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# MORTGAGE FINANCE AUTHORITY

## Major Policy Issues

### FY2006 - FY2008

EFS TECHNICAL REPORT NO. 19

**November 20, 2005**

This publication was produced for review by the United States Agency for International Development. It was prepared by Chemonics International Inc.

## DATA PAGE

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Task: Task 1: Establish a Supporting Framework for the Real Estate Finance Industry

Key Results Area: KRA 1.1: Strengthen the MFA's Institutional Capacity to Supervise the Real Estate Finance Industry in Egypt.

Activity: Activity 1.1.4: Assist MFA Capacity Building and Develop a Business Plan.

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Date: November 20, 2005

EFS Library File: EFS Library/Technical Reports/REP#19 2005-06-22, Bothwell, Mortgage Finance Authority Strategic Business Plan

### List of Key Words Contained in Report:

Mortgage Finance Authority (MFA)  
Mortgage Finance Demonstration Project  
Public-private Partnership  
Central Liquidity Facility (CLF)  
Prudential Regulation  
Outreach Strategy

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## **Introduction**

The Mortgage Finance Authority (MFA) needs to consider and address several major policy issues in achieving its strategic goals and business objectives over the FY2006- FY2008 period.

The most pressing of these issues involve:

- (1) Designing and implementing a mortgage finance demonstration project that can stimulate the development of the primary mortgage market by lowering the cost of mortgage finance for middle income Egyptians,
- (2) Designing secondary mortgage market institutions, such as a central liquidity facility (CLF), that can service the future needs of a growing primary mortgage market,
- (3) Developing an efficient system of prudential regulation, and
- (4) Developing a targeted outreach strategy.

The Egypt Financial Services (EFS) project, funded by the U.S. Agency for International Development (USAID), can provide key assistance to MFA in addressing each of these major issues.

## **Mortgage Finance Demonstration Project**

The most immediate policy issue is to address the high cost of mortgage finance. As discussed in MFA's strategic business plan<sup>1</sup>, only high and very-high income Egyptians with substantial amounts of savings can qualify for mortgages under the terms and conditions currently available in the market. Banks and real estate developers already serve the needs of these individuals through individual housing loans and installment credit. Thus, despite a relatively benign business environment, the growth of the primary mortgage market has been slow since passage of the Mortgage Finance Law in 2001.

MFA can serve as a catalyst for growing the primary mortgage market by forming a public-private partnership. This partnership would design and implement a demonstration project to show that mortgages are the vehicle for making homeownership affordable for middle income Egyptians. The key to the project would be to extend the tenure of mortgages to 20-to 25 years, lower down payment requirements to 5- to 10 percent, and reduce interest rates by 200-to-250 basis points by supplying a government guarantee and eliminating the current 100 basis point charge for the Guarantee and Subsidy Fund (GSF).

The Ministry of Housing would supply the land and utilities, and developers would purchase the land and construct a housing project of moderately sized and priced

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<sup>1</sup> Mortgage Finance Authority, Strategic Business Plan, FY2006-FY2008 (October 2005).

flats and villas using short-term construction loans provided by banks. Mortgage finance companies (MFCs) would provide long-term mortgage financing for consumers using credit guarantees and underwriting standards supplied either by the GSF or the Central Bank of Egypt (CBE). EFS could supply the technical expertise necessary to establish underwriting standards and to structure and price the mortgage loans and loan guarantees.

## **Secondary Mortgage Market Institutions**

The loan structures and underwriting standards developed for the mortgage finance demonstration project could become the basis for standardizing mortgages...a necessary precondition for the eventual development of a secondary mortgage market in Egypt. This is what occurred in the United States, where the explicit mortgage guarantees provided by the Federal Housing Administration, and the implicit government guarantees provided by Fannie Mae and Freddie Mac, led to the creation of a very large and liquid secondary market.

While establishing a secondary mortgage market facility to buy and securitize mortgages requires the existence of a sizable and vibrant primary mortgage market, an interim step could be the design and creation of a CLF to provide funds for mortgage lenders. Again, this is what occurred in the United States, when the cooperative Federal Home Loan Bank System was established in 1932 to borrow in the capital markets and lend to its members, who, like the MFCs in Egypt, specialized in making residential mortgage loans to consumers.<sup>2</sup>

The World Bank is proposing to help the Government of Egypt establish a CLF by supplying loans and a line of credit of at least LE 90 million.<sup>3</sup> Under this proposal, MFA and the Ministry of Investment would be instrumental in helping design the CFL, with technical assistance provided by USAID's ESF project.

There are a number of critical CLF design features that will need to be considered and decided:

- Should the proposed CLF be a government agency? A government sponsored, but privately owned, for-profit institution with publicly traded stock like Fannie Mae and Freddie Mac? Or should it be a government sponsored, not-for-profit, cooperative institution like the Federal Home Loan Banks, where the interests of member-lenders and the CLF are closely aligned?

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<sup>2</sup>For over 50 years, membership in the FHLBank System was limited to, and required for, federally chartered savings and loan institutions specialized in making residential mortgages. It was not until the financial pressures stemming from the "S & L crisis" of the late 1980's arose that membership was open, on a voluntary basis, to commercial banks as well as thrifts.

<sup>3</sup> Arab Republic of Egypt, Proposed Mortgage Finance Project, Aide Memoire (March 2005).

- What mechanisms will exist to ensure that CLF funds are used solely for residential mortgages? By limiting CLF membership exclusively to MFCs and not to commercial banks that make mortgages? By requiring that CLF loans be secured exclusively by residential mortgage loans? By placing explicit limits on the business lines that the CLF can enter?
- Should membership be mandatory or voluntary? Should capital subscriptions be required? How would they be determined?
- What types of prudential regulations should be imposed and what agency should regulate the CLF? The MFA? The CBE? The CMA? A new regulatory board composed of representatives of several agencies?
- What governance structure, operating rules, and risk management policies should the CLF have?
- Should the government explicitly or implicitly guarantee CLF debt?

Fortunately, the banking system in general, and the two MFA-licensed MFCs in particular, appear quite liquid over the near term, so there is time to study and decide these issues while the primary mortgage market is still developing.

## **An Efficient System of Prudential Regulation**

MFA needs to develop an efficient system of prudential regulation for both MFCs and licensed mortgage-related professionals. An extensive list of specific action steps is contained in the MFA Strategic Business Plan for the FY2006 – FY2008 period.

For MFCs, the basic suggested approach is to review and approve risk management and internal control policies, to establish CBE-compatible rules for loan loss provisioning, anti-money laundering and bank secrecy, to establish jointly with CBE an electronic monthly “Call Report” of loan performance and condition and income, and to establish a protocol with CBE to conduct periodic on-site examinations to supplement the quarterly auditors’ reports. Establishing a “prior approval” approach to mortgage contracts and a set of “corrective action” procedures are also recommended.

For licensed professionals, the basic suggested approach is to work with major industry participants to establish a self-regulatory organization (SRO) that will establish and enforce rules of conduct and training and certification requirements. The SRO would operate under a delegation of authority from the MFA Board of Directors, be subject to MFA’s active oversight and its ultimate legal authority and jurisdiction, and be self-financing.

## **A Targeted Outreach Strategy**

Any mass communication strategy should be deferred until the proposed demonstration project can show that mortgages are affordable for the middle class and can be the financing tool for owning a new home in one of the New Communities.

In the interim, MFA should work with the Egyptian Banking Institute to present a regularly scheduled series of seminars to discuss the importance of the mortgage market, the status of its initiatives to stimulate the market and overcome the impediments to its growth and development, and to answer questions from the media and the public.

An effective, targeted media campaign can then be focused on real-life examples of middle class Egyptians who have obtained homeownership through the use of an affordable mortgage.

## **Recommendations for EFS Assistance to MFA**

- EFS can supply the technical expertise necessary to develop the underwriting standards and to structure and price the mortgage loans and loan guarantees under the proposed demonstration project.
- EFS can help supply the technical assistance MFA needs to design and implement the CLF proposed by the World Bank.
- EFS can supply the technical assistance needed to design and implement the system of prudential regulation discussed in the MFA Strategic Business Plan for FY2006 – FY2008.
- EFS can help MFA develop and implement a targeted outreach strategy once mortgages become demonstrably affordable for the Egyptian middle class.