. The project would grow slowly keeping pace with the central institution's ability to manage new branches. An investment of $25 million from whatever source represents over 10 percent of the assets of the nation's largest mortgage banking institution. Such an investment, while not capable of turning GOE policy around, would be attractive to the lending institution and could be used to bring about modifications in operating policy. It appears that an investment of $25 million would be too large for immediate absorption but could be disbursed on a time schedule fixed by the receiving institution's capacity to expand its retail activities.

The following sections detail the context that makes such a conservative assistance program appropriate at this time.

## II. HOUSING PROJECT DEVELOPMENT

### A. Government Sponsored Production

#### 1. The Ministries

During the 1960 to 1976 period, it appears that informal sector housing activity produced three units for every one produced by the formal sector. Of this formal sector production, at least 80 percent was either directly produced by government or financed through the GOE's cooperative housing program. The 1979 housing plan suggests that this GOE dominance of formal sector housing production will continue in the near future, though reductions in direct GOE production are called for.

Government production is undertaken directly by the Ministries of Housing and of Development. These ministries are capable of designing and executing projects. The public sector is the principal employer of the architecture and engineering professionals produced by the nation's educational system.

The ministries contract with public sector construction companies to carry out the projects. In some cases they may use foreign construction companies to provide supervision or technical input. This is unusual in residential projects. The nation's public sector contracting companies predominate in their field in keeping with public sector dominance of the economy.

Rents on government built properties are set in keeping with the incomes of the beneficiaries and often do not relate to the investment or to the maintenance requirements. The GOE is aware that the costs of these programs are too great a burden for the national budget. The plans for some of the new towns indicate a reliance on other mechanisms (private contracting, autonomous public corporations and the cooperative program) to carry out the investment in a way that will reduce the strain on the national budget.

Production figures are greatly confused. The draft 1981-85 plan continues to use very approximate figures which do not specify the producer and use general per square meter costs to set the investment levels without differentiating between types or transaction (rental or purchase). The 1978-82 plan called for production of 150,000 units by the private sector and 175,000 by the public sector. Of this latter figure 120,000 units were to be produced by the Ministry of Housing. No figures are given but it is understood that most of this production was to be of rental units.

Only the national government, at the present time, has the resources of land and financing to carry out large scale residential projects. To give an example of the size of national government commitment to housing production under its own programs, the new town projects currently under construction or in the final stages of planning -- the 10th of Ramadan, Sadat City, the 6th of October and the 15th of May -- will include provisions for some 340,000 households.

2. The Governorates

The governorates may build from their own budget funds, however, their staffs are not as professionally capable as those of the central government and therefore much of the project planning and supervision are carried out by central government agencies. Once again, it appears that most governorate produced units are leased. Two projects now in planning and early construction stages in the governorate of Cairo, Deuwaka and Berket, are being designed to accommodate some 56,000 households. Presently plans call for the units to be leased to families at monthly rates of LE 2 and 3.

3. The Cooperative Program

In existence since the mid-1950s, the General Authority for Housing and Building Cooperatives has been an important vehicle for the production and sale of housing to organized groups of Egyptians. The program has been used primarily by public sector employees who form cooperatives that acquire land and turn to the GAHBC to coordinate construction and the sale of units to satisfy the cooperative's needs.

In its role as advisor to the cooperatives, the GAHBC may review the building site selected by the group as well as the plans for the units. The authority has a large professional staff for this purpose. The authority may then help the cooperative select the construction firm for the job and supervise construction work. Though no accurate figures are available it appears that this program accounts for less than 5,000 loans nationwide per year.

The GAHBC may also operate as a developer. In such cases, GAHBC staff will handle all the technical aspects of the project implementation. During the construction process the Authority will circulate information on the project to prospective purchasers, and if successful in finding an interested group, sell the building. If unsuccessful, the Authority may form a cooperative from a waiting list of individuals.

To finance construction of the project, the GAHBC will require a down payment from the project's beneficiaries (the individual members of the cooperative who will be the ultimate beneficiaries, since the loans for purchase of the units are not made to the cooperatives themselves). The authority may then lend the individuals up to LE 6,000 for terms of 25- to 30-years. The interest rate on the first LE 4,000 required is 3 percent. The remaining LE 2,000 will carry a 5 percent interest rate. There is a 3-year graceperiod on repayment of principal.

It should be noted that many of the GAHBC produced units have prices in excess of LE 6,000. It is understood that the beneficiaries will be able to go to other institutions to seek the additional financing required to cover the full price of unit.

The GAHBC has no depositors nor does it generate any funds internally. It borrows an amount equal to the loans required to purchase the unit from either the commercial banks or the housing finance banks. These loans are made at the Central Bank discount rate (currently 12%) and all GAHBC borrowings are secured by a central government guarantee. The individual cooperatives or GAHBC itself are responsible for the loan servicing. The GAHBC will call on the Treasury to make up the difference between the loan lending rate charged by the financial institutions from which the authority borrows and the 3 to 5% recovered from the project beneficiaries.

The authority sees itself as an arm of the GOE policy, and as a result is more concerned with the expenditure of funds for increased quantities of housing tham it is on recovery of investment. Because there are no limits on family income nor on the cost of the unit which may be financed by the cooperative program, it has been possible for this program to serve a wide range of income levels including families with high income who may rely on the rather limited levels of GAHBC funding to meet initial construction requirements and to provide access to the use of subsidized building materials.

4. Public Sector Impact on Private Sector Project Development

As noted earlier, the commanding position of the government with respect to residential real estate development is such as to deter any interest by private sector developer groups. The GOE controls enormous amounts of land and has the staffing, and at least, in principle, the funding to carry out very large scale projects. Finally, the government is able to offer favorable financing conditions.

In spite of this dominant position, however, government planners recognize that a means must be found to attract more private sector interest in residential project development. Put another way, the government must share some of its responsibility for housing production. Recently, in the case of two of the proposed new towns, the 6th of October and Ameriyah City, the government has carefully considered the potential for the private sector development, through use of commercial terms, with profits from the more commercially viable components of the new town project offsetting the losses to be incurred in some of the components such as housing for low-income families, and has also gone to an international bidding process to attract foreign capital and development techniques.

Furthermore, there is some question in the minds of the GOE planners as to the ability of the Egyptian economy to perform at the pace of the past four years throughout the rest of the century. It is clear that if the present boom tapers off, even moderately, GOE resources will be inadequate to fund the extensive investment program required to bring the nation's infrastructure up to adequate levels.

This problem of private sector intervention in the area of residential real estate development is evident in the activities of the National Company for Housing for Professional Syndicates. This company is not technically a government agency, though it was formed as a result of deliberations by the National Party and the Engineering Syndicate. The capital has come from the syndicate's pension fund and a wide range of public sector financial institutions, and the objective of the company is to produce increased qualities of reasonably priced houses.

At present, however, the company is focusing on commercial real estate development. The company has been allocated a large tract of land in the 6th of October new town, and is in the process of designing a moderate-income housing program for that tract. The fact remains, however, that the advantages to the investor in the private market fall in the area of commercial real estate development. Thus, even those enterprises designed with government support and directed to increase private sector investment in residential real estate for the nation's middle- and lower-income families find entry into the marketplace difficult.

B. Private Sector Residential Project Development

It seems fair to say that subsequent to the nationalization of private sector business activity in the early 1960s, this sector lost the institutional structure from which to launch large scale real estate development programs. The seeds for change, however, were planted in the 1970s with Law 43 and the improved performance of domestic investment. As a result it is now possible to see increasing evidence of private management of complex real estate projects.

1. No Institutional Base

Nevertheless, there is no "developer" organization as we know it in the U.S. Real estate development in Egypt continues to be the result of a combination of land owners, construction companies, financial institutions, and architectural and engineering professionals. Even the Osman and Allam family concerns, the largest Egyptian construction companies, seldom initiate projects by buying up land and assuming the risk.

### 2. A Cash-and-Carry Operation

Most residential real estate projects carried out in Egypt today, be they in the formal or informal sector, rely on cash put up by the eventual project beneficiaries. In the most successful type of project, the land owner and the construction group would advertise before the beginning of construction and collect down payments by project beneficiaries who will, in that way, be guaranteed priority treatment upon completion of the project.

Interested purchasers are given an estimated price and a probable completion date and are shown full plans for the units. The initial deposit runs between 20 and 30 percent of the estimated price of the unit they are selecting. They will then sign an agreement of sale with the developer which, as mentioned before, would probably be a partnership of land owner, architect, and construction company.

The agreement obligates the purchaser to pay the full purchase price in installments during construction of the building. These agreements do not specify the final cost or completion date. The installments are required at regular intervals regardless of the actual construction process.

Construction financing may be used in those cases where the project is particularly big or the land owner and the construction group do not have the funds to begin earth movement or some foundation work. Often this first step is required as proof to potential purchasers that the project has been seriously considered and will, indeed, go forward.

Construction lending is normally handled by one of the major commercial banks in Cairo. In most residential projects the construction loan will be a secured loan that is further supported by the financial capacity of the borrowers. The loan will be for short terms, between 2- and 4-years and will carry a floating interest rate, which is an interest rate that may float with the maximum allowed by the Central Bank of Egypt (currently 15 percent for loans denominated in pounds). In addition, the lending institution may charge a management fee of one-half to one percent.

The absence of long-term mortgage financing for the purchaser of the unit limits the private sector developer's market to those who can pay cash or amortize any short-term borrowings they might make because of their own particular cash position. It is apparent that accumulated wealth forms the basis for most investments in residential real estate in Egypt. This is true at all economic levels. Though incomes have remained low in relation to costs, the work opportunities in the Gulf have permitted a number of low-income Egyptians to accumulate sums sufficient to invest in real estate. In the informal sector these remittances are more likely to be invested in improvement or extension of exising units, but they have also supported much new unit construction.

Cash project-financing eliminates one of the major costs facing residential real estate developers. As a result, exhaustive feasibility studies are not necessary. The current shortage of housing and the widespread speculation in real estate assure a developer of rapid sale of an apartment building. Nevertheless, if sales are not immediately strong, the carrying cost of the unsold units is greatly reduced by the availability of cash produced regularly by the existing purchasers. Consequently, errors in timing are not very expensive.

For example, whereas in most countries time is costly and jobs are completed as soon as possible, the Egyptian developer often gains by moving slowly. The cash payments made by purchasers can be used to pay off any outstanding construction financing, and any excess funds may be invested. Because payments by purchasers are made according to a timetable not based on construction stages, it is often possible to pace the construction so that no additional bank financing is needed.

Clearly, developers using this technique risk the possibility that the purchasers will object to delay beyond the originally promised date of occupancy. Two factors reduce the likelihood that such problems will arise. First, the technique is so widely used that a buyer who demanded his money back would probably face the prospect of having to wait an additional four to five years for the completion of any alternative home or unit in which he might make an investment, and furthermore, that investment would probably require larger sums. Second, the rapid escalation in real estate values during the last few years has created a body of speculators. Because these persons do not need a new apartment as a primary residence, they are in a position to buy the contract of any complaining purchaser and hold it until profitable completion of the units.

During the construction process, particularly if it is prolonged, increases in the payments to be made by the purchaser may be required. Cost overruns of at least 30 percent have been the rule rather than the exception in recent years. The prospective purchaser is required to respond to these increases. A purchaser who is dissatisfied with the length of time of construction or the increase in the cost of the unit has little recourse. He is entitled to demand the return of his deposit and progress payments. This money will usually be returned without interest and, in fact, in some cases, there may be a penalty for breaking the agreement with the developer.

Final transfer of the property does not take place directly between the developer and the buyer of the unit. Transfer taxes require that the builder pay 5 percent on the first unit sold and 40 percent on each subsequent unit. As a result, the individual unit buyers are formed into an association to which the building is deeded by the builder. In such a manner the builder only pays the 5 percent tax of the first unit sold. This technique sets up an ownership situation similar to that of condominiums or cooperatives in the United States. The owner's right to sell, rent, or modify his property is not affected. The establishment of the association does not necessarily provide for the future maintenance or operation of the building. It is merely a tax dodge.

A variety of techniques have been used to attract funds from potential unit buyers by groups with land and plans for residential development. An interesting comment on the progress being made towards institutionalization of residential project development may be drawn from the experience of The Cairo Company. This company required that each prospective purchaser own at least a minimum number of bonds. The purchaser with the largest number of bonds bought at the earliest date received first choice from among the units. In this way a priority ranking was established. The Cairo Company also offered a 2 percent per year interest rate of the bonds.

Bond issues were consistently oversubscribed since most buyers bought bonds in excess of the estimated price of the unit. The Cairo Company operated on the assumption that it would be appropriate to have more bond holders than units, anticipating construction of future buildings.

The Company, however, ran into difficulties with construction leaving a number of bond holders with outright losses. The problems appear to have resulted from the company's efforts to keep investing construction financing into new projects.

It is unusual to find subtantial involvement in residential real estate development by foreign interests. Some of the Gulf State investors, however, have shown that they are not particularly concerned with immediate return and are, therefore, able to make investments in projects which may have a questionable market at present but offer interesting prospects for the future. In one instance, Gulf State investors bought a 150-unit project in Nasr City where the sale price is expected to be around LE 65,000 per unit. Though there are a number of lower priced apartments available in this area (units which have been financed or are being financed through cooperative programs), the investors felt that the land value and construction costs would only increase with time and that their project should have no market problems over a 5-year period.

3. Commercial Real Estate Development

The boom in real estate development in Cairo in recent years has been most apparent in the development of commercial projects, where investors have found plenty of opportunity for a rapid turnover of investment at market prices. Law 43-projects enjoy a 5-year exemption from taxes, an exemption which takes effect only when the project becomes productive. Some hotel projects may be favored with an 8-year exemption.

The process of assembling a commercial real estate development project is not greatly different from that described for residential projects. The market is more attractive. Ideally, investors will look for return of investment and profit in a 4-year time period, allowing a margin to assure the tax exemption. Some of the major commercial banks, such as the National Bank of Egypt, may take equity positions and also provide construction financing. In most cases the project's lender will expect the land to be already owned by the developing syndicate. The property may be mortgaged, but unsecured loans are not unusual. It is unusual, however, to have loans that have terms longer than three to four years.

One atypical project which nevertheless offers interesting insight into the real estate development process in Cairo is the twin-tower, Cairo Plaza project. Among the Egyptian partners in this enormous commercial venture which will combine commercial space, office space and a hotel are: the El-Shams Housing Development Company, the

El-Shark Insurance Company, and the Bank Misr, all public sector institutions. There is also an Egyptian individual in the partnership. The foreign partners are extremely wealthy Saudi-Arabian and Gulf State investors. The initial estimate for construction costs for this project was $150 million of which about 10 percent was put up as equity. Construction financing was provided by the Credit Foncier, the National Bank of Egypt, and the Misr Bank. The Credit Foncier, for example, has taken a mortgage with a 12-year term as part of the package of construction financing. The other banks have lent against the financial strength of the investors.

Project execution has been complicated and is well behind schedule. Negotiations are now underway for the second stage of the construction financing, an amount totalling $35,000,000 to $40,000,000. The lending institutions at this point have asked for the joint guarantees of the project investors. Some observers of this project, which has become something of a scandal, think it would be silly for the project investors to put up such a guarantee since they themselves have the financial capacity to fund the project.

It is not at all clear that the market will support the rentals that would be required to offset the investment in this building if this space were put on the market today. It has been estimated that office space will have to sell for approximately LE 4,000 per square meter to make this project viable. At present the highest rates are around LE 2500 per $m^2$, with LE 1000 per $m^2$ being far more common. Furthermore, there is evidence that the boom in high quality office space has tapered off, possibly because costs have risen so rapidly. The foreign investors in the Cairo Plaza project, however, are not concerned about short-term recovery of investment and are fully prepared to complete the project according to plans and wait for the market to catch up.

4. Financing Construction Materials

Building material purchases are paid for with funds borrowed for construction financing or down payments received from the prospective purchasers of units. There is no system of supplier credits. This situation is as much the result of the nature of the distribution system as the construction finance system.

The more important building materials (cement, steel, glass, wood) are subject to price and quantity controls (they are subsidized). The official system for obtaining building materials requires evidence that the builder has been issued a building permit. Holders of permits then submit their plans and are assigned a quota of materials. The quota slips are taken to distribution centers where supplies are issued for cash payment.

Parallel to the official system is an equally large black market in building materials. The need for a black market arises from the delays builders often encounter in obtaining supplies through official channels and the requirements of many small contractors who build without permits. The source of supplies for the black market appears to be primarily legitimate builders who receive materials through the official distribution system.

Building materials are not distributed on a first-come, first-served basis. Priorities are assigned according to the importance of the project. It is not clear exactly how the priority system works, but it is clear that some builders and some projects receive supplies much faster and on a more regular basis than others. Those builders who become impatient waiting for supplies have the option of purchasing them on the black market where materials are generally available for as much as three times the official subsidized price. A builder with a permit who decides to buy on the black market will, therefore, have no use for the materials he has ordered through official channels. He then becomes a source of building materials for the black market.

Clearly, this system of materials distribution does not encourage development of a credit system. The official channels have no need to offer credit as an inducement. Not only are they the only official source, they also have the best prices. Black market dealers, on the other hand, consider the extension of credit an unsound business practice.

For large projects it is the prime contractor's responsibility to obtain the official quota of goods for the subcontractors. If the subcontractor is required to obtain black-market goods to expedite the job, this also becomes the responsibility of the prime contractor. In some cases the prime contractor will arrange to provide informal financing for the black-market purchases of the subcontractor.

## C. Residential Market Conditions: Rent Control and Family Incomes

### 1. Sales Versus Rental

It is clear that the market in Egypt today favors housing built for sale. In Cairo, apartment units are preferred over single-family units, presumably because the developers are maximizing the use of their property and large, attractive properties are not available within easy reach of urban services.

The conditions which characterize the market for rental are very peculiar, since it would appear that the bulk of the housing stock is rented. The absence of rental construction is not, however, a new phenomenon. The problem was created in 1960 when a strict rent control law was passed. This law sets restrictions on the rents that can be charged on either existing or newly constructed units.

The rents on existing units were frozen at the 1960 level with no provision for future increases to cover maintenance or inflation. Significantly, landlords in the late 1950s had been required to lower rents by approximately 35 percent so that the rents being charged when the controls went into effect were in most cases less than those set when the building was constructed.

For new buildings rent is determined by government-authorized rent control committees on the basis of:

> 7% of the value of the building and land as a return to the landlord and
>
> 3% of the value of building itself for depreciation, repair maintenance, etc.

The value of the land is set at its 1974 price plus 7 percent per year for appreciation. The building's value is based upon its cost as determined by the amount projected on the building permit regardless of any cost overruns.

The tenant/landlord relationship under the law is biased almost exclusively on the side of the tenant. In practical terms, for instance, it is impossible for the lessor to terminate a lease even on the death of a lessee. A tenant's lease is inheritable by spouses, children, parents, and relatives down to third generation if they have lived in the apartment with the tenant for one year prior to his or her death.

The only exception to the rate structure discussed above is for furnished apartments. Furnished apartments may be leased to foreign citizens at an uncontrolled rate. Egyptian tenants of furnished apartments are exempt to a lesser extent based upon the term of the lease. If the Egyptian lessee has rented the apartment for five consecutive years from the landlord he has the option of demanding the rent controlled rate. Similarly, if an Egyptian has subleased an apartment for ten consecutive years he may assume the lease of the tenant.

The use of the furnished apartment exemption is limited to one furnished unit per person in any one city. Members of the landlord's immediate family (spouse and children over 21) may each own a furnished rented unit for lease.

The effect of the rent control law on this very vital sector of the housing market has been complicated and far reaching. The most obvious result of the law to any outsider is the decision by landlords to neglect maintenance of existing buildings. There have been more subtle social and economic effects as well.

To increase the return on his investment, the landlord has two options--both of which usually involve circumventing the law. First, he can demand key money, a large payment in cash, from prospective tenants or rent controlled units. The payment of key money is a standard practice although it is strictly forbidden by law. Tenants have occasionally been successful in recovering key money through the courts, but more often than not, legal action is not taken or the landlord wins the case. Key money is not always paid only to the landlord. A tenant can expect a share of the payment if he is vacating his apartment or if he chooses to sublet it at the rent-controlled rate.

Second, the landlord can increase his income by leasing a furnished apartment to a foreign citizen or, on a short-term lease, to an Egyptian. Either of these options is perfectly legal, but restricts the earnings of a landlord who abides by the section of the law that limits the number of furnished units he may lease. Frequently, a building owner will "sell" apartments to relatives outside his immediate family or to friends. These apartments then can be legally rented as uncontrolled units. Many older apartment houses have had one or two stories added in order to provide units which can be sold and then leased.

When renting furnished, uncontrolled apartments to Egyptians, the landlord must always be aware of the five-year limit on the lease. Often, a two-year lease is signed and simultaneously a pre-dated letter terminating the lease is given by the tenant to the landlord to avoid problems at the end of the lease. Such short-term leases could be a hardship for tenants except that most, either have family members or a friend who are willing to execute a new lease in his name, though the actual tenant does not move. Through this mechanism the landlord avoids a claim that the lease has been in effect for five consecutive years and that the unit, therefore, is eligible for the controlled rental rate.

From the tenant's point of view, the rent control law has provided an opportunity for home ownership in fact, if not under the law. Rates on rent controlled units are very low in relation to estimated market value.

If the tenant pays the rent, he or she is assured of not only a home, but also an estate that can be passed onto any heirs. The existence of key money payments even provides the tenant with the opportunity to realize a cash gain if he must vacate his home. Key money can be regarded as analogous to a down payment for the purchase of a home at almost the purchase price with the advantage that the responsibility for maintenance lies elsewhere and the monthly carrying costs are minimal. The similarity between ownership and rental is so great that there are individuals who invest in rent controlled apartments. An investor can earn a handsome profit by paying key money, taking over the apartment and subleasing it as a furnished unit to foreigners or perhaps as office space to a company. On an investment of LE 70,000 to 100,000 for a large apartment in a good area an investor might pay a controlled rent of 15-25 pounds per month whereas the sublease may bring in 500-700 pounds per month.

Among the individuals which the team met (most of whom were benefiting from the rent control laws) there was general agreement that rent control was stifling development and a major cause of current housing problems. It was also agreed, though, that the low monthly payments and existance of tenure rights made rent control a very sensitive political issue. The consensus was that substantial change was not likely for may years, but that some movement towards decontrol had to be initiated immediately.

2. Family Income Levels

A summary cost analysis suggests that a small (100 $m^2$) luxury apartment would have construction costs of LE 300/$m^2$ and would sell for at least LE 40,000. The majority of Egyptian families cannot afford such a unit.

A recent IBRD analysis of family expenditures estimated that annual urban family income is distributed as follows:

| | | |
|---|---|---|
| 0- 778 | LE | 26.6% |
| 779-1113 | LE | 23.7% |
| 1114-1782 | LE | 28.5% |
| 1784+ | LE | 21.2% |

The expenditure data appears to support an estimated median family income of LE 1,000 per year.

Wage levels in Egypt have been rising rapidly during the recent past. A 1975 survey, for instance, indicated that approximately 50% of the urban families had expenditures of less than LE 500 per year. An increase of more than 100% in five years is an impressive gain, but it has not brought incomes up to the levels needed for housing unit rental or purchase at market rates, because inflation in housing costs has easily matched the rise in income.

The gap between the income needed to buy a house and the income available to most families is at the heart of the housing shortage in Egypt. Recognition of this gap has resulted in extensive subsidies to reduce the cost of building and financing a home. The private sector is also aware of the discrepancy, and has limited its efforts to the segment of the market that can easily afford high prices for construction and financing.

The extent to which most people are excluded from the housing market can be seen in Table 1. Assuming that 25% of the median family income or LE 250 per year is available for housing, the table below examines the maximum mortgage which could be afforded at 3,6,9 and 12% for 15, 20, and 25 years terms. At the best possible terms (3% for 25 years) the median family income will support a maximum mortgage of only LE 4,283.

Table 1

Maximum Affordable Mortgage by Median Income Family

| | 3% | 6% | 9% | 12% |
|---|---|---|---|---|
| 15 years | 2,941 | 2,407 | 2,002 | 1,692 |
| 20 years | 3,662 | 2,835 | 2,257 | 1,844 |
| 25 years | 4,283 | 3,183 | 2,420 | 1,928 |

Table 2 converts the mortgage amount for Table 1 into a maximum sale price assuming a 30% down payment. This loan to value ratio of 70% is relatively generous. Often, down payments of 50% or more are required to obtain what long term financing exists. The 30% requirement, however, appears reasonable for the median income family. As can be seen from the Table, the maximum affordable house would be LE 6118.

Table II

| | 3% | 6% | 9% | 12% |
|---|---|---|---|---|
| 15 years | 4,201 | 3,439 | 2,860 | 2,417 |
| 20 years | 5,231 | 4,050 | 3,224 | 2,634 |
| 25 years | 6,118 | 4,504 | 3,457 | 2,754 |

With most new construction covering units at prices well above LE 6,000, it is obvious that even with long term financing most families cannot on their income afford even low cost housing now being built. Private sector builders do not have any incentive to build housing for this price range. Private sector financial institutions believe the risk of default is too great.

The recommendations contained in Section IV of this report are designed to help create the capital market conditions that would expand the number of families that can afford housing at market rates. Once in place, these capital market programs might be fine-tuned to reach lower and lower levels of income. What is anticipated is a reduced level of GOE budget commitment, not its elimination.

The income figures make clear, however, that the income problem has the greatest influence of any factor on the attractiveness of the residential market to private sector investment.

## III. THE FINANCIAL SECTOR

Two earlier reports, the 1977 by the Joint Housing Team Finance, and the subsequent report by Richard T. Pratt Associates, Inc., presented a thorough analysis of the Egyptian financial system in general and the housing finance system in particular. In that an objective of the present team is to identify, and put forth recommendations for a program wherein AID can assist the Egyptian financial system in the mobilization of domestic savings for long-term mortgage finance, the objective of this section is to update the two earlier reports and identify those financial and monetary issues relevant for the development of such a project.

The structure and character of the financial system has changed substantially since the enactment of the Foreign Investment Law in 1974 and the abolishment of functional specialization in 1975. Other recent developments have liberalized the activities of some of the specialized banks in Egypt, created new specialized financial institutions, and have increased the flexibility of the Central Bank in its conduct of monetary policy.

### A. The Central Bank of Egypt

The Central Bank of Egypt was established in 1975 as an autonomous public entity with the responsibility for controlling and supervising the country's banking system. The bank is also responsible for formulating monetary, credit and banking policies and as such has responsibility for determining discount and interest rates as well as liquidity and reserve ratios. The

Central Bank conducts the banking operations for the government as well as other public entities and administers the public debt for the country.

B. Commercial Banks

1. State Commercial Banks

The banking system in Egypt is dominated by four national commercial banks which prior to 1975 were assigned to provide financing for certain kinds of public sector economic activity. Under this system of functional specialization, the banks had little operating flexibility and were essentially instruments for carrying out government policy in their respective areas. This system of functional specialization was abandoned in 1975 at which time foreign banks were allowed to enter the market, and public sector entities were free to deal with any public sector bank they wish.

Almost all loans granted by the four public sector banks are short term and in local currency. The maximum interest rate on local currency loans is currently fixed by the Central Bank at 15 percent. Most loans are secured by personal guarantees and merchandise.

In addition to the traditional demand and savings account deposits the national banks have recently become more agressive for additional deposits and have introduced several new forms of saving deposits. For example, LE 100 invested in an appropriate bond today will return LE 240 in ten years. Current income bonds earn interest paid semi-annually. Interest rate on savings and time deposits currently range between 5 percent and 11.5 percent. Non-interest bearing lottery bonds are also avaialble from the banks.

2. Joint Venture Banks

Under the Foreign Investment Law of 1974, foreign banks were authorized to conduct business in Egypt. By the end of 1980, 44 banks had been established under this law. In order to conduct business in Egyptian pounds as well as other foreign currencies a joint venture bank must possess a majority Egyptian partner. Of the 44 banks, 18 have a majority Egyptian partner and are authorized to engage in a full range of banking activities, and compete in most areas with the four government owned commercial banks.

The consolidated balance sheet for these 22 joint venture banks as well as the 4 national banks is presented in table IV-1. Row 5, shows bank assets to have nearly tripled from 1976 through 1980. In 1980 alone, assets increased by 40 percent. During the same period, 1976-1980, time and savings deposits (row 8) increased from LE 482.5 million to LE 2635.2 million for an increase of 447 percent. In 1980, savings increased by 57 percent.

To date Egypt's Commercial Banks have not been active in the origination of mortgage loans. Loans are made, however, to the General Authority of Housing and Building Cooperatives, the Credit Foncier, and the Housing Development Bank. As indicated in Table IV-2, row 11, these loans amount to LE 18.9 million at the end of 1980. If Central Bank loans are included, row 11, a total bank lending to mortgage banks amounted to LE 164.5 million by the end of 1980.

There are twenty-six additional joint-venture banks and branches of foreign banks operating in Egypt whose activities are restricted to foreign currency operations exclusively. The consolidated balance sheet of these 26 banks is shown in Table IV-3.

Central Bank regulations impose a 25 percent reserve requirement on all deposits of the above banking institutions. However, to permit competition with other international financial center banks, the 15 percent reserve requirement on foreign balances is not enforced.

3. Specialized Financial Institutions

Specialized banks are defined as "non-commercial" and are intended to serve specific sectors of the economy. Such institutions are state owned and do not accept deposits. The Agriculture and Development Credit Bank provides short-term facilities to small farmers for crop financing. The Development Industrial Bank formed in 1976 has committed LE 60 million in medium-and long-term loans to private sector industries at a subsidized fixed rate of 8 percent. In 1980, the National Investment Bank was established to fund the operations of public sector companies and to facilitate the financing of large scale projects. The Bank has an authorized capital of LE 3.2 billion.

Table III-1

Consolidated Balance Sheet of Commercial Banks 1976-80

(In millions of Egyptian pounds)

| End of Period | 1976 | 1977 | 1978 1/ | 1979 2/ | 1980 |
|---|---|---|---|---|---|
| 1. Foreign assets (net) | 1.5 | 707.7 | 969.7 | 1,061.7 | 1,087.2 |
| Foreign assets | 769.1 | 1,333.0 | 1,729.8 | 1,921.6 | 2,707.3 |
| Foreign liabilities | -767.6 | -625.3 | -760.1 | -859.9 | -1,620.1 |
| 2. Reserves | 451.2 | 495.4 | 505.4 | 803.2 | 1,268.9 |
| Deposits with Central Bank | 381.9 | 420.4 | 415.5 | 681.3 | 1,109.0 |
| Cash | 69.3 | 75.0 | 89.9 | 121.9 | 159.9 |
| 3. Domestic assets | 2,966.8 | 3,454.5 | 4,249.7 | 5,078.7 | 7,321.8 |
| Claims on public sector | 2,530.4 | 2,911.5 | 3,601.3 | 3,930.3 | 5,455.4 |
| Central and local government | (1,306.7) | (1,549.4) | (1,806.0) | (1,969.4) | (2,770.4) |
| Public authorities | (339.2) | (266.8) | (587.1) | (576.9) | (936.8) |
| Public sector companies | (884.5) | (1,095.3) | (1,208.2) | (1,384.0) | (1,748.2) |
| Claims on private sector 3/ | 262.1 | 441.4 | 581.7 | 1,012.2 | 1,747.3 |
| Claims on specialized banks | 174.3 | 101.6 | 66.7 | 136.2 | 119.1 |
| Unclassified assets | 194.3 | 277.4 | 384.6 | 393.5 | 641.8 |
| 5. Assets - Liabilities | 3,613.8 | 4,935.0 | 6,109.4 | 7,337.1 | 10,319.7 |
| 6. Borrowing from Central Bank | 1,104.9 | 1,530.1 | 1,588.9 | 1,078.2 | 1,622.5 |
| 7. Demand deposits | 544.1 | 782.4 | 947.6 | 997.1 | 1,206.2 |
| Private sector 4/ | 539.9 | 780.7 | 937.3 | 990.5 | 1,202.3 |
| Specialized banks | 4.2 | 1.7 | 10.3 | 6.6 | 3.9 |
| 8. Time and savings deposits | 482.5 | 652.9 | 983.3 | 1,678.2 | 2,635.2 |
| Private sector 5/ | 482.1 | 625.8 | 966.0 | 1,643.4 | 2,598.1 |
| Specialized banks | 0.4 | 27.1 | 17.3 | 34.8 | 37.1 |
| 9. Public sector deposits | 891.3 | 1,283.7 | 1,693.2 | 2,332.8 | 2,948.6 |
| Central and local government | 99.9 | 108.3 | 164.9 | 241.3 | 348.1 |
| Public authorities | 147.1 | 257.4 | 431.2 | 579.4 | 880.6 |
| Public sector companies | 644.3 | 918.0 | 1,097.1 | 1,512.1 | 1,719.9 |
| 10. Counterpart funds | 155.6 | 141.6 | 123.2 | 105.2 | 65.8 |
| 11. Capital accounts | 184.4 | 226.1 | 334.8 | 461.7 | 755.4 |
| 12. Unclassified liabilities | 251.0 | 318.2 | 436.4 | 683.9 | 1,036.0 |
| Memorandum item: | | | | | |
| Foreign currency deposits 5/ | 266.7 | 519.5 | 746.8 | 1,216.0 | 1,747.5 |

Sources: Central Bank of Egypt and IMF: International Financial Statistics.

Table III-1(footnotes)

1/ Foreign currency assets and liabilities valued at unified (established) exchange rate.
2/ Adjusted to take into account the reclassification of public entities that occurred in consequence of the budget reform undertaken at the beginning of 1980.
3/ Includes cooperatives.
4/ Includes foreign currency deposits of residents (including international organizations located in
5/ Excludes earmarked deposits.

Table III-2

Summary Balance Sheet of Mortgage Banks, 1976-80

(In millions of Egyptian pounds)

| End of Period | 1976 | 1977 | 1978 | 1979 | 1980 |
|---|---|---|---|---|---|
| 1. Cash | 0.1 | 0.2 | 0.1 | 0.2 | 0.2 |
| 2. Foreign assets (net) | 0.2 | 0.2 | -4.2 | -0.3 | 0.6 |
| Assets | (0.2) | (0.2) | (1.2) | (4.0) | (5.2) |
| Liabilities | (--) | (--) | (-5.4) | (-4.3) | (-4.6) |
| 3. Claims on public sector | 4.4 | 14.8 | 32.7 | 53.5 | 114.3 |
| Central and local government | (0.8) | (0.9) | (9.9) | (1.0) | (1.3) |
| Public authorities | (2.1) | (11.1) | (20.0) | (50.4) | (110.5) |
| Public sector companies | (1.5) | (2.8) | (2.8) | (2.1) | (2.5) |
| 4. Claims on private sector 1/ | 46.9 | 59.6 | 79.2 | 98.2 | 123.1 |
| 5. Claims on banks | 0.4 | 0.1 | 10.7 | 15.3 | 12.6 |
| Central Bank | (0.1) | (--) | (0.2) | (0.1) | (0.9) |
| Commercial banks | (0.3) | (0.1) | (10.5) | (15.2) | (11.7) |
| 6. Unclassified assets | 7.7 | 9.3 | 5.4 | 7.3 | 16.4 |
| 7. Assets = Liabilities | 59.7 | 84.2 | 123.9 | 174.2 | 267.2 |
| 8. Private sector deposits 1/ | -- | 0.2 | 1.6 | 3.3 | 3.2 |
| 9. Public sector deposits | 6.4 | 7.1 | 12.4 | 13.3 | 8.6 |
| Central and local government | (--) | (--) | (4.6) | (0.4) | (2.3) |
| Public authorities | (0.1) | (--) | (0.3) | (4.6) | (1.2) |
| Public sector companies | (6.3) | (7.1) | (7.5) | (8.3) | (5.1) |
| 10. Bonds | 3.8 | 3.7 | 3.4 | 3.5 | 3.4 |
| 11. Funds due to banks | 21.4 | 42.7 | 68.1 | 110.0 | 183.4 |
| (a) Central Bank | (0.2) | (24.2) | (52.5) | (91.9) | (164.5) |
| (b) Commercial banks | (21.2) | (18.5) | (15.6) | (18.1) | (18.9) |
| 12. Capital accounts | 20.9 | 22.6 | 25.5 | 30.8 | 38.9 |
| 13. Unclassified liabilities | 7.2 | 7.9 | 12.9 | 13.3 | 29.7 |

Source: Central Bank of Egypt.

1/ Includes cooperatives.

Table III-3

Consolidated Balance Sheet of Foreign Currency Banks, 1978-80 1/

(In millions of Egyptian pounds)

| End of Period | 1978 | 1979 | 1980 |
|---|---|---|---|
| 1. Cash | 21.1 | 9.6 | 9.2 |
| 2. Foreign assets (net) | 351.5 | 396.4 | 383.6 |
| Foreign assets | (494.3) | (585.2) | (761.7) |
| Foreign liabilities | (-142.8) | (-188.8) | (-378.1) |
| 3. Claims on public sector | 11.2 | 24.8 | 20.9 |
| Central and local government | (4.5) | (4.5) | (4.2) |
| Public authorities | (6.7) | (10.7) | (6.8) |
| Public sector companies | (--) | (9.6) | (9.9) |
| 4. Claims on private sector 2/ | 166.2 | 253.4 | 425.5 |
| 5. Claims on banks | 90.6 | 100.3 | 277.9 |
| Central Bank | (14.6) | (14.8) | (46.6) |
| Commercial banks | (76.0) | (85.5) | (231.0) |
| Specialized banks | (--) | (--) | (0.3) |
| 6. Unclassified assets | 32.3 | 69.3 | 54.2 |
| 7. Assets = Liabilities | 663.9 | 853.8 | 1,171.3 |
| 8. Private sector deposits 2/ | 347.0 | 465.2 | 562.1 |
| Demand | (68.2) | (74.0) | (86.5) |
| Time and savings | (278.8) | (391.2) | (475.6) |
| 9. Public sector deposits | 16.1 | 32.7 | 40.0 |
| Central and local government | (0.2) | (0.1) | (0.7) |
| Public authorities | (1.4) | (1.8) | (7.8) |
| Public sector companies | (14.5) | (30.8) | (31.5) |
| 10. Funds due to banks | 179.1 | 207.2 | 327.7 |
| Central Bank | (0.6) | (7.8) | (28.9) |
| Commercial banks | (178.5) | (199.4) | (298.1) |
| Specialized banks | (--) | (--) | (0.7) |
| 11. Capital accounts | 61.4 | 88.1 | 124.3 |
| 12. Unclassified liabilities | 60.3 | 60.6 | 117.2 |

Source: Central Bank of Egypt.

1/ Banks established under Law 43 of 1974 dealing exclusively in foreign currencies.

2/ Includes cooperatives and international organizations located in Egypt.

Insurance Companies

There are at present three large public sector insurance companies and one professional reinsurer. Insurance companies are playing an increasingly important role in the financing of new industrial projects through equity participation. To date insurance companies are not permitted to invest directly in mortgage loans. They do however, deposit funds with the Credit Foncier.

Postal Savings System

The Postal Saving System operates in the traditional manner, serving as a vehicle for savings accumulation for its depositors. Funds mobilized under this system serve to finance a part of the government's budget deficit and do not constitute a source for mortgage credit.

Stock Exchange

In December 1979, the government established a Capital Market Authority to redevelop the country's stock and bond exchange. By late 1980, only 74 companies were listed on the stock exchange, and 10 of these were law 43 companies. Tax laws have been a major constraint on the development of this market in that existing laws impose a 41 percent withholding tax on income earned from shares. Proposed change in the tax laws should soon reduce the tax burden to that equal to income earned from bank deposits.

Other 1980 Financial Developments

In addition to the National Investment Bank mentioned above, the Egyptian Government announced during 1980 plans to establish three new specialized financial institutions. A new National Development Bank is to assist in the development of projects in the governorates, the Egyptian International Bank is to establish a "window" to the international money of the world, and the National Export-Import Bank is to assist in the financing of Egypt's exports.

C. Mortgage Finance System

There are currently three mortgage lending institutions in operation in Egypt. Two of the institutions; the Credit Foncier Egyptien, and the Arab Land Bank are classified by the Central Bank as Mortgage Banks, and as such the balance sheet of the two institutions is presented in table IV-2 above. The newly establsihed Housing Development Bank has been classified by the Central Bank as an investment bank to reflect a wider scope of activities.

As indicated in Table IV-2, row 7, assets and liabilities of the two mortgage banks increased by 347 percent between the years 1976 and the end of 1980. During 1980 above the increase amounted to 53 percent. As indicated in row 11-a, most of this increase was represented by borrowings from the Central Bank, funds which are earmarked for GAHBC programs.

1. Credit Foncier Egyptien

The Credit Foncier is the dominant institution with approximately 80 percent of the assets of this group of banks or about LE 168 million. By year-end 1980 about 60 percent of its loan portfolio of LE 144 million was in mortgage loans, the remainder in a variety of projects including commercial real estate ventures. The CFE may now solicit savings deposits, and a slow growth in this source of funds is evident. It does not challenge bank borrowings as the institution's primary resource (67% of LE 140 million in resources). The CFE continues to operate on a very conservative and profitable basis. Recently, management has decided to take a more active look at the mobilization of resources from outside the government but plans are still in the early stages.

The CFE benefits from the pass-through lending to the GAHBC, because it is able to pick up the additional loans that unit purchasers must take out in order to reach the amount required to purchase a unit. Such loans carry a market rate of at least 12 percent. The CFE has asked for the authority to make the government's 3 percent and 5 percent GAHBC loans directly in order to eliminate the need for two loan contracts.

Recently, the CFE has embarked on two voyages which offer promise of an expanded scope of activities. The first is the formation of a joint venture in combination with the National Bank, the National Investment Bank and the Reinsurance Company. The purpose of this joint venture will be increased levels of housing production and finance taking advantage of the CFE's large land holdings and real estate development experience and the substantial financial strength of the other partners. Among the objectives considered by the partnership is the creation of some form of secondary market for mortgage loans.

The second voyage recently undertaken is that of retailing services. Only the smallest of steps have been taken so far, but by opening up a loan office in the Helwan area the CFE has begun to test the waters for expansion of its contacts through branching. To date, the CFE has opened offices in six regional capitals and Cairo (Alexandria, Port Said, Tanta, Mansoura, Zagazig and Minieh ), but none of these operate an agressive retail business. In Cairo, with a population exceeding eight million, the CFE had no branch office until the opening of the Helwan project office. A successful experience with this small beginning could profoundly change the operating style of the CFE.

2. Arab Land Bank

Prior to 1975 the Arab Land Bank had been involved primarily in Jordan, and by 1978 had originated only 200 loans in Egypt. Since then the pace of activity has increased bringing the loan portfolion to L.E. 89 million at the end of 1980. The Bank makes construction loans for low and moderate income housing as well as hospitals, office building and hotels. The bank has a paid in capital of LE 5 million and is a wholly owned government organization. It has only one branch and does not solicit deposits. The principal source of funds is the Central Bank, and these funds go to finance the cooperative program.

3. Housing and Development Bank

Formerly, the Reconstruction and Housing Bank, the name was changed in May 1979, to its present name. Owned by a group of public sector banks, insurance companies and government institutions, paid in capital totals LE 18 million. The Central Bank has made a LE 80 million facility available. Actual funding did not begin until late 1979, therefore the bank's experience is quite limited.

Registered by the Central Bank as an investment bank rather than a mortgage bank, the bank plans to offer a wide range of general banking functions, as well as financing housing and new community projects, and other joint venture investment projects.

Authorized to accept deposits, the Housing Development Bank recently began a program to encourage savings for the purchase of a home. After saving a minimum of LE 2,500 the depositor is provided a mortgage of equal amount to purchase a flat built or approved by the Bank. To date, the bank has 150 qualified depositors in the program and has made 30 loans. While insignificant in terms of the housing finance needs, this program represents an attempt to break out of the traditional mold of obtaining nearly all funds for housing finance from the Central Bank.

In addition, the Bank participates in the subsidized housing finance schemes though the Cooperative as do the Credit Foncier and Arab Land Bank.

## D. Structure of Interest Rates

As indicated above, the Central Bank has responsibility for monetary policy in the country. Until 1975 there was a statutory ceiling on interest rates. In 1975, banking legislation was passed authorizing the Central Bank to fix limits on interest rates depending upon current monetary and credit conditions. As indicated in table IV-4 maximum interest rates payable as of January 1, 1981 ranged from 5 to 11 percent. On the lending side the maximum rate for loans to the non-government sector is 15 percent.. The discount rate, that rate at which commercial banks borrow from the Central Bank is currently 12 percent.

Despite the increases in nominal interest rates, the continued high rate of inflation has caused real interest rates to remain largely negative. Egyptian citizens are now permitted to hold foreign exchange deposits whose rates are not limited by Central Bank. For certain types of deposit rates approach those paid by the LIBOR overnight rate.

Table III-4

Structure of Interest Rates 1/

( In per cent)

| | |
|---|---|
| Deposit rates | |
| Demand | No interest paid |
| Savings 2/ | 8 1/2 |
| Time | |
| 7 days 3/ | 5 |
| 15 days 4/ | 6 |
| 1 month | 7 1/2 |
| 3 months | 8 1/2 |
| 6 months | 9 |
| 1 year | 9 1/2 |
| 2 years | 10 1/2 |
| 3 years | 11 |
| 5 years | 11 1/2 |
| Lending rates 5/ | |
| Regular | 13-15 |
| Cotton or export related | 11-13 |
| Central Bank | |
| Discount rate | 12 |
| Export Refinancing | 10 |

1/ As of January 1, 1981
2/ Transactions must be carried out by means of savings book.
3/ With a minimum deposit of LE 100,000.
4/ With a minimum deposit of LE 100,000.
5/ Banks have the right to increase the rate by one percentage point on balances in arrears.

## IV. FINDINGS AND RECOMMENDATIONS

### A. Findings

1. GOE plans and programs call for greatly increased expenditures on housing. The National Housing Plan produced in 1979 indicates that by the year 2000 the nation will need to have constructed approximately 3.6 million units. The plan for the first five years, 1981 through 1985, calls for production of about 675,000 units. The Plan makes clear that the nation cannot rely on direct budget funding to cover this kind of investment. For the period 1981-1985, the Plan calls for the government's direct involvement in formal sector production to remain below 30 percent, decreasing to 25 percent by the last year. The Plan document projects a LE 4 billion deficit in the resources available for investment and suggests that LE 2.86 billion will have to come from foreign resources. Of principal importance is the realization that a determined effort will have to be made to mobilize resources from elsewhere than the government budget.

2. If the present situation continues, GOE direct contributions to housing investment will grow almost automatically as a result of the increase in the spread between the Central Bank discount rate and the mortgage rate for the cooperative housing program. At present, the cooperative program permits loans of up to 30 years with interest rates ranging between 3 and 5 percent depending on the size of the loan. The current Central Bank discount rate is 12 percent. During the past 4 years, the lending rate permitted by the cooperative program has not changed

significantly. The Central Bank discount rate has increased from 6 percent in 1976.

Though the bulk of GOE production is rental units, the cooperative program serves as the principal financial mechanism for acquisition of GOE sponsored units. (There are no data on GAHBC sponsored production but it would appear to be no more than 5000 units per year nationally.) The program's benefits are technically available to a wide range of incomes, but the principal beneficiaries appear to be middle-income public-sector employees who are capable of working with their employers to form cooperatives. There are few limitations on the type of benefiting organization or individual, and recuperation of investment is not carefully monitored. The result is that the program offers a potential for almost automatic increases in the application of government resources with a subsequent reduction in the government's flexibility to direct its housing investment program.

3. <u>Private sector resources will be increasingly vital if the government is to achieve its housing investment objectives</u>. The GOE will have to take further specific actions to mobilize such private resources. Such actions would comply with the GOE policy to increase activity in the banking sector and to move the economy towards a more open-market management.

The first such steps taken, the promulgation of law 43 and the related laws, have been successful and have drawn new resources from the private sector. Sixty percent of investment in 1979 for example, came from foreign savings with remainder being made significantly. The Central Bank discount rate has increased from 6 percent in 1976.

Though the bulk of GOE production is rental units, the cooperative program serves as the principal financial mechanism for acquisition of GOE sponsored units. (There are no data on GAHBC sponsored production but it would appear to be no more than 5000 units per year nationally.) The program's benefits are technically available to a wide range of incomes, but the principal beneficiaries appear to be middle-income public-sector employees who are capable of working with their employers to form cooperatives. There are few limitations on the type of benefiting organization or individual, and recuperation of investment is not carefully monitored. The result is that the program offers a potential for almost automatic increases in the application of government resources with a subsequent reduction in the government's flexibility to direct its housing investment program.

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The disparity between incomes and the cost of living is really a more fundamental type of restraint. Although in ideal conditions, for example, construction materials to be used for housing may be acquired at subsidized rates under the cooperative program, labor costs are less easily controlled. The scarcity of skilled labor, a result, in part, of the emigration of an important segment of the nation's labor force to the Gulf States, has driven the cost of construction labor up considerably. The wage/price disparity has also led to reduced disposable income, making it difficult for families to save and difficult for families to support market rate rents or mortgage amortization programs. Accumulated wealth, whether from the sale of assets or the hoarding of foreign earnings has been the major housing investment resource and real estate investors are attracted only by cash projects. It is not clear how the GOE plans to work out of this politically sensitive wage/price bind, but the outcome will be very important to the process of savings' mobilization and the attraction of investment to housing.

Finally, among the major constraints is the predominance of a short-term bias in risk taking. The investment opportunities offered to the mass of new investors in the economy has permitted a rapid return and profit. This opportunity for easy gain in an investment-starved economy has been complemented by a sense of insecurity with respect to the political situation. The memories of the 1960's have not been obliterated and Al-Infitah is not very old. Most Egyptian investors do not appear inclined at this time to accept risks of more than 3 to 5 years.

5. <u>The existing banking institutions appear to be structurally capable of taking on increased responsibility in the area of housing investment</u>. Minor modification of authority may be required but a lack of institutions does not appear to be a major constraint to the mobilization of resources for housing finance. Some increase in capital will probably be required since many of these institutions are very new, having developed as a result of the promulgation of laws during the last half of the 1970s.

The public sector banks operate on a commercial basis and maintain considerable autonomy from the government. Their principal form of response to new government programs appear to be through capital subscription in institutions such as the National Company for Housing or the Housing Development Bank, but they appear to maintain full control over their lending assets and to consider themselves profit-making institutions.

The National Housing Fund and the Reconstruction and Housing Bank mentioned in earlier studies have now been formalized in the Housing Development Bank, which opened for business in late 1980. This institution, considered an "Investment Bank" by the Central Bank, has a full range of banking powers including long-term mortgage lending.

The Housing Development Bank is too new to have any track record though it appears to enjoy political favor. Its principal source of working capital is still the Central Bank and its initial output will be loans generated by the cooperative program, encroaching in one instance (Nasr City) on the business previously handled by the Credit Foncier. The CFE continues to be the most sizeable and experienced lending institution in the housing finance field.

6. The housing finance system is still without a secondary market or bond market. The Cairo Stock Exchange is undergoing a process of revitalization and is now the target of a government program to make it a more attractive vehicle for investment. This is the primary capital market initiative of the GOE at present. Certainly, any major increase in investment in long-term housing finance will require establishment of a liquidity mechanism so that loan originators may sell their assets.

The character of the investment climate in Egypt today does not favor an active long-term debt market. The restrictions mentioned in 4. above are factors. A return to an active stock market will indicate the return of investor confidence and should begin to lay the foundation for a market in long-term debt.

7. The result of these conditions is that long-term financing for the acquisition of housing is not used by upper income groups, is available to only a small percentage of the nation's middle income families and is not available to low income families.

The primary form of financing housing construction or improvements is cash with "progress" payments made during the course of construction. Down-payments provide the initial construction financing. The system favors unit ownership and very low carrying costs. Accumulated wealth provides the key to access to a dwelling unit whether it takes the form of key money for rental units or the payment to contractors during construction.

The traditional GOE approach to provision of housing, through subsidization of interest rates or costs, provides severe competition for any longer term form of housing finance designed to fully recuperate investment. This is particularly true in the case of the nation's low and moderate income families.

The policy of using direct budget outlays to help families acquire housing is unlikely to change as long as the GOE remains committed to wage and price controls and as long as the government so dominates employment. The GOE plans make clear that in spite of the substantial assistance GOE programs are not sufficiently effective.

The initial success of the small experiment in Helwan with home improvement loans, however, suggests that a key to greater acceptance of the market-oriented, cost-recovery approach may be the very availability of the funds themselves, funds which can be obtained free of the more cumbersome bureaucratic requirements involved in government programs. In sum, the flexibility of private sector financing may be a strong advantage in an otherwise very competitive situation.

## B. Recommendations

### 1. The Focus

The primary objective of this study is to surface the options for increasing private sector intervention in the housing finance markets that would assist the government in its effort to increase housing production as quickly as possible. This focus is carefully oriented toward the GOE policy of increasing private sector, market-responsive activity in the economy. The report also examines the possibilities for a combination of GOE and US government programs to help achieve GOE policy objectives.

It is clear that there are certain fundamental issues which set the context in which housing programs can be designed. Any joint GOE-AID program will have to deal with these issues either directly or by recognizing that little can be done at present to resolve the problem. One problem made clear by the description of existing conditions is the lack of large scale experience with organized shelter development outside the government. The CFE makes about 1,000 loans annually; the GAHBC probably makes fewer than 5000 (about 1,500 with funds passed through the CFE) and the bulk of private sector activity consists of small projects not directed by major financial or construction sector institutions.

At the same time, it is evident that a better base exists for the expansion of capital markets today than was the case four years ago. And, in fact, the very expansion of those capital markets fits well with the national policy determination to open up the economy. Because this opening must be a gradual process, it is recommended that programs combining GOE and AID resources encourage the recent positive developments in the capital markets so as to help direct some of the benefit to the housing sector.

2. The Objectives of a Joint Program

Ideally, the objectives of a joint program would include the following:

- Encouragement of savings directed specifically at housing.
- Extension of the risk financial institutions are willing to take on mortgage loans.
- Expansion of the retail efforts of thrift and mortgage lending institutions and a concurrent increase in the flexibility of operations.
- Establishment of a mortgage loan purchasing institution (the beginning of a secondary mortgage market.)

The Joint Housing Team and Richard Pratt reports have made clear recommendations dealing with national policy with respect to housing finance mechanisms and institutional structure. The reports have also highlighted the fact that a pool of untapped resources exists which could be more efficiently directed at the financing of shelter programs.

The conclusions drawn from this present analysis suggest that it would be difficult for AID to propose a joint program which would bring about the profound reforms of policy necessary to carry out such recommendations as across-the-board rationalization of rental charges and interest rates and reduction of the central government role in shelter finance and construction. Some recommendations have been accepted. The Credit Foncier is now authorized to accept deposits though this new authority has not been used to develop the wide-spread savings activity which was the intent of the recommendations.

Rent controls, low interest rate loans to cooperatives, and a heavy predominance of government organization in residential construction appear to be facts of life which could not be changed by the mere availability of expanded resources. It seems most likely that the changes can be brought about by the gradual expansion, over time, of the activities of the formal, not directly governmental, mortgage loan market.

Essentially, this means improving the retail aspects of the housing finance system. The expansion of the banking sector in recent years and the implementation of GOE policy to reopen capital markets suggest that agressive retail banking can capture new resources and make loans at market rates. There is room for an active private sector along-side the obviously inadequate public sector programs.

Thus, encouragement of savings directed at housing and the expansion of the retailing of housing finance services appear to be realizeable objectives. The extension of risks and the development of a secondary mortgage market appear to be objectives of a longer term nature. These latter two will be more reliant on the development of national conditions such as:

- greater confidence in the viability of private sector capital markets leading to development of a bond market;
- less reliance on strong GOE-set wage and price controls (including rent controls); and
- perhaps an increase in the importance of the private sector as an employer.

In summary, the objectives of a joint program would be selected to help build on the base of retail thrift and lending activities which exists and which, to some degree, is already the focus of AID programs.

3. The Selection of Program Contents

The specialized mortgage lending banks offer the logical base for program design. Of these, the Credit Foncier has by far the largest clientele and longest experience. None of the three has adopted an agressive retail policy. The new Housing Development Bank has opened a savings program window but it is not clear that the Bank's real interest is retail banking as the government has labeled the HDB an investment bank. The Arab Land Bank would appear to be formally structured to handle expanded retail business, but is small (assets of LE 90 million) and has a management that does not appear inclined to pursue such a course of business. The offer of additional working capital might change that attitude.

The HDB clearly has political support. Its Board of Directors includes the CEO's of the CFE and the ALB. It is not clear how the GOE would react to the selection of only one of these institutions for special treatment under a joint program.

The early experience of the home improvement lending program in Helwan, an element of the current AID-GOE housing project, would appear to offer the most interesting opportunity for further joint work in the housing finance area. The new program, in essence, is the first step in a more agressive retailing program, providing the CFE with an opportunity to make its service more accessible to the Cairo population. If this program is successfully coupled with increased mechanization of banking processes, and a switch to monthly account tabulation, then the CFE will be able to experience a more immediate and regular client contact new type of business relationship. In fact, the experience may stand out in the financial community where only the National Bank of Egypt, with 40 percent of the assets of the commercial banking sector, has established a network of 108 branches around the country and truly can be considered a retail bank. (The NBE had 27 branches in Cairo with its eight plus million population at the end of 1979. The Riggs Bank in Washington, D.C. had 26 branches in a metropolitan area of four million where the bank is confined to opening branches in the Federal District only.)

The CFE appears to be the only housing finance institution in a position to launch a retail/banking program, but any expansion of outreach by the mortgage banks would help to build the private sector lending experience to the point where important new resources were collected and the visibility of private sector mortgage lending was such that some political pressure would develop in support of secondary market activities. (It should be noted here that though the mortgage banks, and the four major commercial banks, are government-owned, they operate autonomously much like private institition s and seek to run a profitable business. Thus for the purposes of this analysis they are considered private sector instititions.)

Expansion of the program initiated in Helwan could include the making of standard mortgage loans. Such a program could be directly linked to a savings effort, not via a contract (the HDB approach) for that is too rigid a mechanism in the context of Egypt's economy, but merely by giving clients with savings account experience priority. If requirements are needed, the consistency of deposit activity could be used as a mark of the capability to handle the steady amortization requirements of a mortgage loan.

Additionally a number of Egyptian financiers have suggested that if long term mortgages at interest rates somewhat below the market were promised as a result of savings activity, families would accept a rate on their savings that was also below the market, thereby, permitting a profitable spread at rates more acceptable to some of the country's low and middle income earners. A mix of capital including GOE funds, HG funds and an AID grant, might be used to initiate this program at an attractive cost (e.g. average cost of capital, 6 percent.)

During this phase a single financial institution might be selected (to reduce administrative problems) to generate loans between 6 to 10 percent depending on the size of the mortgage needed. Mortgage loans (with 15-25 year terms) might be limited initially to a maximum of 50 percent of the purchase price of the house and might be tied to the amount of the deposit. The institution would pay 6 percent interest in the savings deposits versus the 8 to 12 percent currently available on LE denominated savings.

In a second phase, the program might be extended to other institutions and to broaden the appeal of long term lending, a private or government-sponsored mortgage insurance program might be established. Such a program would reduce the risk for lenders, thereby permitting better terms (80 percent of the unit value for example), and provide a means for setting uniform lending criteria.

Table III.2 shows that the assets of the mortgage banks amounted to LE 267 million or approximately $325 million. The principal resource was loans from the Central Bank, 62 percent of total liabilities at approximately $200 million. The capital base was $47 million. A joint program which injected $25 million, for example, would have a tremendous impact. Some of these funds could be invested directly in facilities, others leveraged through lending. The result of an expansion in retail activity out to be very positive in the present context of the Egyptian financial sector. Since one of the primary objectives must be savings mobilization, and the related involvement of more people in the nations capital markets.

The joint program would be of interest to the CFE and HDB at a minimum. The lack of any substantial banking experience works against early involvement of the HDB.

The CFE, on the other hand, has been working with AID programs, and also is the nation's most experienced housing finance institution. The installation of new computer equipment should help the CFE to modernize its collection and account management techniques. Above all these institutions have not drawn on a wide range of mechanisms to attract resources. Though they appear conservative in their management style, it is likely that at least the CFE would respond to the potential of another approach to resource mobilization if the appropriate political approvals were in place.

The commercial banks might also be targets for a joint program leading to expanded retail facilities. They would probably require guarantees of some sort as they are leery of making loans out over five years. Incorporation of these institutions into the retail housing finance business might depend on the longer term success with development of a secondary market or an insurance program.

The design of the retail program would draw on the costs presently associated with the opening of the Helwan office and the installation of data processing facilities. The CFE will have some familiarity with personnel and facilities costs but would need to spend some time working up an expansion plan with budgets acknowledging more flexible processing techniques at the branch level.

4. The Long Term Possibility

The establishment of a mortgage market institution would offer mortgage originators the opportunity to sell their assets, thereby maintaining a more liquid position and the flexibility to move in the market when the opportunity presents itself. Capitalization of such an institution could come from a joint GOE/AID program. The GOE has capitalized a number of housing related institutions such as the National Company for Housing and the Housing Development Bank by requesting participation from major public sector financial institutions (banks and insurance companies.)

A possible choice as the implementing institution for such a program might be the new financial company (now in the final stage of incorporation) which will result from a partnership of the National Bank of Egypt, the National Investment Bank, the Reinsurance Company and the Credit Foncier Egyptien. Among the long-term objectives motivating establishment of this new company is participation in a secondary market for housing finance.

Such an institution would undoubtedly be given the authority to operate across a wide band of income levels. Nevertheless, it could provide the liquidity mechanism which would permit an institution, most likely the Credit Foncier, to fund lending activities over a range of interest rates that reflect, more closely than existing government programs, market trends, but that also permit access to low income families.

A new secondary market institution would have to generate working capital through bond sales. Such bonds would have to be competitively priced in order to attract private market investors, and the establishment of such a market in the present vacuum might well require initial support from public sector companies through investment of pension fund assets, for example.

In order to assure the full acceptance of such a secondary market by the full range of investor types, the new institution will have to be given the flexibility to manoeuvre in the market as necessary, and not be so narrowly focused as to suggest that it represents merely another form of government program.

As mentioned earlier, it does not appear possible to carry out a secondary-market-oriented project at this time. The primary effort must be to move away from direct GOE participation in the capital markets as they pertain to housing and to induce private sector action. A secondary market program at this time would result in full GOE ownership of the existing portfolio. The bond market must open up and rental construction must become a viable investment for a joint project in this area to become attractive.

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