STRENGTHENING EGYPTIAN MORTGAGE CONTRACT COMPLIANCE & CONSUMER PROTECTION, WITH SUGGESTED LEGISLATIVE AMENDMENTS

EGYPT FINANCIAL SERVICES
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1. Executive Summary

This report provides an update and an extension of the discussion initiated in the Consultant's Concept Paper of December 2005.[1] Pursuant to the Scope of Work, this report addresses the current status of document standardization, provides a list of proposed amendments to the mortgage finance laws and regulations in a narrative form that can be drafted more specifically by local counsel, and provides concepts and methods of advancing consumer protection that relates to developer installment sales contracts.

Standardization of mortgage contracts is an essential early component of establishing a mortgage finance market. Standardized contracts that are familiar to a variety of stakeholders—lenders, consumers, regulators, and investors that will include a liquidity facility as well as foreign capital sources—must be achieved early on so that mortgage loans that are originated at this stage will be regarded with the same level of confidence and fungibility as future loans.

On the other hand, if loan origination occurs in an *ad hoc* manner, with lenders each implementing unique features that require careful examination and create confusion, liquidity in the mortgage finance market will be significantly stifled and will fail to reach its potential. "[If the individual loans are not similar], the whole rationale of the exercise is undermined…."[2] Worse, if the loans that are originated do not conform to the requirements of the mortgage laws, they may be voided by the court system. Where non-conforming agreements are in widespread use, such adverse court decisions may have a devastating ripple effect throughout the mortgage finance industry.

The December Concept Paper pointed to several serious lender compliance issues that related to document standardization efforts. The most significant problem was the requirement in the Real Estate Finance Law (REFL) that all mortgage loans effectively be made on a fixed interest, fixed tenor basis. It was observed that the two Mortgage Finance Companies (MFCs) in existence could not make loans on this basis and remain sufficiently liquid to stay in business. Adjustments were being made by the MFCs to the then-standard contract forms to provide for loans that were not compliant with the REFL but which enabled the MFCs to originate at least a modest number of loans. The Concept Paper further discussed the disadvantages of the tripartite loan structure required by the REFL, and additionally provided a lengthy set of proposed technical changes to the mortgage finance contracts in use at that time.

At the time of the review made for this report, we were advised by the Mortgage Finance Authority (MFA) that standardization of mortgage finance contracts had been completed, though as of this writing no further information has been provided to EFS. We have not

[1] Wilkes, David C., *Concept Paper: Legal Support to Improve Mortgage Financing in Egypt: Analysis and Recommendations*, Technical Assistance, December 15, 2005.
[2] Proxenos, Soula, "Essentials for Secondary Mortgage Market Development" (Real Property Markets: The "Real" Solution for Economic Development) at 36.

been supplied with the amended contracts and therefore cannot comment on the changes that were presumably made.

However, based upon interviews conducted during the current visit, this report details the continuing apparent non-compliance of MFCs and banks with the plain provisions of the law. This fact highlights the significant predicament in which the Egyptian mortgage finance market finds itself: whatever the exact nature of the MFA's amendments to the mortgage contract documents, loans will continue to be legally non-compliant unless legislative action is taken. In particular, if the contract documents have been made to conform to current lending practices, then the contracts do not accord with the REFL. In contrast, if the updated contract documents conform to the provisions of the REFL, then lenders will be unable to utilize these contracts given their current practices. As discussed in the December Concept Paper, current lending practices are based on basic liquidity and administrative needs for responsible lending, and should be respected. This report details specific deviations from the REFL among the MFCs and retail banks. A resolution of the divergence between REFL standardized contracts and actual lending practices must be achieved if mortgage finance is to move forward.

We go on to consider the subject of installment sales contracts offered by developers directly to purchasers. The sample contract that was provided for review was well-drafted and clearly spelled out the rights and obligations of the parties for the most part. Review was limited to areas in which a consumer protection scheme would be useful in relation to these contracts, and did not involved the revision of the contracts themselves. It is recommended that a licensing scheme for those developers who choose to offer installment sales be made to include a bare minimum of informational items. Because title under these contracts does not transfer until all payments have been made, consumers should be informed of the limited nature of their rights in the property and to alienate the property. Registration of these sales contracts is recommended as a means of providing notice of the purchaser's interest during the life of the contract. Developers should also be required to execute a so-called "splitter agreement" with the purchaser once ownership transfers in order to release the property from the development financing lien. It may be possible to execute the splitter agreement at the time of contract and hold it in escrow pending full payment of the contract; this will protect the purchaser against the possibility of the developer abandoning the project without ever releasing the unit and delaying registration indefinitely.

The final section of this report contains a summary listing of suggested legislative and regulatory amendments stemming from both the Concept Paper and this report.

2. Document Standardization

2.1 Overview

We have been advised that the process of standardizing the three forms of mortgage finance contracts under the Real Estate Finance Law (REFL) (purchase and sale; home improvement; and construction), has been materially advanced since the matter was last examined by this Consultant in November 2005. At that time, MFA Chairman Saleh made it clear that document standardization was a major priority. He indicated that his goal was to produce a standardized set of mortgage finance contracts by January of 2006. Lenders seeking to originate loans pursuant to the REFL would be required to utilize these form contracts. We were left with the impression at that time that a process was underway by MFA legal counsel to implement Chairman Saleh's directive. Since that time, however, then-MFA Counsel left his employment and the position of Counsel remains to be filled at the MFA.

It has very recently been suggested that the task of document standardization has in fact been completed by our Egyptian counterparts and that a Ministerial Decree in this regard is imminent. However, no such documents have been provided to us, or reviewed, and so it is impossible to gauge the progress that has actually been made on this task. Inquiry of the two Mortgage Finance Companies (MFCs) indicates that no set of standardized documents has been provided to them.

While one cannot say for certain whether the revised set of contracts that were described to us are a material improvement over the documents as they stood in November 2005, it is clear that document standardization will require significantly more effort and consideration than might at first be expected.

In whatever manner the contracts have been revised, it seems highly unlikely that the documents have succeeded in overcoming a significant legal conundrum: as detailed below, current lending practices are widely in significant deviation from the letter of the law, so that if documents have been standardized to comply with the REFL then those contracts cannot realistically be used by the lenders; alternatively, if the contracts were made to accord with current lending practices, then the standardized contracts do not comply with the law. Either way, significant compliance issues are raised.

The form and content of standard form mortgage finance contracts will have deep and far reaching effects in the level of success of the Egyptian home finance industry. The production of standardized loan documents that are required to be used by mortgage finance lenders will affect the business models of the current MFCs and their viability; the likelihood of retail banks making significant entry into the mortgage finance market; and the legal validity of virtually all loans now in existence pursuant to the REFL. The process, more than anything, will most certainly be a determining factor in the ultimate success or failure of the country to develop a secondary mortgage market. This exercise in contract drafting involves far more than minor language selections and the addition of “boilerplate” contract clauses. These issues are detailed in the following section.

2.2 Compliance Concerns Related to Standardization

As explored in much detail in the December 2005 Concept Paper, the current REFL and Executive Regulations, as amended, contain two massive roadblocks to success: (a) an effective requirement in the law that all mortgages be made at a fixed rate of interest for a fixed tenor; and (b) a tripartite form of loan agreement, which is the only form of its kind in the world—even among the Shari’a-compliant banking systems of the Gulf states. These two requirements are greatly at odds with any form of internationally accepted mortgage lending business practices and the practical requirements of operating a lending institution. So much so, that indeed our investigation reveals a wholesale disregard—in differing forms discussed herein—by the MFCs and retail banks of the clear requirements of the governing law. The loan contracts that are the basis for mortgage finance loans on the books today are, in the main, either non-compliant with the law on their face or else may be considered effectively void under the REFL in future court proceedings; in either case, they are surely subject to challenge in the courts and thus put all REFL loans in serious jeopardy unless legislative action of some kind is taken soon.

Several forms of portfolio-wide non-compliance have been found[3]:

The REFL dictates the contents of the mortgage finance contract. The REFL provides for a loan that is required to be for a fixed interest rate (or cost) and a fixed term. Specifically, Article 6(C) of the law states:

> “[The Agreement shall state] the number and amounts of the installments of the balance of the price, and the conditions for their settlement, providing they shall be determined until they are fully collected.”

If a mortgage finance contract adheres to this law, then the “number and amounts” of the payments due under the loan must be known—and stated—at the origination of the loan, which is impossible with a variable rate or variable tenor loan. As detailed in the Consultant’s December 12, 2005, Concept Paper, it is near impossible for a lender in a developing real estate market to issue long-term financing on this basis absent compensating institutional devices to provide liquidity. The proposed Egyptian Liquidity Facility (ELF) is a form of such device, though the MFCs have yet to be able to avail themselves of the ELF’s virtues while continuing to operate under pressure to originate a

[3] The statements made herein are based solely upon discussions with lender personnel concerning practices and the contents of form loan documents; no direct examination was made of actual loans as might occur in an audit, nor was the consultant’s work performed in the manner of an audit.

volume of mortgage finance loans[4]. Many loans have of course already been originated in a manner that forces the lender itself to compensate for liquidity and other forms of bank risk.

The confluence of the practical realities of long-term lending with the current law and the lack of a liquidity facility has, quite predictably, resulted in lenders issuing extra-legal mortgage finance contracts. This fact presents issues of its own, but will raise further concerns once documents are fixed in a standardized form that adheres to the current law.

2.2.1 Variable Tenor Loans

This Consultant observed in the December 2005 report that one of the MFCs was stepping beyond the bounds of the REFL by issuing loans with an adjustable tenor, though asserting that this had received tacit government approval. In other words, if interest rates increased during the life of the loan repayment period, the lender will notify the borrower that the term of the loan has been extended, and the converse if interest rates decrease. In doing so, the MFC has protected itself from increased borrowing costs, though it obviously fails to be able to state the "number … of the installments" in the contract within either the letter or clear spirit of the REFL.

2.2.2 Variable Rate Loans

More recently, the Consultant has learned that another MFC is plainly varying the interest rate charged on its loans from year to year based on its borrowing rate. Indeed, the MFC's lawyer believes that the contracts that were being filed with the registration office became effectively void once the interest rate changed. He stated that the total loan cost shown in the contract will change each time the interest rate is changed, yet the contract shows only the total cost as a fixed number, and the contracts do not specify an interest rate at all. The reality is that the contracts do not indicate an interest rate because the law effectively calls for only a fixed cost of the loan and does not permit the variations in interest to which local MFC counsel has referred. Nonetheless, this concern reflects a serious dichotomy between lending practices and the law.

2.2.3 Cherry Picking REFL Provisions

A very different form of non-compliance exists as well within the current mortgage finance market. As discussed and detailed later in this report, retail banks have begun issuing their own form of loans secured by real property. These banks have evidently determined to extract the useful portions of the REFL—principally the anticipation of an expedited, more efficient foreclosure system—while omitting the more onerous, burdensome, document-intensive, and complex requirements of the REFL. A sample loan agreement examined by this Consultant clearly recites, as follows:

[4] Even with the ELF in place, this is not a full substitute for permitting lenders to originate loans in accordance with prudent risk management rather than relying solely upon the ELF as a crutch; it is noted that a draft proposal of the ELF itself recognized the need for adjustable rate financing.

> "This agreement is made on / / according to the provisions of law No. 148/2001 concerning the real estate finance and its executive regulation … ."

The agreement indicates that the lender is licensed pursuant to the REFL, and that the purchaser wishes to enter into a real estate finance contract according to the REFL. The contract goes on to reference the applicability of the REFL in several additional clauses as well.

In "cherry picking" provisions of the REFL, we have been further advised that the retail banks seek not only the more efficient REFL foreclosure procedures but also the exemption from the 3% requirement for other types of non-mortgage finance loans and the stamp duty waiver.

Noticeably, the contract is not in the tripartite form required by the law, but rather is made only between the lender and the borrower.[5] The contract likewise lacks many of the other specific requirements of the REFL. Because the REFL requires the use of the specified tripartite agreement and other provisions that are lacking from the mortgage finance loans being made by banks, the loans are arguably invalid under the REFL. Local Egyptian counsel would be best suited to advise on the likely outcome under court review; it seems probable that at the very least these lenders will be prevented from utilizing the desired REFL foreclosure provisions (which will be a significant factor for the lender but of even greater significance for a secondary market purchaser). At worst, the entire loan might be struck as void, and this will have drastic consequences for all other loans in a given portfolio made under the same form contract.

2.2.4 Effects of Standardization on Current Practices

The point of document standardization is that mortgage contracts should be (1) legally compliant, (2) predictable by the parties, (3) permit the efficient origination of loans, (4) permit the efficient bundling, purchase, and due diligence functions involved in pooling loans for sale, and (5) reliable instruments free from legal question in the eyes of a secondary market.

Under the REFL, notwithstanding questions about whether the law accords with lender needs, document standardization could be a fairly straightforward process because the law is instructive on the exact form of the agreement. However, if real estate finance agreements are standardized to comply with the letter of the law, and lenders (MFCs and

[5] We have received anecdotal information that some form of a tripartite agreement (unseen by the Consultant) is prepared as a "preliminary agreement" by at least some banks, and then is effectively shelved in order to execute a more standard two-party agreement. Presumably, the tripartite agreement is prepared to be provided in the event of a loan review, but it is clear that this is not the agreement upon which the parties rely nor should it be satisfactory for compliance purposes.

banks) are required to *use* the standardized documents to issue a valid loan, then problems related to the above lending practices will surely be presented.

On the one hand, if required to utilize legally compliant loan forms, lenders will need to fundamentally alter their current mortgage finance lending practices by adhering to the fixed rate-fixed tenor loan requirements as well as the tripartite arrangement. If they do so, however, particularly with respect to rate and tenor provisions, lenders will put themselves at intolerable lending risk absent a compensating liquidity facility. Banks will simply not lend money under this scenario and have no incentive to do so. Further, even if a liquidity facility is fully implemented soon, the recognition that the current forms of agreement are not legally compliant will place existing loans that are now on the books in legal jeopardy absent legislative intervention. In either case, compliance audits will surely raise these issues as significant problems, and could result in significant friction between lenders and regulators.

2.3 Issues Arising From the Three-Party Loan Structure

2.3.1 Overview

The effect of the introduction of the Real Estate Finance Law (REFL)[6] has been to create two distinctly different schemas for bank lending that involves the financing of real estate in Egypt. The REFL and its regulations very specifically define the contents and structure of a mortgage finance agreement. The REFL creates a highly unusual (even within Egypt) form of contract that requires three parties.[7] Pursuant to REFL Article 6 the three parties to the mortgage contract are: (a) the borrower-purchaser (“investor”); (b) the lender (“financier”); and (c) the seller of the real estate.[8] In contrast, in developed real estate finance markets, real estate loans are two-party agreements made between the borrower and the lender. Indeed, as discussed above, banks in Egypt are making real estate-backed loans as two-party agreements. There is no requirement in international practice that the seller of the property be a party to the loan agreement. Indeed, the seller is typically well removed from the loan agreement and often seeks, as much as possible, to ensure that the sale of the property will not be constrained by the purchaser’s efforts to obtain financing.

[6] Law Number 148 of 2001, Cabinet Decree No. 1 of 2001 issuing executive regulations, and Prime Minister’s Decree No. 465 of 2005 amending those regulations.

[7] Notably, the tripartite form of agreement is the only one of its kind in the world; the closest analogy to the tripartite mortgage contract specified by the REFL are the Shari’a compliant contracts prevalent in the Gulf States; however, these are distinctly different from the Egyptian contracts in that they are rent-to-buy asset-based contracts that in reality join the lender and borrower as holding a joint interest in the property and in that sense these are not tripartite contracts at all; the Egyptian contract is considered more similar to a “*Murabahah*”, or “cost-plus” agreement, in which an agreed profit margin is stated at the outset, except that the traditional concept involves continued ownership of the asset by the lender whereas the REFL contemplates title transfer at the outset.

[8] This report will generally refer to “borrower” and “lender” for ease of comprehension.

Moreover, the borrower under such contracts may be a purchaser of property, but not necessarily so. Very often the borrower is simply seeking to liquidate his or her property wealth through a home equity loan, perhaps for the purpose of making improvements to the property itself. Frequently, such loans are made for other purposes as well, such as the funding of a small business enterprise that may have no connection to the real property that is securing the loan.

The underlying reasons for the REFL's tripartite finance contract structure relate to Shari'a law concerns that the agreement between lender and borrower must involve tangible property, among other things. Many believe that an agreement that solely involves the facilitation of money (as in a typical Western mortgage contract) violates Islamic law, though disagreement exists among Islamic lawyers on this point, as is clear from the fact that all other loans in Egypt are made as two-party agreements.

Historically, though, we understand that retail Egyptian banks have extended loans to customers to finance the purchase of real property as well as to construct improvements to real property that was already owned by the borrower (the loans will collectively be referred to herein as "Bank Loans"). It seems that the question of whether the real property was registered was not in all instances a significant concern, and that collateral might be provided in various non-real estate forms. In that sense, such loans were not true "mortgage" loans, but have nonetheless always been regarded as such by Egyptian lenders and registration offices. Many Bank Loans are made with the requirement of registration to ensure the lender's security, but the loans are in many other respects less burdensome and more efficient to originate.

The REFL does not prohibit the continued origination of Bank Loans that simulate mortgages and they continue to be offered by retail banks to the general public.

In contrast to the mortgage finance agreements required by the REFL, these Bank Loans are two-party agreements between only the lender and the borrower. Bank Loans are also a useful means of accessing capital for home improvements and achieving many of the very same objectives intended by the REFL. Yet, by nature, Bank Loans involve much less effort and cost than REFL finance agreements, partly due to the fact that property registration is not a prerequisite, partly because these types of loans have been around much longer and are generally better understood by the general public and lenders than the new REFL loans, and, most important, because the seller's contractual participation is not required to originate the loan. Moreover, where registration is involved, it has been observed that registry offices treat loans originated under the REFL distinctly differently than Bank Loans, with which registry personnel are far more familiar and comfortable.[9]

[9] *See e.g.,* Hall, Justin T. Jr., Recommendations to Expedite Mortgage Registration Under Sigueal El-Shaksi, at 14 (Technical Report dated March 6, 2006).

There is, in fact, little incentive for a consumer to seek an REFL loan when a Bank Loan (or developer financing, discussed later) is more readily and efficiently available. Most significantly, the REFL's requirement that financing agreements be made among three parties effectively prevents the MFCs from offering home equity-type loans, in which there is no "seller" of the property.

The primary reason a REFL loan would be competitive with a Bank Loan is the longer tenor available under the REFL, which presumably would make the installment costs cheaper for the borrower and better match the asset life. Retail banks, relying principally on short-term deposits as a source of funds, generally lack the necessary liquidity match to be able to make such long-term loans. Yet, ironically, the REFL provisions themselves as discussed above and in this Consultant's December Concept Paper make it impossible for the MFCs to sustain liquidity absent a compensating facility such as the ELF. This has resulted in three effects, each of which confounds the purpose of establishing the REFL:

(1) MFCs have been compelled to resort to extra-legal real estate financing agreements that are not in compliance with REFL Article 6, thus casting doubt on the validity of these loans and future loans so drafted;

(2) MFCs appear to be charging significantly more for so-called mortgage loans than the banks, which reflects the higher costs of the MFC risks, borrowing costs, and transaction costs they face, so that the net effect is to negate the cost saving effect (and competitive advantage) of the longer term loan offered by the MFCs; in the area of home improvement loans, for example, retail banks may charge an interest rate of between 5% to 10%, while the MFC will charge 13% to 14%.

(3) Many MFC loans are issued on a 10-year term or less, perhaps also a result of the difficulty MFCs face in achieving liquidity, thus further negating any competitive advantage with Bank Loans.

In addition to the many hurdles faced by the MFCs that stem from unfamiliarity with their product, difficulties in registration, underwriting inefficiencies, and liquidity risks, the Bank Loans put the MFCs at a tremendous competitive disadvantage compared to ordinary retail banks. Not surprisingly, we have further been advised by one of the MFCs that the tripartite agreement, in comparison to standard two-party agreements, are simply far too confusing and complex for the great majority of potential loan applicants; MFC personnel can hardly understand the mechanics of the loan structure under the REFL.

The high degree of flexibility of the Bank Loans to efficiently accommodate varying consumer scenarios will continue to undermine efforts to achieve a significant volume of loan originations under the REFL. It is recommended that regulatory and legal changes be implemented to make REFL financing agreements more competitive with Bank Loans and to better level the playing field between the MFCs and traditional lenders.

2.3.2 True Home Equity Loans Restricted by Tripartite Agreement

Beyond enabling a higher level of homeownership, the most significant use of mortgage finance as a national economic catalyst is as a home equity loan or line of credit. In international practice, home equity loans are routinely issued to homeowners against the value of their real property for the purpose of making construction improvements to the property. More important, the loan proceeds need not be used in connection with the subject property at all: they are frequently used for many other productive uses, particularly for the financing of small entrepreneurial enterprises. Whether for construction purposes, small enterprise, or other consumption of products and services, it is evident that the home equity loan is a significant national economic stimulus.

The current REFL and Executive Regulations unnecessarily restrict lenders from making home equity loans to the point at which the vast majority of truly practical loans cannot be originated. The tripartite form of agreement requires, of course, three parties. In the case of a home equity loan there are only two parties: the lender and the borrower. The only way in which three parties can execute an REFL loan as a home equity loan is to bring a construction contractor into the agreement as a third party. Yet, the circumstances in which a construction contractor would—or *should*—be a party to the contract are quite few and far between. Because the purpose of the loan is essentially irrelevant, there is often no need for a contractor to be involved in the loan transaction. If the loan is for non-home improvement purposes (e.g., small business financing), then there is simply no opportunity to enter into a three-party contract. Moreover, even for construction-related home equity financing, a general contractor will often be unnecessary and Egyptian homeowners will prefer to contract directly with individual specialists (e.g., electricians, masonry contractors, plumbers, etc.) as needed.

The foregoing perceived obstacle to lending under the REFL has been confirmed directly with the Egyptian Housing Finance Company (EHFC), which currently has no home improvement loans in its portfolio.

In any event, there is no good reason to require the general contractor to be a party to the financing agreement. Unlike the purchase and sale of a home, no “asset” is being transferred here for purposes of Shari’a law concerns. It rather appears that the home equity loan product under the REFL is made to be a three-party agreement simply because the purchase and sale agreement was legislated as a three-party agreement. It is recommended that, even if the purchase and sale agreement remains a three-party agreement, the home equity form of agreement should be reformulated as a two-party agreement in accordance with international standards. This will have a further beneficial effect of creating a more attractive loan financing product for international investors once securitization is functioning. Of additional importance, this will provide a strong stimulus for a greater volume of registrations of existing urban properties, thus unlocking the trapped real estate wealth of many property owners who are not considering a sale, and providing capital for improvements and stimulating spending for small businesses and various consumer purchases.

2.3.3 Tripartite Obstacles to Registration

Though there should be no difference between the registration of bank-originated, two-party mortgage agreements and tripartite agreements, it has been observed that registry offices are confused as to the proper procedures for recording tripartite agreements. The problems are further compounded at the time that all of the installment payments under the tripartite agreement have been paid. The inclusion of the seller's name on the agreement and purchaser's deed despite the fact that the seller has since terminated his rights in the property create unnecessary confusion.[10]

Although these problems are not fatal to the process, they are unnecessary, cumbersome, require additional hours of clerical training and personnel, and can be expected to result in far more clerical errors in recordation than if a standard two-party agreement were implemented for mortgage finance contracts.

2.3.4 Tripartite Agreement as Obstacle to Mortgage-Backed Securitization

As discussed in the Consultant's 2005 Concept Paper, the tripartite agreement, being the only mortgage form of its kind in the world so far as research can reveal, will be unattractive to secondary mortgage market investors. In the Concept Paper the Consultant observed:

> "Particularly in the early stages of a new mortgage market, investors in the secondary market will be uncomfortable with the new mortgage instruments, even where the mortgages are in a familiar and standard form; * * * Early securitizations may require the payment of a premium to investors because of a lack of data and familiarity. With experience, much better deals will occur. Nevertheless … the Egyptian tripartite agreement will present investors—from the very outset—with a high degree of unfamiliarity and likely discomfort with the "standard" Egyptian mortgage instrument being offered to the Secondary Mortgage Market. This should be considered carefully."[11]

Further research to date continues to indicate that the REFL's tripartite agreement is so unique as to be unworkable as a securitizable instrument in international practice for all intents and purposes. For related reasons, the tripartite agreement may even present

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[10] See n. 8, Hall Report at 15.
[11] Concept Paper, *supra* n. 12, at n. 12.

obstacles to fulfilling the objectives of the ELF. This is a compelling rationale for considering legislative reform that would permit two-party mortgage finance agreements pursuant to the REFL.

2.4 Additional Document Standardization Issues

In addition to the items discussed above, which primarily relate to the tripartite form of agreement and the lack of variable financing options, the following matters have been raised in discussions with local counsel for one of the MFCs and should be considered in refining the standardized mortgage finance agreements and regulatory amendments.

2.4.1 Statement of Contract Price

The current contract form is quite confusing in regard to the statement of the contract price. Confusion is experienced not only by lender personnel, but, perhaps more important, by consumers and by the registry office. The contract mentions the sales price, the total price of the contract, Guarantee and Subsidy Fund (GSF) payment, the installment payment amount, the down payment, the number of installments, and insurance. The contract further refers to an amortization schedule that is attached to the contract. Issues of concern raised by counsel include:

- The phrase "selling price" in fact refers to the appraised value and not necessarily the value agreed upon between the buyer and seller;
- The phrase "total price" in fact refers to the amount of principal plus interest, and does not include additional costs that make up the complete cost of purchasing the home, such as insurance, fees, etc.;
- Likewise, by multiplying the "installment amount" and the "number of installments", one would not derive the total cost because the installments include principal, interest, insurance, and GSF payment;
- The clause describing the pricing of the contract omits any mention of the interest rate being charged by the bank.[12]

Counsel indicated that registry office personnel are particularly confused as to which is the appropriate price to use in recording and charging for the transaction. He further stated that, in his view, the fact that the contract does not reflect the interest rate (or the fact that the interest rate will vary from year to year) but at the same time does make reference to a "total price", could result in invalidating the contract that is recorded. He observed that once the interest rate changes, the total price must therefore change but this is not reflected in the contract so that the information shown in the contract is no longer true.

[12] This fact, of course, is related to the notion that this is conceptually not an interest-bearing loan under the REFL, but rather an installment contract; EHFC counsel is troubled, however, by the very real circumstance that the MFCs must lend and price the loans based on interest rates, which creates a significant conflict.

It was further observed that the statement of pricing in the contract was surplus because the amortization schedule already laid out the contract price.

2.4.2 Contract Terms Unlikely to be Enforced in Foreclosure

In the event of default, the lack of clarity in the contract document may result in a circumstance in which the borrower can counter with a so-called “accounting law suit” as a means of hedging against interest rate fluctuations. Specifically, because the contract mentions neither the interest rate charged (13% in the case of EHFC) nor the late fee charges (2% at EHFC), in an accounting law suit the court would assign an accountant to audit the payments made and those due under the contract and compute the amount due the lender. In the absence of a contract that mentions the actual interest rates agreed to between the lender and borrower, the court will likely compute the amount due at the statutory rate of only 7%. This might actually create an incentive for a client to default and effectively cut his interest rate by more than half and eliminate the late fees.

2.4.3 Assignment of Contract and The Stamp Duty

A technical problem, easily solved by regulation, may crop up upon assignment of the mortgage finance agreement pursuant to REFL Article 7. Normally, a stamp duty of 0.8% is charged upon “Loans and Debts” over 10,000 EGP pursuant to Section 3 of Stamp Duty Law Number 111/1981, Decree 57. Mortgage finance contracts have been specifically excepted from that Stamp Duty based upon an advisory letter from the Ministry of Finance to the Ministry of Justice.

However, Section 2 of Law 111/1981 requires the charging of a Stamp Duty upon “Fund Transfer and Assignment of Debts” of 0.6%. There is concern that in the absence of further clarification from the Ministry of Finance, or further regulation, the Stamp Duty may be charged if the mortgage finance contract is assigned.

3. Consumer Protection Issues Concerning Developer Installment Contracts

The Consultant has examined a sample installment sales contract form supplied by a well known Egyptian developer. The contract was examined solely for the purpose of considering consumer protection concerns that might arise. It is also recognized that the sample contract examined may differ substantially from installment sales contracts made by other developers and there is currently no “standard form” for such contracts. The suggestions made below are, therefore, necessarily general and will need to be refined to address additional installment contract issues and developer practices that may be apparent from other forms of contract. Recent discussions among USAID, EFS, and new leadership at the Ministry of Housing have raised hopes of several new practices in the new communities affecting developer practices. Included in the discussions are registration of installment contracts, which could lead to standard contracts that meet minimum consumer protection requirements.

The installment sales contract is distinctly different from a mortgage finance contract because it is in fact a "rent-to-own" product, similar to the Islamic Law-compliant *"murabahah"* transaction, in which the "borrower" does not receive title until the full amount of debt has been paid. As such, it is important that the consumer clearly understand the fact that his rights to alienate the premises are restricted to whatever the contract provides. Further, while ownership does not occur under the sample contract until the full purchase price has been paid, registration of the property does not occur until the entire project is completed, i.e., not just the unit being purchased under a given contract. In this regard, the Consultant's December 2005 Concept Paper includes a proposed "splitter agreement", by which individual units that had been transferred could be released from project financing; this tool should be promoted through regulation to require such a release at the time of full payment of an installment agreement as well.

The following suggests items concerning developer installment sales contracts that should be addressed by regulation[13]:

3.1 Licensing

Developers that wish to provide installment sales contracts should be made subject to a licensing scheme, if they are not already, at a nominal cost sufficient only to cover the expense of administration. In conjunction with licensing, developers who wish to maintain their license will be required to report relevant data concerning the volume and value of installment sales made and geographic location. This will provide regulating and consumer protection authorities with greater awareness of the magnitude of such financing as well as the ability to enforce regulations that promote consumer education and protection.

To the extent that developers are already subject to licensing, then the following items should be added to the conditions required of licensure.

The consequence of issuing installment contracts by an unlicensed developer, or non-conforming contracts by a licensed developer, can be the voidability of the contract at the will of the purchaser, thus providing incentives to both the developer to become licensed and the consumer to deal only with licensed developers.

Notably, regulatory requirements for installment contracts issued by developers will be quite minimal in comparison with the requirements of a mortgage finance agreement, but should contain a bare minimum that will protect the consumer.

[13] The Consultant has not had an opportunity during this visit to review these recommendations with local counsel to EFS; it is quite possible that some of these recommendations are already in place outside of the REFL and Executive Regulations thereto.

3.2 Unit Release for Registration

As noted above, a prospective Egyptian purchaser who seeks to purchase an apartment secured by, and subject to, the "umbrella" financing arranged between the project developer and its lender will be unable to register his unit until the full project is completed. Notably, the sample installment agreement reviewed specifically provides:

> Registration
> The [seller] shall abide by fulfilling his obligation to sign the final sale contract after the [purchaser] fulfills his obligation towards paying the full price agreed herein before the Real Estate Publicity and Notarization Department and handing out all documents and necessary papers for registration and publicity to the [purchaser], *provided this obligation to make registration at the Real Estate Publicity Department is made jointly after completion of the project as per the instructions of the New Urban Communities Authority … .*

This provision makes it fairly unlikely that registration will occur promptly, if at all. The requirement of "joint" participation by the developer, possibly many years after the project was initiated, makes registration still less likely. Of course, further problems will be encountered if the developer never reaches completion.

This is an easily corrected problem, and will greatly stimulate the volume of property registrations, through the use of a "splitter agreement". This form of agreement, annexed to this report, results in a partial release of lien, and is executed at the time the unit has been paid for and releases the individual unit in exchange for the payoff proceeds. The unit is released, with the construction mortgage remaining in place on the balance of the property. Given the length of time between origination of an installment agreement and transfer of title (in contrast to a mortgage finance agreement), it might also be possible to provide for an escrowed splitter agreement between the developer and purchaser that can be released from escrow by a third party trustee upon satisfaction of the contract terms.

3.3 Registration of the Installment Contract

While registration of the purchaser's ownership interest must contractually await his full payment of all installments—and at that time a splitter agreement may be used to record the purchaser's interest in advance of full project completion—it is also strongly recommended that the installment contract be recorded at the outset.[14] Recordation of the installment sales contract puts all interested parties on notice of the consumer's use rights, which are akin to lease rights, in the premises. This has the effect of preventing the developer from the unscrupulous, but not uncommon, practice of selling a single unit multiple times.

[14] The subject of registration of installment contracts and the related mechanics is discussed in greater detail in the report of EFS Consultant Justin T. Hall, Jr., *supra* n. 8.

3.4 Required Contract Terms

It would be undesirable to "over-regulate" developer installment contracts. However, there are several basic contract elements that should be required in every contract by regulation in order to create an enforceable installment contract and that will better ensure consumer understanding of the true terms of the loan. A regulation is suggested, as follows:

1. The installment contract shall contain:

    a. the names of the seller and the buyer, the place of business of the seller, the residence or other address of the buyer, and a detailed description that identifies the property being sold in a unique manner;

    b. The sale price of the unit; to the extent that additional improvements are requested of the seller by the purchaser, the additional cost of such improvements shall be added to the contract as an amendment, and all cost figures recalculated to reflect the increased costs and included in the amendment;

    c. The amount of any down payment made by the buyer;

    d. The difference between the amount of the down payment and the amount remaining to be paid under the contract (i.e., the difference between items (b) and (c) above);

    e. An itemized list of all charges that are included in the installment amounts, such as effective annual interest rate, insurance, fees, service charges, other charges;

    f. The amount of any fees charged in addition to the amounts contained in the down payment and installment payments, such as application fee, registration fee, etc. These amounts should clearly disclose the fact that they are above and beyond the down payment and installment payments;

    g. The number of installment payments required and the amount of each installment and the due date of each payment necessary to pay the balance;

    h. If installment payments other than the final payment are stated as a series of equal scheduled amounts, and if the amount of the final installment payment does not substantially exceed the scheduled amount of each preceding installment payment, the total number of payments and the amount and due date of each payment need not be separately stated;

i. The due date of the first installment payment may be fixed by a day or date or may be fixed by reference to the date of the contract or to the time of delivery of the unit to the purchaser;

j. Additional items may be included to explain the calculations involved in determining the balance to be paid by the buyer;

2. Directly above the space reserved for signature of the buyer, the installment contract should include, in large, conspicuous print, language such as the following:

   a. "Do not sign this contract before you read it or if any spaces intended for the agreed terms are left blank."

   b. "You are entitled to a copy of this contract at the time you sign it." (the requirement that a copy be provided to the consumer would similarly need to be added to the regulations);

3. Regulations should further be developed to inform the consumer of the importance of:

   a. Making a pre-contract inspection of the premises (in pre-constructed projects this is obviously of limited value);

   b. Understanding that because title is not transferred until all payments have been made, the purchaser will be limited in his ability to transfer his rights and will rely upon the discretion of the seller;

   c. Maintaining his mailing address as current with the seller so as to better ensure that notices regarding the contract are timely received;

   d. Recognizing that under the contract his rights may be severely limited in the event of a default;

   e. Recognizing that in the event of default the seller may be able to collect liquidated damages pursuant to the contract, and explaining the nature of liquidated damages;

   f. Ensuring that the unit is registered as early as possible in the process in order to protect the buyer's use rights.

4. Summary of Suggested Legislative and Regulatory Amendments

As discussed in this report, above, it appears that there are many loans made by both the MFCs and banks that are either non-compliant with the tripartite requirement or the fixed rate requirement or the fixed tenor requirement. The appropriate response to this circumstance should be carefully considered. Assuming that either the laws and regulations are changed to accommodate widespread, otherwise legitimate, banking practices, then the outstanding loans that were made prior to legislative change will need to be addressed so as to avoid challenge. On the other hand, if the law will remain unchanged, and the MFCs and banks are compelled to make loans that comply with the law, then provisions will equally need to be made to address the legitimacy of the portfolios of loans that are currently in force. Local counsel will need to address the best means of accomplishing this. Ministerial Decree may be an attractive option, but the degree of weight given to such a decree by a future court is uncertain. Also, resolving widespread problems by fiat rather than taking the more difficult, but more effective, route of resolving the situation through legislation and regulation will tend to undermine confidence in the real estate mortgage system.

The following provides a summary listing of items recommended for essential legislative and regulatory amendment, as appropriate.

4.1 Tripartite agreement

For all of the reasons discussed in this report and the Consultant’s December Concept Paper, the tripartite form of agreement has already begun to prove that it is highly cumbersome and confusing, stifles loan originations, hinders the registration process, and will ultimately be an unattractive investment for both the ELF and future investors in a secondary market. Moreover, banks today are barely paying lip service to the tripartite requirement, and the loan documents they rely upon are two-party agreements.

There are very few reasons supporting the continuation of the tripartite form of contract, yet its form is specified in both the REFL and the Executive Regulations. It is recommended that appropriate action be taken to permit the use of two-party loan agreements in accord with international standards. This change alone will spur loan originations by the MFCs as well as property registrations.

However, should the Government choose to retain the tripartite form of agreement, provisions should be made to permit the legitimate use of two-party agreements by both MFCs and banks under the REFL, with consumers allowed a choice of agreement types: the tripartite being Shari’a compliant and the two-party agreement as “grandfathered” by previous bank use.

MFCs and banks, however, should be made aware of the fact that two-party agreements will not be eligible for collateral or for securitization through the ELF, and lenders will be able to plan their lending activities accordingly.

4.2 Fixed Rate Requirement

The MFCs and the banks have amply demonstrated that long-term loans cannot be made in a developing real estate market on a fixed rate/fixed tenor basis. The REFL and Executive Regulations effectively permit nothing other than a fixed rate, fixed tenor mortgage loan. Although in concept this requirement was assumed to be for the consumer's benefit (i.e., by making all payments predictable) it actually has the reverse effect as lenders pass along the increased cost of liquidity risk to the consumer and price most consumers out of the market for home loans. These high-rate loans also significantly increase the chance that the consumer will default on the loan and lose his home; these are certainly not consumer-oriented results. Allowing variable rate financing, supplemented by the liquidity provided by the ELF, is among the single greatest tools by which the pace of mortgage finance loan originations will pick up. The rationales for requiring fixed rate loans are belied by the fact that most other loans, including the mortgage loans currently offered by the banks, are based on variable rate structures under existing law.

4.3 Move Contract Form Items to the Regulations

Both the aforementioned tripartite requirement and fixed rate/fixed tenor requirement are spelled out in the statutory law itself, and then mirrored in the regulations. This creates a supreme level of inflexibility to respond to the developing and changing needs of the new market; many of the non-compliance issues that are beginning to surface are the direct result of the fact that the REFL includes too much specificity about the form of contracts when such issues should be handled through non-legislative regulation, which can be much more responsive to the needs perceived by the MFA and its constituents. It is strongly recommended that, at a minimum, the REFL requirements that specify the form of agreement (e.g., tripartite, fixed rate/fixed tenor, etc.) should be moved to the Executive Regulations and removed from the REFL altogether. This would be in keeping with international practice as well, and thus sets a stronger foundation for an eventual secondary market. A preliminary move to relocate the tripartite and fixed rate/fixed tenor provisions to the Executive Regulations may also make it easier, at the appropriate time, to modify them as needed.

4.4 Assignment

As discussed in the December Concept Paper, Article 7 of the REFL permits unilateral assignment by the investor virtually at will and without providing for the legitimate underwriting concerns of the lender. As discussed in the Concept Paper in detail, though the lender's approval is required, the burden of challenging the investor's desired assignment is heavy and not easily overcome. Among other things, this will prove to be an obstacle to loan sales to the ELF and to a secondary market.

Ideally, the technical items contained in the assignment provision of the REFL should be moved out of the statutory law and into the Regulations. The following technical items must also be addressed in regard to assignment:

4.4.1 The law does not specify the manner in which the investor must notify the financier of such intention. It is highly plausible that an investor may simply assign his right and then say that he called the financier by telephone but received no rejection in writing – a claim that would be difficult to disprove.

4.4.2 If the investor does notify the financier in writing, there is no specification of when the 30-day period begins to run, i.e., from mailing of the notice or its receipt.

4.4.3 The 30-day requirement, in a mortgage market in which a lender may eventually service thousands of loans, may be insufficient to underwrite the assignee, particularly in Egypt, where credit verification is still in its infancy. At the very least, provision should be made for a good faith extension of this period if needed.

4.4.4 There is no legal mandate by which the assignee is required to provide his or her credit information to the financier, or within any particular time-frame. At best, assignees would have every incentive to wait as long as possible, thus shortening the financier's 30-day window in which to reject.

4.4.5 The Executive Regulations and/or Contract Documents should clarify that the phrase "serious reasons that would expose his interests and rights to danger" may include various underwriting concerns of the financier, which are within the discretion of the financier to determine.

4.4.6 The Executive Regulations and/or Contract Documents should further provide at least a general requirement of compliance by the assignee with the underwriting requirements and application and approval process of the financier, and that failure to so comply can be the basis for rejection of the assignment application.

4.4.7 The Contract Documents should specify the precise notification obligations and underwriting rights of the financier and a right of extension of time by the financier if needed. But, the specific underwriting standards, equity requirements, and approval standards of the financier should not be detailed in the Executive Regulations or the contract documents in order to provide the financier with the needed flexibility to make appropriate decisions concerning a potential assignee who is unknown at the time of loan origination.

4.4.8 The Executive Regulations and Contract Documents should provide the financier with the right, upon appropriate notice and mutually agreeable terms, to inspect the property in order to make an updated evaluation of the value and condition of the security.

4.4.9 While the REFL provides that upon the financier's failure to object within 30 days of the investor's notice to assign the mortgage is considered to be assigned, the Executive Regulations, in contrast, state that the financier must give a written approval to the investor in order for the assignment to take place. What would happen in the common situation where the investor has properly requested to assign and the financier never gives its approval? According to the REFL the assignment is valid. According to the Executive Regulations, it is invalid because the lender did not give a "written approval." This issue requires clarification.

4.4.10 As noted earlier in this report, there is a possibility that despite the specific exemption of mortgage finance contracts from the Stamp Duty based upon the advisory letter of the Ministry of Finance, a Stamp Duty of 0.6% will be charged based upon Section 2 of Law 111/1981, which requires the charging of a Stamp Duty upon an assignment of debt. This may be rectified by a further advisory from the Ministry of Finance, or a direct amendment to the law.

4.6 A Comprehensive Consumer Disclosure Scheme

Although the REFL appears to have been designed to protect consumers' interests, the law and regulations provide extremely little in the way of disclosure requirements that would promote better understanding of the mortgage finance transaction. The following, drawn from the December Concept Paper and this report, are suggested items to be addressed in the Executive Regulations:

- A standardized pamphlet should be developed and required to be provided at the initial contact with the consumer that describes the mortgage finance concept in plain, simple terms, the obligations of the parties, and the types of events that might result in foreclosure, as well as a candid description of the nature of the foreclosure remedy;

- A requirement that, before the consummation of the loan, a disclosure statement should be provided to the consumer that informs him whether the lender will service the loan or may transfer it to another lender or servicing company, as well as information advising the consumer of what steps may be taken to resolve complaints or answer questions;

- Requirements that, after the consummation of the loan, statements should be delivered to the consumer annually or more frequently that summarize all payments made, the balance due, and any escrow deposits and payments made during the year. These statements may also indicate any shortages or surpluses in the escrow account and advise the consumer of the action being taken;

- A requirement that a written statement should be delivered to the consumer in the event the loan servicer or lender sells or assigns the servicing rights to a consumer's loan to another loan servicer; this should occur prior to the transfer.

- A requirement that consumers should timely be provided with clear notification of delinquency or interest rate changes (in the event an ARM product might eventually be permitted) and the time and manner in which corrective action may be taken.

- Regulations should specify the manner in which copies of all disclosure documents and consumer acknowledgements shall be maintained on record with the lender;

- Regulations pertaining to the scope of any advertising related to mortgage finance promotion.

4.7 Developer Installment Loan Regulations

As set forth in detail above in this Report, there are several areas in consumer disclosures can be improved in connection with Developer Installment Sales Contracts. These points are summarized below and may be addressed through the Regulations:

- A licensing scheme should be implemented, if not already in place, that not only regulates a portion of the contents of developer installment sales contracts but will also require that developers supply various data about their financing activity;

- Installment contracts entered into by an unlicensed developer, as of a determined effective date, are voidable at the instance of the purchaser;

- The consumer must be given sufficient information to clearly understand the fact that his rights to alienate the premises are restricted to whatever the contract provides;

- Adequate disclosure should also be made to the consumer informing him of the importance of:

    - a pre-contract inspection;
    - recognizing that his rights may be limited in the ability to transfer his rights;
    - maintaining his current mailing address (for notices) with the seller;
    - the limits of his rights upon a default;
    - the possibility that liquidated damages may be awarded in favor of the seller in the event of default;

- Registration of the individual units should be permitted as early in the process as possible, even at the time of contracting, if only to register the purchaser as having use rights in the premises until the agreement is paid off and thereby "put the world on notice" and prevent the practice of selling off the same unit multiple times;

- In connection with registering individual units, require the implementation of a "splitter agreement" by which individual units can be released from the project financing;

- Regulations should provide a "bare minimum" set of contract terms and disclosures for installment sales, as detailed earlier in this report.