MORTGAGE LENDING IN THE PALESTINIAN TERRITORIES: FUNDAMENTALS FOR JUDGES AND LAWYERS

VOLUME 1
FUNDAMENTALS

Palestinian Judicial Training Institute

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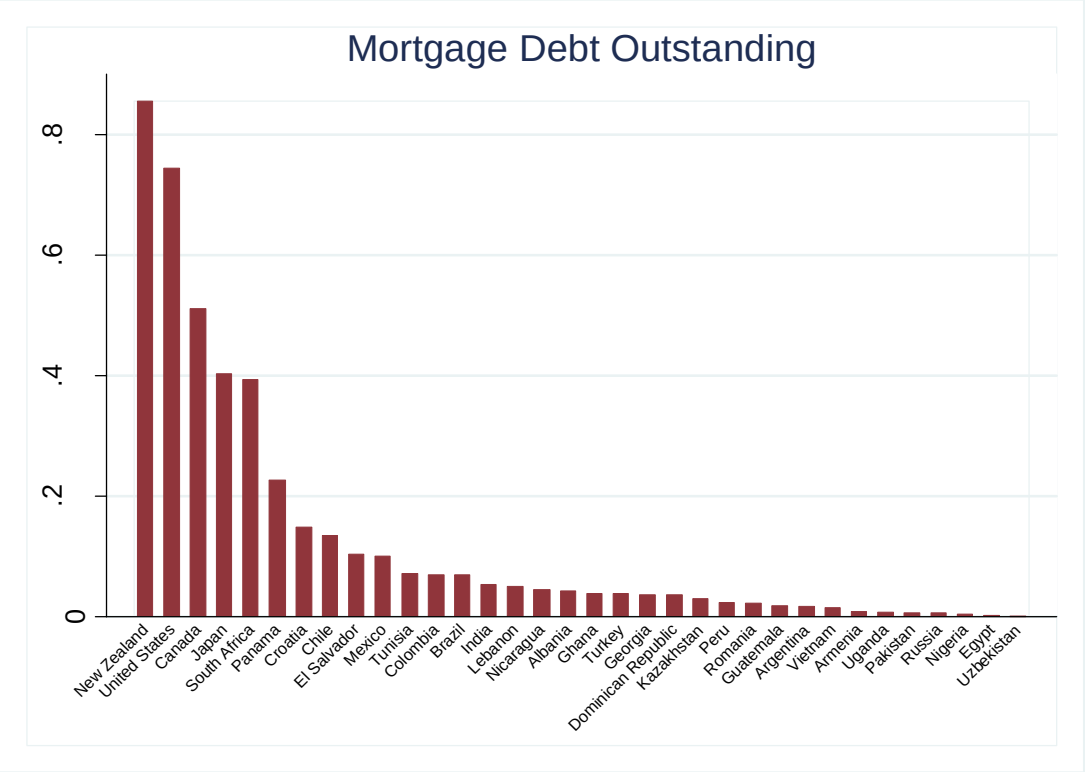
I. PURPOSE OF THIS TRAINING COURSE

Mortgage lending – the extension of credit secured by a mortgage of real property – is one of the main forms of bank lending in the world today and its use is increasing in developing countries as they strive to improve the housing conditions of their populations (See Figure 1). The use of

Mortgage lending can be a major component of the financial sector and driver of economic growth. Mortgage lending as a % of GNP can be in the range of 10% of GNP today even in emerging markets, and has been showing steady growth.

Figure 1. Mortgage Debt Outstanding as a % of Gross Domestic Product in Selected Countries



Source: International Finance Corporation

mortgages as security in financing acquisition and improvement of housing entails unique issues of law and economics and is subject to detailed regulation by the civil law as well as by national banking regulators. This training course is designed as an introduction to residential mortgage lending and the use of mortgage collateral for lawyers and judges in the Palestinian Territories.

While practically any obligation may be secured by mortgage, the main focus of this course material is mortgage lending to citizens for housing, which is an important and growing banking activity as well as a vital component of improving housing conditions for Palestinians. Also, while any citizen or legal entity can make a loan secured by mortgage, in these materials attention is paid primarily to mortgage lending by licensed financial institutions, by far the largest segment of the market.

These materials begin with a technical description of mortgage lending and mortgage collateral, the purposes and content of mortgage law, and the general conditions for development and expansion of residential mortgage lending activity. This is followed by a discussion of mortgage lending from the perspective of the financial institutions that originate most loans, including the process of making the loan and the economics of mortgage lending. The sections on economics of mortgage lending include the costs to the creditor, the risks faced by residential mortgage creditors, how creditors determine interest rates and other loan terms, and the effect of loan terms on the ability of citizens to borrow. The discussion of the economics of mortgage lending also focuses on recent research showing

how laws affecting creditors' rights and court enforcement of creditors' rights may affect the amount and terms of mortgage lending in a country.

These materials include a review and discussion of the current mortgage law in the West Bank and Gaza, focusing on formal requirements for creation of the mortgage and the procedures for enforcing mortgage liens against real property.

A glossary of terms common to mortgage lending is included at the end of these materials for convenience.

Volume II of these materials includes some relevant readings in mortgage law and mortgage markets, including excerpts from the key laws, regulations and documents governing mortgage lending in the Palestinian Territories today.

II. WHAT IS A MORTGAGE LOAN?

What is a mortgage loan?

A mortgage loan is a loan secured by a pledge of real property. Any obligation may be secured by a mortgage of real property and any natural or legal person may make a mortgage on real property which it owns to secure repayment of a present or future obligation. A loan secured by a mortgage may be used for any legal purpose. The predominant use of loans secured by mortgages in most developed countries today is acquisition or improvement of housing.

The mortgage is a legal contract by which real property owned by a debtor or a third party is pledged to secure the debtor's obligation to repay a loan. The mortgage is:

- a public, registered contract;
- an executive document, not requiring a judgment of a court to become enforceable against the maker;
- subject to certain legal formalities in its creation, including notary certification, which invest it with strong evidentiary value in proving the existence of the debt;

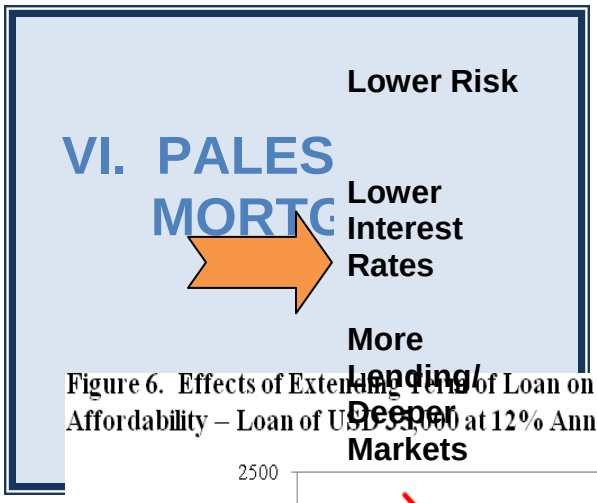
- a non-possessory pledge of real property, meaning that despite its existence the debtor retains ownership of the real property and is entitled to use and occupy it until such time as he fails to repay his obligation;

- an accessory to the primary obligation, in that it exists only so long as the underlying obligation remains unpaid; and

- enforceable by attachment and sale of the mortgaged property pursuant to procedures specified in law.

The theory of collateral

A main reason that the ability to enforce a mortgage may be important is of course the possibility that people will not honor their obligations if there are no significant consequences for failure to do so. But the theory of mortgage collateral also suggests that by providing an efficient means of recapturing an investment, the costs and risks of lending are reduced. Greater certainty in collection of debts by possession and sale of collateral eliminates or greatly reduces the risk to the creditor of lost interest and principal. Enhancing loan collection procedures also may reduce the creditor's costs of lending. It is widely believed that reduced costs and greater certainty in collection procedures result in lower interest



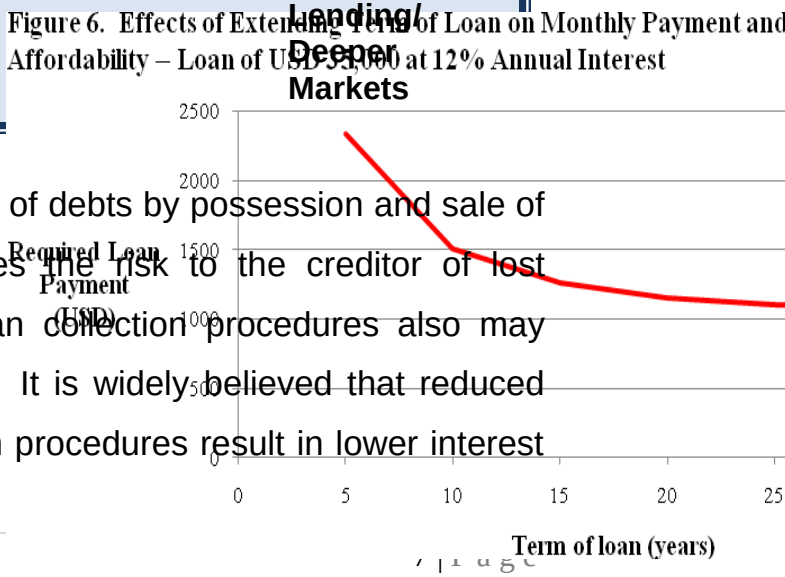


Figure 6. Effects of Extending Term of Loan on Monthly Payment and Affordability – Loan of USD 53,000 at 12% Annual Interest

Figure 5: Effect of Increase in Interest Rate on Amount of Loa with Gross Monthly Income of $1,000 Can Afford By Paying 3 Income

rates, and greater willingness of creditors to make more credit available for housing construction and acquisition, either by making loans deeper into the socio-economic strata or by offering larger loans. Reduction of costs and other financial risks may also mean greater proceeds from sale of the mortgage collateral, which benefits not only creditors, but in theory the debtors also.

> *"One of the pillars of a modern credit economy is the ability to own and freely transfer ownership interests in property, and to grant a security interest to credit providers with respect to such interests and rights as a means of gaining access to credit at more affordable prices. Secured transactions play an enormously important role in a well functioning market economy. Laws governing secured credit mitigate creditors' risks of default and thereby increase the flow of capital and facilitate low-cost financing. Discrepancies and uncertainties in the legal framework governing security interests are the main reasons for the high costs and unavailability of credit, especially in developing countries. ...uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of nonperformance or, in severe cases, leads to credit tightening....Enforcement systems should provide efficient, cost-effective, transparent, and reliable methods (both non-judicial and judicial) for enforcing a security interest over assets. Enforcement proceedings should provide for prompt realization of the rights obtained in secured assets, designed to enable maximum recovery according to market-based asset values."*
>
> *Principles for Effective Insolvency and Creditor Rights Systems, The World Bank (Revised)2005*

The conditions for residential mortgage lending

It is generally acknowledged that certain conditions should exist in a country to allow development and expansion of residential mortgage lending. These conditions include:

- A stable economic environment, including stable inflation and interest rates and real property values. Stable interest rates preserve the value of the creditor's investment. The economic environment should be sufficiently stable so that both the creditor

and the borrower can be confident that the currency in which the mortgage is denominated will retain its value, and that the value of the property that serves as the collateral for a mortgage loan will not substantially erode over time.

- A system of property rights that allows ownership and pledge of land and buildings.

- A well functioning land registry or equivalent system to register and prove ownership rights and establish the rights and relative priorities of mortgage creditors.

- Fair and efficient court procedures for enforcement of creditors' rights.

- Educated consumers who understand the benefits and risks of borrowing.

- Effective banking regulation to protect the financial system against the long term risks of mortgage lending.

The objectives of mortgage law

It is a main premise of these materials that the law of mortgage and the way in which it is implemented by the courts can affect the amount and cost of credit offered by financial institutions, as well as the willingness of borrowers to use credit to meet their personal needs. Creditors want a flexible legal device that is not expensive to use or enforce and assures

reasonable security for their claims. Flexibility also provides the ability to design a financial instrument that meets the needs of and is acceptable to potential borrowers. Creditors and borrowers both want low transaction costs, because the costs of lending are typically passed through to borrowers. Low transaction costs lowers risks and makes use of credit more attractive to consumers. Borrowers want transparent and easily understood transactions and assurances that their rights and financial interests will be protected in the event that they suffer unforeseen financial reversals.

In a mortgage loan transaction the interests of the creditor and the borrower may coincide in some respects and diverge in others. Good mortgage law is essentially a process of balancing the rights and interests of creditors and debtors with the goals of both efficiency and fairness. It is usually safe to assume that borrowers will generally try to meet their obligations in the absence of genuine economic hardship, and that creditors typically seek to enforce a mortgage only as a last resort. Both creditors and debtors have legitimate interests that need to be respected and protected. The respective interests of creditors and borrowers are summarized below in Table 2.

TABLE 2: INTERESTS OF MORTGAGE CREDITORS AND BORROWERS

Creditors

- ✓ Flexible legal concept. Does the law facilitate a variety of mortgage loan products which respond to current needs, including, for example, construction finance and leasehold mortgages?
- ✓ Efficient and Cost Effective Creation. Is documentation simple, easily prepared and easily registered? Are legal and registration fees reasonable?
- ✓ Registration.
  - ✓ Is the mortgage registration system quick and reliable?
  - ✓ Are creditors' priorities protected?
  - ✓ Are all material third party interests reflected in the land register?
  - ✓ Can a mortgage loan be disbursed safely within days of executing legal documents?
- ✓ Broad Coverage. Does the mortgage lien fully cover principal and interest, costs of execution, costs of property maintenance, penalties, and other potential costs of enforcement?
- ✓ Enforcement.
  - ✓ Is the enforcement procedure simple and cost effective? Is there an opportunity to avoid or limit court proceedings?
  - ✓ Is the creditor's prima facie case for enforcement well defined, ruling out vague and frivolous defenses?
  - ✓ Are there opportunities for negotiated acquisition prior to enforcement?
  - ✓ Can the property be sold through direct/negotiated sale rather than public auction?
  - ✓ If enforcement sale is necessary, are there clear pricing mechanisms within which the creditor may proceed without fear of liability?
  - ✓ Do pricing mechanisms realistically reflect the market for distressed properties, and consider all of the expenses of the creditor?
  - ✓ Are statutory time periods for notices and other required steps reasonable and minimally necessary to achieve the purpose?
  - ✓ Is judicial discretion to delay or suspend execution based on objective criteria and reasonably limited?
  - ✓ Are there reasonable limitations or disincentives to frivolous appeals?
  - ✓ Are there quick and effective procedures for possession of the property?
  - ✓ Is the residential mortgage creditor worse off in bankruptcy proceedings than in normal mortgage enforcement proceedings?
- ✓ Transferability. Is simple and low cost transfer of the debt and mortgage possible?

Borrowers

- ✓ Transparency of lending transaction. Are all material risks, terms and procedures of the mortgage transactions disclosed to the borrower in a simple and transparent way?
- ✓ Are the direct costs of making the loan reasonable?
- ✓ Control of property and loan. During the term of the mortgage loan can the property be sold, refinanced, and the loan repaid with no or minimum penalty?
- ✓ Is there adequate notice and sufficient time to correct a default before enforcement proceedings are commenced?
- ✓ Is the debtor's equity investment in the property protected?
  - ✓ Are enforcement proceedings reasonably designed to maximize the price for the property?
  - ✓ Is pricing market based?
  - ✓ Is there some form of official oversight of pricing?
  - ✓ Is there a right to object to inadequate pricing?
  - ✓ Are there disincentives to unfair pricing?
  - ✓ Is the debtor entitled to an accounting?
- ✓ Is there an opportunity to assert material breaches of rules and procedure to a court?
- ✓ Is the time to redeem the property from execution adequate?

The International Monetary Fund has identified the fundamental question in this regard as the extent to which creditors are able to use "self-help" remedies in the enforcement of mortgage collateral.[1] The current practice in the Palestinian Territories of enforcing executive mortgage documents through the Land Department would be considered to be such a "self help" remedy to some extent as it avoids a court action. But unlike the laws of some countries which allow creditors to take direct action to possess and sell a mortgaged property, the Land Department procedure still involves a state authority in enforcement of the mortgage contract.

Regarding the issue of "self-help" by creditors, the IMF states that a balance of interests should be reached between protection of debtors against abuse of their rights, on the one hand, and avoidance of excessive state and/or judicial involvement at each stage of the enforcement process, starting from a creditor's delivery of a notice of default to a borrower and continuing through sale of the mortgaged property and distribution of the sale proceeds. A main point of the IMF assessment of systems for secured credits is that with regard to enforcement procedures, "speed in realizing the value of the collateral is key."

A crucial distinction in many countries today is whether creditors are required to obtain a court judgment on the merits of their claim as a condition of enforcing their security interest in mortgaged property. Many countries today allow secured creditors to move directly to the execution of executive titles such as notary certified mortgage documents. At the same time, in the opinion of most expert commentators such as the IMF, such remedies must be accompanied by protections for debtors, such as

[1] Pascale De Boeck and Thomas Laryea, Development of Standards for Security Interests, International Monetary Fund.

requirements of adequate advance notice, adequate waiting periods before enforcement, reasonable rights to cure defaults, and a requirement that the creditor use commercially acceptable methods to sell the mortgaged property. Ultimately, all agree that debtors should be entitled to challenge a mortgage enforcement action in court.

Table 3: Time for enforcement of mortgage security in selected countries[2]

Time From Commencement of Mortgage Enforcement Proceedings to Execution Sale for Typical Cases in Selected Countries	
Country	**Time (months)**
Austria	6
Belgium	18-36
Denmark	6
Finland	2-12
France	10-18
Germany	6-12
Greece	3-24
Ireland	18-24
Italy	60-84
Netherlands	4-6
Portugal	18-30
Spain	7-9
Sweden	4-7
UK	8-12
Croatia	24-60
Mexico	9-30
USA	8.4

An often overlooked benefit of good mortgage law is that alternative systems of securing credit may provide few formal legal protections to debtors. Such systems include, for example, mortgage by assignment of the property deed as security, irrevocable powers of attorney, installment purchase contracts, lease to own contracts, future dated checks and other

[2] Butler, Stephen, Chiquier, Loic and Hassler, Olivier, 2009. "Enforcement of Mortgage Rights." In Chiquier, Loic and Lea, Michael, eds., *Housing Finance in Emerging Markets*. Washington, DC: The World Bank.

forms of security that lack the many protections given to debtors under the mortgage law. For example, in many countries an assignment of a title deed as security, or an installment purchase contract, still do not protect the borrower's accumulated equity investment in the home in case of a default. Some countries have prohibited entirely the use of future dated checks as a security device because of the possibility of attaching criminal penalties to what is essentially a civil contract matter. In contrast, because of long established rules and precedents, use of legal mortgages can achieve a better balance between the rights and interests of debtors and creditors.

III. THE BUSINESS OF MORTGAGE LENDING

A good understanding of the business of mortgage lending can be useful to understanding the law of mortgage. This section describes what the business of mortgage lending entails, including a description of the types of mortgage loans in use today, and the business processes of creating, servicing and enforcing mortgage loans.

Types of mortgage loans

Many different types of mortgage loans are in use today. Variations arise to deal with the particular economic circumstances of a country. Most mortgage loans are amortizing loans, which means that the principal amount of the loan is repaid periodically in regular installments over the term of the loan, along with interest on the unpaid balance.

The two basic types of amortizing loans are the fixed rate mortgage and adjustable rate mortgage (also known as a floating rate or variable rate mortgage). Combinations of fixed and floating rates are also common, whereby a mortgage loan will have a fixed rate for some period of time, and vary after the end of that period.

> *Fixed rate mortgage loan*. In a fixed rate mortgage, the interest rate remains fixed for the life (or term) of the loan. Among countries the term can range from 5 to 30 years, with the longer terms usually found in more developed markets. Fixed rate mortgage loans can

either be “level payment amortizing loans” or “constant amortization loans,” though the latter is rarely used in residential property transactions. With a level payment loan the monthly or other periodic payment on the loan remains the same over the entire term of the loan, but the allocation of the periodic payment between interest and the principal obligation changes as the loan is repaid. (In a constant amortization loan the same portion of principal is paid with each payment (e.g. 1%) and so the periodic payment necessarily changes as the loan is repaid.)

Fixed rate mortgage lending poses significant risk to creditors who rely on short term deposits because of the possibility of interest rate changes that could result in “negative spread” (discussed below) on assets and liabilities. Accordingly, the interest rates on such loans are usually much higher than current short term interest rates and the rates charged on fully adjustable rate loans. Fixed rate mortgage loans are not widely used in the Palestinian Territories today.

Adjustable rate mortgage. In an adjustable rate mortgage the interest rate changes periodically, and along with it the borrower’s required periodic loan payment. The adjustment is typically made in line with some market index, such as, for example, the interest rate on government or treasury securities or the interbank borrowing rate, and the interest rate on the loan is set at some fixed premium (e.g. + 1.5%) over the index rate. Some adjustable loans may be fixed for a period of time, after which they periodically adjust up or down in line with the index rate.

Adjustable rate mortgages transfer part of the risk of mortgage lending (see below, “interest rate or market risk”) from the creditor to the borrower, and thus are used in many emerging markets where banks are unable to obtain funding for long terms at fixed rates, or such funding is very expensive. Adjustable rate mortgages predominate in the Palestinian Territories today. Since the risk of increasing interest rates is transferred to the borrower, the initial interest rate on an adjustable rate loan will most likely be lower than the rate on a long term, fixed rate loan, depending on market conditions.

Not all mortgage loans are amortizing loans. A “balloon payment” mortgage loan does not repay all principal over the term of the loan and leaves a balance to be paid at maturity, which may equal some or all of the original principal obligation. Such loans usually require a current payment of interest either at a fixed of floating rate. A balloon payment loan, which is uncommon in residential lending, poses significant risks to borrowers as it assumes they will have the resources to repay the loan at maturity or be able to obtain a new loan.

Other types of mortgage loans that have been used in emerging markets include:

Graduated Payment Mortgage Loan. This is a loan with low initial monthly payments which gradually increase over a specified time frame. These loans are good deals for young families who cannot afford large payments now, but who have good prospects and it is more than probable that they will be earning a higher income at some future time. This is a form of “negative amortization” loan for

which some amount of required principal payments in the early stages of the loan are deferred and added to the outstanding principal balance of the loan to be paid at a later date. Negative amortization loans on which the principal balance of the loan increases over time may not be permitted under the laws of some countries. It is unclear whether such loans are permitted under current Palestinian laws which restrict increases in the amount of the principal obligation after registration of the mortgage.

"Rollover" or renewable mortgage. This is a loan on which the periodic payments are calculated on the basis of a long maturity, say 20 or 30 years, but the outstanding balance of the loan is payable at an earlier date, say the 5th year. In such loans the creditor typically commits to renew the loan at the interest rate being charged by the creditor at the time of renewal. This type of loan has some of the advantages of an adjustable rate loan for the creditor in the form of periodic interest rate adjustments. For the borrower, it has some of the advantages of a fixed rate loan in the form of lower periodic payments, and at the same time, because it is amortizing, lessens some of the risk to the borrower of a balloon payment loan.

Price level adjusted mortgages. Used in some emerging markets, this is a form of loan in which payments are adjusted for inflation not by changing the interest rate, but by changing the the amount of outstanding principal obligation. As inflation or deflation increases or decreases the amount of the outstanding principal of the loan, the amount of the monthly payment also increases or decreases. The periodic payment is adjusted each month based on a predetermined index, such as the Consumer Price Index. The loan is nevertheless

fully amortizing, meaning the entire principal amount is repaid over the initial term of years fixed for the loan. The theory of this form of loan is that the value of the home and the borrower's income will be increasing with inflation, allowing the borrower to make higher payments. This type of loan can permit substantially lower monthly payments because it does not have to include a factor for inflation in the loan interest rate, and they have been shown to be less volatile than adjustable rate loans. Again, it is unclear whether a loan having an increasing principal balance would be permitted under current Palestinian practice.

Loan Origination Procedures

Creditors are typically extremely careful in making mortgage loans because of the long term and sizable risks involved, which adds to the costs of lending (See Economics of Mortgage Lending, below). Most creditors engage in a process of pre-qualification whereby loan officers interview and gather basic information on a potential borrower to determine if he would qualify for a loan under the creditor's standards. This process will result in quite a few applicants being told that they do not qualify for a loan. However, the pre-qualification process will not necessarily screen out all unqualified applicants or properties and there may be a further investment of the creditor's time and resources in processing the application only to disqualify the applicant at a later point on the basis of more complete information. The level of these costs may be affected by the populations' experience with credit and the availability of good information on the borrower's credit worthiness and on the mortgaged property. These costs of doing business and marketing their services to

citizens must be factored into the creditor's overall costs of lending and must be compensated if the creditor is not to experience losses.

Assuming that a prospective borrower is found qualified in a pre-qualification procedure, a creditor will typically provide a good deal of assistance in helping him to complete a loan application, including answering inquires and providing advice on how and where to obtain necessary documentary evidence. Again, this assistance is usually provided before the information is completed to the extent necessary to make a final determination on the application.

Most creditors use standardized application forms and requirements that allow quick review of borrower qualifications, cross comparison of applications and easy extraction of data for management information and reporting to bank regulators. Borrowers are typically required to represent to the creditor whether any of their debts are past due, the source of any money they are putting into the transaction, and vouch for the accuracy and completeness of the information submitted. The other side of this coin is that creditor's are required to provide borrowers with information pertaining to the structure, costs and legal implications of the mortgage loan, and in most modern jurisdictions the form and content of these disclosures are regulated by law. In the Palestinian Territories information dislcosures to be made to borrowers by banks are regulated by the Regulation No. 04/2009 of the Palestine Monetary Authority (March 24, 2009).

Assembling an application file is usually a meticulous process subject to strict requirements established by the creditor and in some cases by banking regulators. The many documents that a creditor may be required to compile just to get to the point of evaluating the application may include:

- ✓ Title certificates, title reports and other verification of title to the mortgaged property.
- ✓ A property survey (if land is involved).
- ✓ An appraisal of the value of the property.
- ✓ Verifications of the applicant's employment. These inquiries are frequently sent directly by the creditor to avoid the risk of manipulation, but only after obtaining the borrower's consent to release of the information.
- ✓ Verification of the applicant's income, also typically sent directly by the creditor.
- ✓ Verification of the borrower's assets and accounts. Again, this type of inquiry may be made directly by the creditor.
- ✓ Information on prior credit history, to the extent available, including:
    - financial statements of businesses
    - account statements
    - particulars on prior loans and their status
    - credit card statements
    - tax documents
    - rent receipts
    - utility payments
    - telephone and cell phone payments
    - insurance payments (car, medical, life)
    - accounts with local stores or grocers
    - rent-to-own payments
    - school tuition
    - child care
    - child support and alimony payments

Obtaining the necessary information can be difficult and time consuming, particularly for self-employed individuals or those who have large sources of “informal” income which may nevertheless be verified and will support a loan. Creditors in general look for stable sources of income that are likely to be available over the entire term of the loan and which can be reasonably documented.

At this point in the process a creditor must also confirm that the prospective borrower has the funds to pay all of the creditor’s reimbursable costs of making the loan as well as any required down-payment or equity contribution to be made by the borrower toward purchase of the home. The creditor’s concern with respect to these funds is that they not be acquired by the borrower in such a way as to pose a risk to the priority of the creditor’s mortgage or undermine the borrower’s ability to repay the loan, as well as to get clear picture of the borrower’s net assets after the transaction is complete. Any amounts borrowed to obtain a down payment to purchase the property, for example, must be offset against a borrower’s assets, and it may also represent an interest of a third party in the property that conflicts with the creditor’s interest.

Only when the application is complete, which can take weeks, can the creditor accurately assess whether to make the loan, a process called “underwriting.” This is a process of determining whether the prospective borrower has the capacity to repay the loan and has demonstrated a history of meeting his obligations, and that the real estate offered as collateral is of sufficient value to offset the risk of lending. Under the regulations of the Palestinian Monetary Authority and the Palestinian Capital Markets Authority bank and non-bank mortgage lenders are

required to accurately assess the borrower's ability to repay the loan and are prohibited from making loans to unqualified borrowers.

In underwriting loans, most creditors have guidelines in the form of quantitative parameters that allow them to assess the quality of the loan and the likelihood of repayment. These guidelines may differ among creditors but usually fall within a narrow range. The typical tests applied by creditors include:

- **Total housing-expense-to-income ratio.** This determines the relationship between the borrower's total monthly housing costs and his monthly income. Housing costs include principal and interest payments on the mortgage loan plus any property taxes and insurance of property against damage. This ratio of total housing costs to monthly income used by most creditors today is generally in the range of 30%. With respect to mortgage loans made by non-banking mortgage lenders in the Palestinian Territories, the Capital Market Authority under its Regulation No. 7/T/R/Ain of 2007 provided that the housing expense to income ratio may not exceed 40%. The Palestinian Monetary Authority has not adopted similar regulation for banks, but rather has adopted a maximum total debt to income ratio (see below).

- **Total debt-to-income ratio.** This ratio compares the sum total of all of the borrower's debts to his total monthly income. The other debts added here include ongoing financial obligations such as installment loans, consumer debt, lease payments, credit card debt or other revolving accounts, and alimony and child support. This ratio of total debt obligations to monthly income used by most creditors is generally in the range of 40%-50%. Under Regulation 04/2009 (march 24, 2009)

The Palestinian Monetary Authority has established a maximum total debt to income ratio of 50% for all Palestinian banks today.

- **Loan-to-Value Ratio**. The loan-to-value ratio is the ratio of the loan amount requested to the appraised value of the mortgaged property or the price of the property, whichever is lower. Most creditors in the world today lend from 50-80% of the value of the mortgaged property; 60-75% is the typical range in the Palestinian Territories today. The Palestinian Capital Markets Authority has established by regulation (PCMA Regulation No. 7/T/R/Ain of 2007) that non-banking mortgage lenders may lend no more than 80% of the property value for employed borrowers and no more than 70% for self-employed borrowers. The Monetary Authority has established by regulation (PMA Circular 5 of 2008) that banks may lend no more than 85% of property value but on a case by case basis will allow a 90% LTV ratio if the last 5 percent is insured by the Palestinian Mortgage and Housing Corporation.

  This loan to value ratio determines how much of the borrower's own money is in the property to cover any potential costs and losses to the creditor from the borrower's inability to repay, because all proceeds of sale of the mortgaged properly would be available to repay the creditor. The loan to value ratio is also important to protect the creditor in the event of price decreases in real property markets. Through a good deal of international research It has been determined that the likelihood of a borrower not repaying his loan is directly and significantly related to the loan-to-value ratio, with higher ratios related to a higher probability of problems with the loan. The theory here is that borrower's with significant personal investment in the property are less likely to risk losing their investment.

Calculation of the loan to value ratio usually requires that the creditor value the property by an appraisal carried out by a qualified independent appraiser or an employee with appropriate training in property valuation. In the Palestinian Territories today licensing of appraiser is done by the Palestinian Capital markets Authority and is a legal condition of offering appraisal services. Licensed banks are required by the Palestinian Monetary Authority to perform appraisal of mortgaged properties and appraisal is central to the PMA's review of a bank's loan underwriting practices and creation of adequate reserves against loan losses.

Appraisals can be costly and typically involve a physical inspection of the property and the neighborhood in which it is located and an assessment of factors that could adversely affect the value of the property. Appraisals are usually carried out using one of two methods, a market evaluation which compares recent sales of comparable properties or a replacement cost valuation which estimates how much it would cost to replace the subject property. Sometimes both methods are used and compared.

Upon completion of these inquiries and analysis a loan may be further referred to a loan committee within the bank that makes a final decision on advancing the loan.

In summary, the process of making a loan is typically a painstaking and highly regulated process based upon data which seeks to determine whether the borrower is truly capable of repaying the obligation and likely to do so.

Loan Servicing

Loan servicing commences after funds have been advanced to the borrower and entails all of the activities necessary to collect and apply payments, manage borrowers' accounts, respond to borrowers' inquiries, resolve disputes and monitor the performance of the loan, and may ultimately include enforcement of the mortgage.

Most creditors have good accounting procedures to ensure that each payment is properly applied and allocated between the interest and principal accounts of the loan. Most mortgage loan contracts call for interest to be paid in arrears each month - that is, the interest payment that is due on the first day of a month actually pays interest that is due for the prior month. Some mortgage contracts call for interest to be paid in advance, whereby the interest payment due on the first of a month pays for interest for that month.

Most mortgage loan contracts provide for payment of interest first, and then fees and other charges due with respect to the loan, and only then are remaining amounts of the borrower's periodic loan payment applied to reduce the principal of the loan. Since most modern mortgage loans are level payment amortizing loans this is usually a simple accounting reconciliation, but it becomes more complex if borrowers make larger payments than required, if permitted, or partial payments, in which case the creditor must determine, sometimes in consultation with the borrower, the appropriate treatment of the payment.

Similarly, creditors are required to maintain effective systems for storing, accessing and protecting the loan documentation against hazards.

A significant part of mortgage loan servicing consists of following up with borrowers on late or missed loan payments. Most institutions employ a system for providing notifications to borrowers of missed or late payments which include direct contact by phone or otherwise as well as a series of mailed notices at specific intervals. These efforts usually begin as early as possible after a late or missed payment, and the level of urgency of these notifications typically increases as the time passes. Rarely will any further action toward enforcing a mortgage be taken until all avenues of resolving the problem have been explored directly with the borrower. The Palestinian Monetary Authority's Fair Lending Regulation (No. 04/2009) specifically prohibits banks from demanding immediate repayment of a loan without first giving adequate notice to the borrower.

Dealing with problem loans is the most time consuming and costly aspect of loan servicing, considering the need for heightened communications with borrowers and the complexities of the loan enforcement procedure. In addition to the increased monitoring and supervisory challenges, including repeatedly contacting the borrower and increased monitoring of the condition of the mortgaged property, the process may entail loan restructuring negotiations and ultimately enforcing the mortgage in court or through administrative procedure. If the creditor manages to acquire the property (which maybe permitted if the borrower consents) the process includes managing the property for some period of time and disposing of it. To forestall these expenses most creditors seek to identify problem loans as early as possible and to work with the borrower to avoid the worst consequences.

A key component of this process is to obtain data that will allow the creditor to determine whether the borrower is likely to be able to address the problem on his own, or if some form of loan modification will be necessary, or if the problem is unlikely to be resolved even if the loan terms were to be modified. To accurately make this assessment the creditor will need to understand any material changes in the borrower's financial position, and the cooperation of the borrower is crucial in this respect. Lack of cooperation by the borrower is most likely to result in further action by the creditor as the best approach to protecting its interests.

Because of the legal implications of this process most creditor's will keep good records of each interaction with the borrower regarding the loan, and in most cases these records will show that the creditor took all appropriate actions to work with the borrower and avoid enforcement of the mortgage. Maintenance of good records of correspondence with a borrower in loan files is required by regulations of the Palestinian Monetary Authority.

When a borrower falls behind in his obligations a creditor may be required to closely monitor the status of the mortgaged property to determine whether it is still occupied and to assess its condition and whether it is being maintained. In some cases, to protect its own interests a creditor may be forced to pay for actions to protect the property, including payments for property repairs and taxes. Any reasonable expenditures of this sort are included in the creditor's claim against the property.

A creditor may, but is not obligated to, offer the borrower an opportunity to restructure his loan or to pursue other options that may resolve the problem. The objective is to restore the loan or at least to to reduce the

creditor's eventual costs in the event that the borrower's situation cannot be improved. This opportunity is generally offered where the creditor believes that it is likely either to cure a default or at least limit everyone's losses. Typically, and with good reason, the option of adjusting the loan is offered only to borrowers who are willing to cooperate with the creditor. Loan adjustments may be economically feasible depending on the creditor's assessment of the expense of enforcing the mortgage, the time it would take and the likely outcome. At the same time, too generous use of loan restructuring can lead to higher loan defaults if borrower expectations are raised. If loan restructuring is offered it may take several forms, including allowing the borrow to make small supplementary payments over time to bring his loan current, or increasing the term of the loan and decreasing the interest rate and thereby decreasing the amount of monthly payments, or providing a temporary suspension of payments until an immediate financial crisis has passed. Any such adjustment is in the discretion of the creditor and can only be expected if there is a very good possibility of eventually recouping the unpaid amounts.

Where a creditor determines that restructuring a problem loan is not likely to solve the problem, the creditor can consider asking the borrower voluntarily to sell the property for their mutual benefit and thereby avoid a legal procedure. This alternative could not only save the creditor substantial time and expense that would otherwise be incurred in pursuing a legal remedy for sale of the property, but could also result in less stress and embarrassment to the borrower and a higher price for the property because it is sold through normal market procedures and without the taint of a troubled property. Lower costs also benefit the borrower because the costs of enforcement are paid directly from sale proceeds on a priority basis and are therefore deducted from the borrower's share of proceeds.

Because banks are subject to stringent regulation, when loan payments are past due and the institution determines that it is unlikely that the loan will ever be brought current again the creditor will be required to place the mortgage loan on a “non-accrual” basis for accounting purposes. This action reflects the creditor’s judgment that some amount of the loan will not be repaid. Under the current rules of the Palestinian Monetary Authority this step is required for all loans on which payments are 90 or more days past due.

In addition, upon determining that some or all of a mortgage loan is uncollectible, the institution must take a charge against its loan loss reserves to ensure that the value of the institution’s assets is accurately reported. Individual institutions create loan loss reserves in their discretion based upon such factors as past loss experience for similar mortgages; changes in economic conditions that might affect outstanding mortgages; the degree of concentration of loans within a limited number of geographic areas; and the overall size of the loan portfolio. These reserves are a charge against the bank’s earnings, but are typically included in the bank’s total capital. Accordingly, charge-offs against loan loss reserves may not only reduce earnings, but also eventually reduce the level of a bank’s capital and therefore its ability to lend. Of interest for purposes of the present discussion is that loan loss reserves are, or should be, calculated at least partly on the basis of expectations of how much of a non-performing loan the bank can reasonably be expected to recapture through enforcement of a mortgage, a calculation that may be directly affected by the performance of the law and the courts.

Only after all measures have been pursued will most creditors seek a legal remedy of enforcement of the mortgage against the borrower's property. The current procedures for enforcement are described in Section VI of this volume.

IV. THE ECONOMICS OF MORTGAGE LENDING

Mortgage creditors face many complex economic risks as well as direct and indirect costs which determine whether lending is feasible and at what price. This section provides an overview of the risks to creditors as well as the costs of the business, how risks and costs affect the interest rates charged to borrowers and the ability of households to afford loans.

Overview of economic risks to creditors

A creditor incurs risk from mortgage lending which, though based on probabilities and capable of being addressed to a reasonable extent by prudent lending practices, must be compensated by borrowers if the creditor is to remain solvent over the long term. Some part of the price the creditor charges to borrow funds must be related to covering probable losses due to risks assumed by the creditor. These risks include:

Credit risk, or the chance that the borrower will not repay his loan and the value of the collateral will be insufficient to repay the creditor. Credit risk is typically described as a function of 3 factors: (1) the size of the loan in terms of the value of the collateral (loan to value ratio), (2) the probability that the borrower will default on the loan, and (3) the amount the creditor can expect to recover from enforcing its rights against the collateral, which expectation is affected by the time and costs of the enforcement action.

Liquidity risk, or the possibility that the creditor will not have sufficient funds to meet its obligations because of a mismatch of the cash flows from

its assets and liabilities. This might occur, for example, if the payment schedules on the creditor's loans did not match the payment schedules on its bonds or deposit accounts, or if a significant number of its borrowers simply stopped making loan payments on time.

Market or interest rate risk is the possibility that increases in market interest rates will decrease the value of the creditors assets while at the same time increasing the rates the creditor must pay to depositors, in the worst case resulting in the creditor paying more for its deposits than it is earning on its loan assets. This risk increases dramatically if the creditor offers borrowers fixed rather than adjustable interest rate loans over extended periods of time without holding deposits on similar terms.

Portfolio risk is the possibility that the creditor's loan portfolio is concentrated demographically or geographically on a segment of the population or a geographic area that is vulnerable to specific economic forces such as regional economic downturn, natural disaster or political turmoil.

There are additional risks that must be accounted for that are common to all business enterprises, including the risk that the management, employees or agents of the enterprise will behave fraudulently, negligently or just poorly (agency, transaction or operational risk), damaging its reputation in the industry and its market share (reputational risk) and subjecting it to legal and regulatory action (regulatory or compliance risk). And of course creditors are subject to the normal acts of god (volcano, earthquake, etc.), particularly if they rely on property collateral and

insurance, as well as man-made political risks such as border closings that prevent borrowers from earning an income.

Unfortunately, many of the tools a creditor has available to reduce these risks serve to limit the amount of credit available for consumer and housing finance, including by encouraging lending only to higher income segments of the population, limiting the size of loans with respect to the value of the mortgaged property, using adjustable rate loans that place the risk of interest rate changes on borrowers, and limiting the duration of loans so that the terms and status of the loan and borrower can be frequently reviewed. In fact, in most countries it is possible to characterize the main challenge of extending housing finance to more people as one of addressing the risks and direct costs of lending without placing the entire burden of risk on ordinary borrowers.

Overview of the direct costs of mortgage lending

In addition to risks for which creditor's must be compensated, the creditor's actual direct costs of mortgage lending include:

Funding Costs, or what the creditor must pay to depositors and bondholders to obtain the funds to make loans. Funding cost is the main component of interest rates, and is usually a blend of the rates paid by the creditor on deposits and bonds.

Capital Costs, or the costs of a licensed and regulated creditor's minimum required capital as well as the costs of holding capital reserves against loans. Capital reserves are a requirement imposed on every licensed financial institution. The cost of capital is essentially the yield demanded by

equity investors on their investments in the creditor as well as the opportunity cost of holding capital in cash or other low risk accounts.

Loan Origination Costs paid by the creditor**,** which include the costs of marketing, processing, underwriting, and completing loan transactions. These costs are averaged over the creditor's entire mortgage lending operation, including the costs of loans that are processed but rejected by the creditor or never completed by the borrower. These costs may not include costs of property appraisal, legal representation, title reports and registration of a mortgage, which are in most cases passed directly through to borrowers. The laws may affect the amount of these costs by, for example, establishing expensive formalities which must be carried out by notaries or attorneys or by the nature of the registration system for land titles and mortgages.

Loan Servicing Costs include the costs of collecting and processing borrowers' payments; trying to collect delinquent payments; maintaining regular contact with the borrower and monitoring the property, and dealing with problem loans. These costs may vary among loans, but experience in developed loan markets suggests that the servicing costs for mortgage loans, which are typically paid by the borrower in the form of a premium on the loan interest rate, can add on average from 0.25 to 0.5% to the interest rate of the loan.

Default Costs include all the expenses that a creditor incurs as a result of some of its borrowers failing to satisfy their obligations under the mortgage contract. Default costs include the direct costs of implementing a loan collection procedure, including property maintenance costs if necessary,

as well losses from failure to capture all principal and interest payments due.

Loan origination costs

As a general rule, many costs of originating a mortgage loan are passed directly through to borrowers and are paid when the loan is disbursed. These costs typically include the costs of verifying the borrowers credit information and obtaining a credit report, obtaining a property appraisal, obtaining a certificate of title or title report, and registration of the mortgage document, as well perhaps as some of the creditor's overhead costs for processing the loan. Precise costs for appraisals and government fees are usually passed through directly, while a creditor's other general costs for loan processing may be charged in the form of a lump sum loan origination fee paid by the borrower when the loan is made.

Loan servicing costs

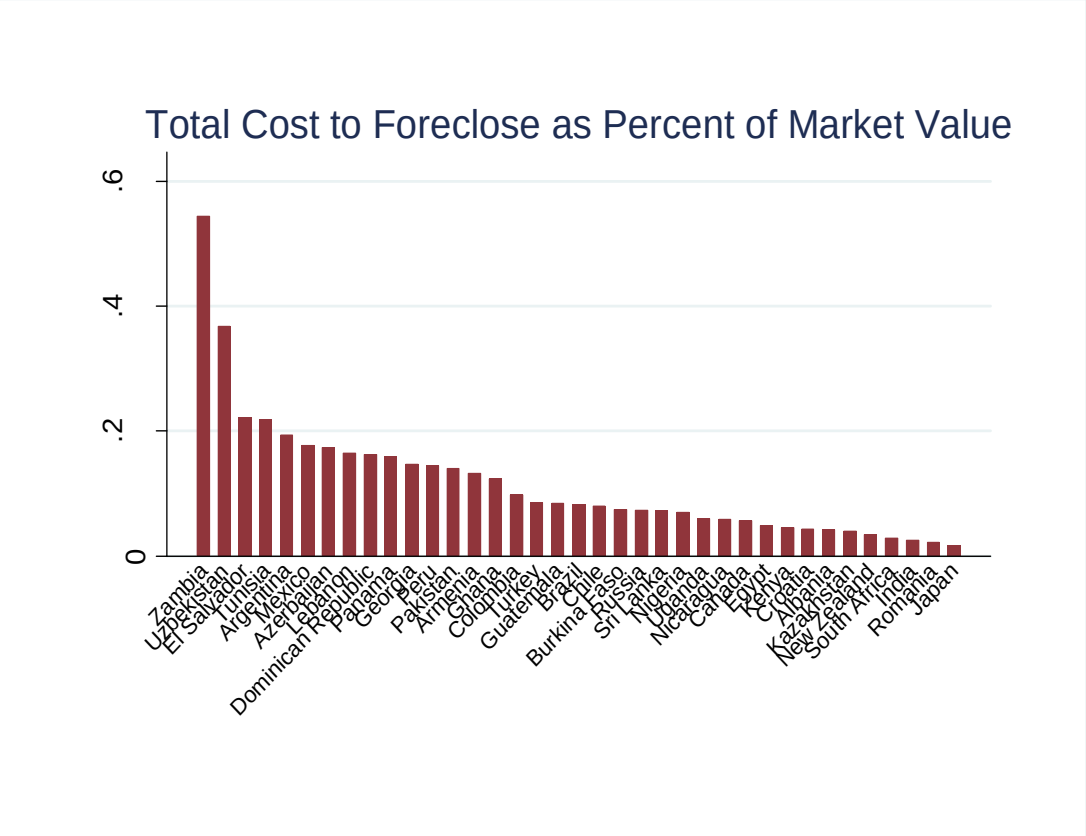
Loan servicing costs are incurred over the entire term of the loan and are usually paid to the creditor in the form of a small addition to the interest rate on the loan. Such costs may include for example accounting, notices and statements to the borrower, borrower inquiries and communications, amortization of management information systems, and document storage and retrieval. They are not insignificant and can add as much as 0.25 percent to the loan interest rate. Dealing with problems loans and loan defaults is a special and costly case of loan servicing.

The costs of enforcing a mortgage loan

The costs of defaults on loans in a creditor's portfolio of mortgage loans will depend on the proportion of the loans that go into default and the average loss that the creditor incurs for each default. The timing of defaults may also affect the net costs that a creditor experiences, because the sooner a default occurs, the larger will be the unpaid principal balance that the creditor will need to recover through recourse to the mortgaged property,

Research suggests that the costs of enforcing a mortgage can be high – ranging from 0.1% to 0.6% of the value of the mortgaged property. High enforcement costs contribute to higher interest rates and smaller loans and ultimately are paid by the borrowers.

Figure 2. Cost of enforcing a mortgage against residential property as a % of property value in selected countries



Source: International Finance Corporation

and the shorter will be the period during which the creditor will have collected payments to compensate itself for those losses. Across the world today the costs to enforce a mortgage against a borrower as a proportion of the value of the mortgaged property range from less than 0.1% of the value of the mortgaged property to almost 0.6%. (See Figure 2).

Generally speaking, the costs that a creditor will incur if a borrower fails to repay the loan will be the unpaid principal and interest of the loan plus the direct costs of enforcement and sale of the property, less the amount that the creditor receives when the property is sold.

To calculate the expected costs of default over its entire mortgage loan portfolio a creditor will multiply the probability that a borrower will default (probability of default, or POD) by the expected costs if a default occurs (loss given default, or LGD). For example, If by experience a creditor can expect that 5% of its mortgage loan borrowers will eventually default and on each default it will incur costs equal to 30% of the principal amount of the loan, the average cost of default for each loan would be 1.5% of each loan. (30% X 5% = 1.5%; see Figure 3).

Creditors should, and most do, include a premium on interest rates charged to borrowers that over time, on average, will provide sufficient funds to cover the costs of default on the entire portfolio of loans of the same type. This calculation may be affected by the creditor's expectations about how long the average loans will be outstanding, and therefore the period of time it will be collecting this interest rate premium. In countries where loans are paid off quickly, as in the Palestinian Territories today, the

actual default premium added to an interest rate may have to be larger than in countries where long loan terms are more common. Moreover, in emerging markets which lack long experience with mortgage lending and

Figure 3. Calculation of interest rate premium for expected costs of default across a mortgage loan portfolio

Probability Of Non-payment	*X*	*Expected Costs Given Non-payment*	=	*Average Cost Of Non-payment*
5%		*30% of Loan Amount*		*1.5% of Loan Amount*
(1) Average cost of non-payment (%)				*1.5%*
(2) Average duration of loan (years)				*5*
(3) Average addition to interest rate for default costs(1÷2)				*0.30%*

historical data about loan defaults, creditors may make very conservative assumptions about both the probability and cost of default, leading to yet higher interest rates.

The determinants of mortgage interest rates

Creditors determine the interest rate for mortgage loans by calculating the rate that would pay all of the expenses incurred in making the loan, including compensation for risks, and then adding on a market rate of profit. The interest rate structure looks something like Figure 4 and would be comprised of, for example :

Cost of funds	7.0
Capital costs	0.20
Loan servicing costs	0.50

Interest rate (market) risk premium	0.20
Costs of default (credit risk) premium	0.40
Profit	1.0
Total Interest Rate	9.30%

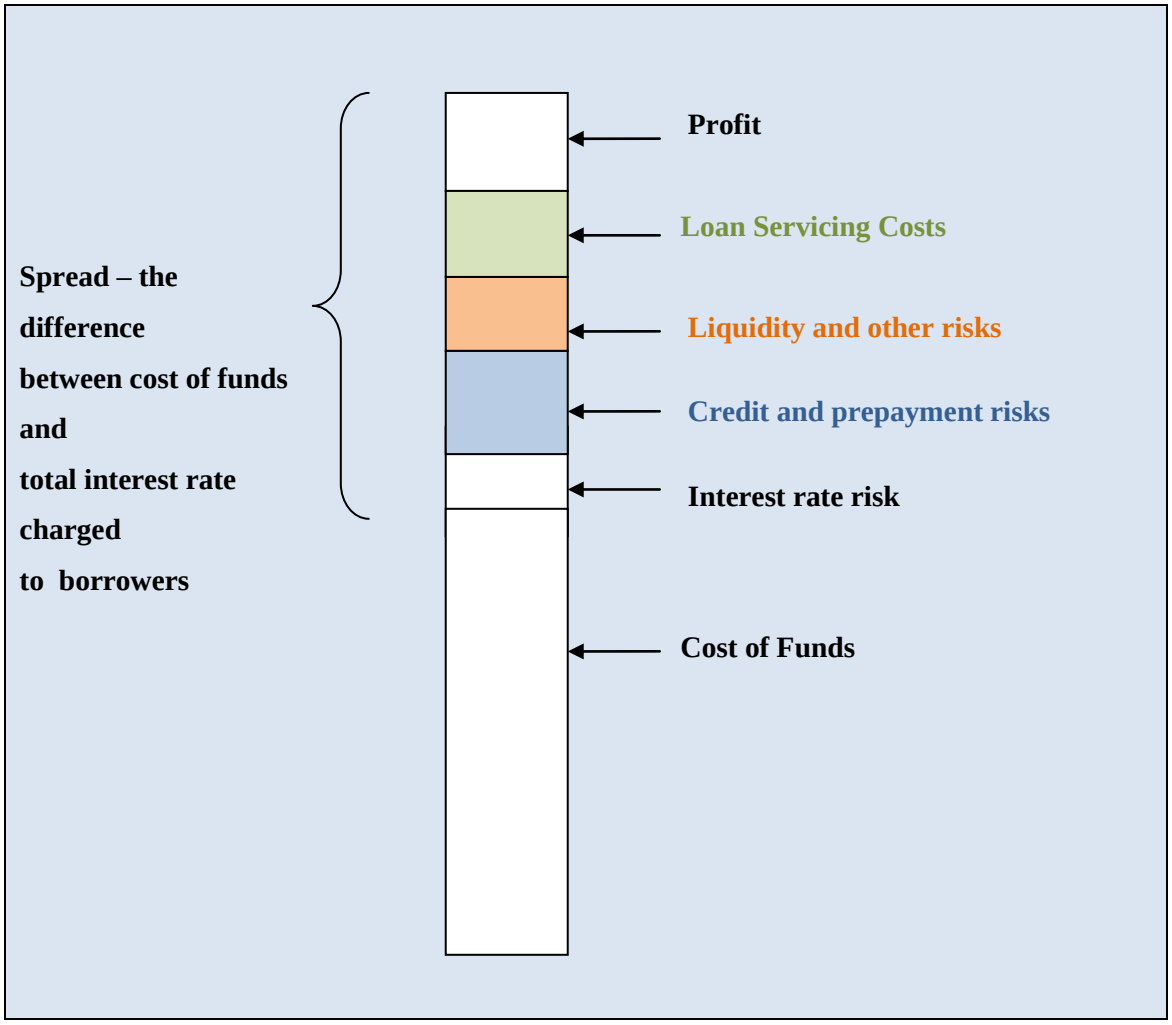
As discussed further below, there are several points where the quality of laws and judicial enforcement of a creditor's rights can affect the composition of interest rates. Capital costs and funding costs may depend to some extent on the perception of the safety and security of bank lending generally and the ability of banks to recapture lent funds without losses. The expected costs of default, and therefore the size of the credit or default risk premium, can be directly affected by the expectations of how long it will take to seize and sell mortgaged property, and the efficiency of the sale process. Servicing costs for loans can increase if borrowers are not faced with quick and effective penalties, leading to repeated late and missed payments. Though only a part of the overall interest rate, decreasing the risk of non-payment by providing quick and effective enforcement mechanisms can lower interest rates by reducing bank borrowing costs, liquidity and risk premiums added to interest rates and servicing costs.

The determinants of loan maturities

The length of a loan term, particularly the level payment amortizing loans most commonly used for residential mortgage lending, has a direct and significant impact on the size of required payments and therefore the ability of households to borrow. The term of mortgage loans is related to several factors, including the volatility of interest rates, the sources and duration of

the creditor's funding and in some instances the level of the creditor's security and ability to enforce collateral rights.

Figure 4. The Structure of Mortgage Interest Rates



The main risk to creditors in making long term loans at fixed rates of interest is that the interest rate will almost certainly change over time and the rate demanded by depositors and other sources of bank funding may be higher than the interest rate the creditor earns on its outstanding loans, resulting in an unsustainable "negative spread" between the creditor's cost of funds and the interest it is earning on it loan assets. This risk is serious with regard to mortgage loans, which are typically made for terms in

excess of 10 years and often for as long as 25-30 years. Lack of long term funding is the main impediment to providing longer term mortgage lending at fixed interest rates in many developing countries.

Bank regulators look closely at the possibility of “negative spread” and to protect the financial system require financial institutions to maintain a balance between the cost of funds and the interest earned on loan assets. One way of doing this is to maintain a close relationship between the average maturities of their assets – the length of time depositors and other sources of funding are committed to leaving their funds in the bank – and the average maturities of their loans. Creditors achieve this balance in a number of ways:

- Adjustable interest rate loans, on which loan interest rates increases to match increases in market rates. There are many variations of adjustable and renewable loans, all with the purpose of allowing the creditor to increase interest rates periodically to cover any mismatch in the rates on its assets and liabilities.

- Accessing longer term deposits from capital market investors. Some investors - including pension funds, insurance companies, and other institutions - need the stability of long term investments with fixed interest rates and are willing to lend the banks money for long terms. Use of mortgage loans as collateral to raise funds in capital markets is discussed further in Section V of these materials.

- Accessing longer term deposits from retail savers. Banks extend the duration of savings deposits by offering special terms for deposits such as contractual savings accounts and certificates of deposit

which are committed for a minimum duration at the risk of financial penalties. In reality most bank deposits are more stable in fact than in law, and even though much of the deposit base may be short term legally experience shows that it is longer term in fact. Bank regulators will usually allow some portion of even short term deposits to be characterized as longer term deposits provided the banking system can demonstrate that they are stable.

Making Loans Affordable

Form the perspective of borrowers the most important determinants of their ability to borrow are the interest rate and the maturity of the loan. Since most modern mortgage loans are level payment amortizing loans the interest rate and the maturity can greatly affect the amount of the borrower's periodic payment and therefore the ability of the borrower to repay the loan with a reasonable portion of his income. International standards suggest that a reasonable portion of a family's gross income to pay towards a housing loan is 30%, and that above that amount housing payments may begin to impinge on other family needs.

Table 3. Effect of Decrease in Interest Rate on Affordability for US$ 30,000 Loan Repaid Over 20 Years`

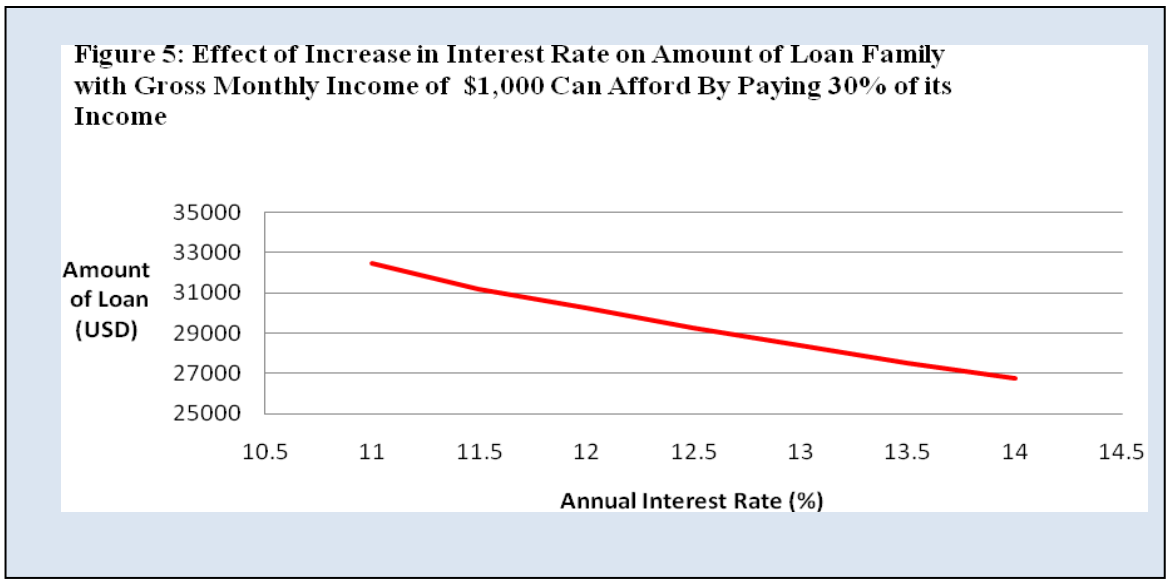
Rate (%)	Amount of Monthly Payment (US$)	Required Family Annual Income (US$)
14%	435	17,400
13.5%	423	16,920
13%	410	16,392
12.5%	397	15,876
12%	385	15,396
11.5%	373	14,916
11%	361	14,436

Tables 3, 4 and 5 show the effects of lowering interest rates and extending loan maturities on a borrower's periodic payments. Table 3 shows that for each ½ of a point interest rate reduction the monthly payment on the mortgage loan would decrease by about 2% percent, and assuming that the family is required to pay 30% of its gross income toward the loan the lower interest rates will allow extension of credit to a larger segment of the population in the Palestinian Territories. Table 4 and the accompanying Figure 5 show the effect of interest rate reductions on the amount of a loan a family can afford to repay using the usual 30% of income underwriting standard.

Table 4. Effect of Decrease in Interest Rate on Amount of Loan Family with Gross Monthly Income of $1,000 Can Afford By Paying 30% of its Income

Annual Interest Rate (%)	Approximate Amount of Loan Family Can Afford at 30% of Gross Income (USD)
11	32,500
11.5	31,200
12	30,250
12.5	29,250
13	28,400
13.5	27,500
14	26,750

An alternative way of looking at this same data is to hold the family income constant and determine the size of the loan the family could afford at different interest rates. Table 4 shows the effect of a decrease in interest rates on the size of the loan for which a family may be eligible



Similar results are obtained by extending the term of the mortgage loan, which reduces the required monthly payment and therefore increases the size of the loan a family can afford.

Table 5. Effects of Extending Term of Loan on Monthly Payment and Affordability – Loan of USD 35,000 at 12% Annual Interest

Term of Loan (Years	Monthly Payment	Required Monthly Income (30% of Gross Family Income)	Approximate % of Palestinian Families Served
5	$778.56	$2,335.67	1-2%
10	$502.15	$1,506.44	10%
15	$420.06	$1,260.18	20%
20	$385.38	$1,156.14	25%
25	$368.63	$1,105.89	30%
30	$360.01	$1,080.04	35%

Again assuming a loan of US$ 35,000, Table 5 and the accompanying Figure 6 show that for each 5 years the term of the loan is increased the required monthly payment decreases significantly, making the loan affordable to a wider segment of the population.

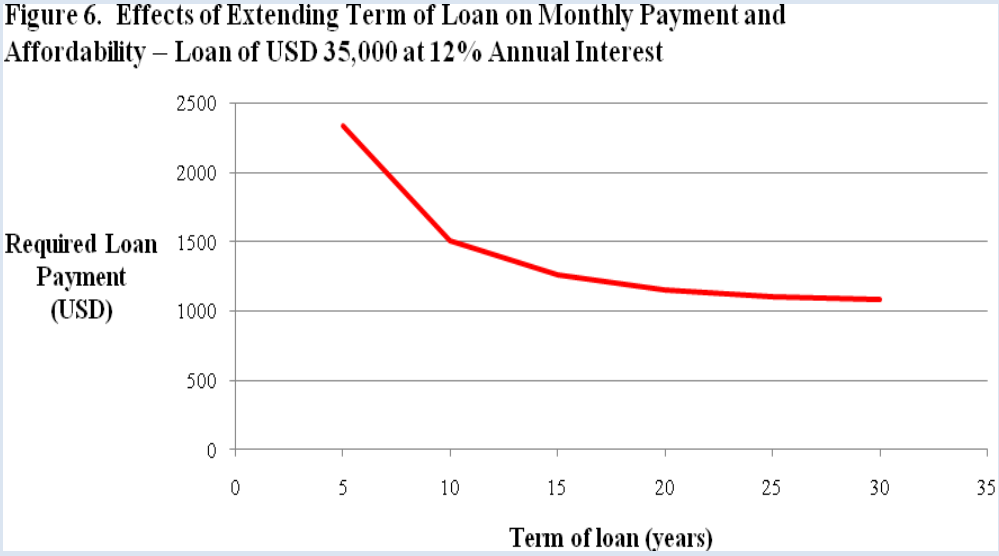


Figure 6. Effects of Extending Term of Loan on Monthly Payment and Affordability – Loan of USD 35,000 at 12% Annual Interest
Required Loan Payment (USD)
2500
2000
1500
1000
500
0
0
5
10
15
20
25
30
35
Term of loan (years)

V. THE RELATIONSHIP OF MORTGAGE LAW AND ENFORCEMENT OF CREDITORS' RIGHTS TO THE AVAILABILITY AND COST OF CREDIT

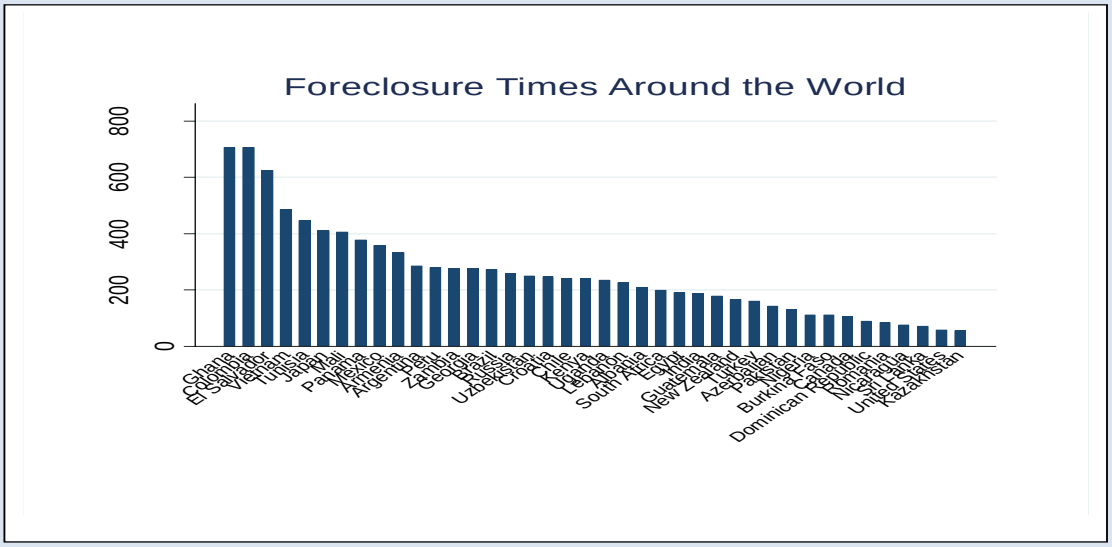
Legal rules and procedures relating to collateral and enforcement of creditors' rights can be either incentives or disincentives to lending and borrowing. In theory, as a legal device the mortgage responds to everyone's interests. It provides the creditor with a preferred position over other creditors, a simple way of establishing the existence of the debt, and collateral which usually holds its value and for which there is usually an active market. The debtor retains the legal title and use of his home, and enforcement of the creditor's rights is usually closely regulated by law to protect the debtor's investment.

Long delay and uncertainties in the enforcement of mortgages threaten loss of collateral value and loan interest, and undermine the intentions of the mortgage law to provide the creditor with a relatively quick and certain recapture of its investment. Uncertainties and inefficiencies in the enforcement process discourage creditors from making loans, and encourage them to seek alternatives to the legal mortgage, which alternatives may actually provide fewer protections to borrowers.

There is a growing body of empirical evidence that an efficient system of enforcing collateral rights increases the amount of credit

Time to enforce a mortgage around the world range from about 60 days to well over 400 days. There is evidence that the depth of the mortgage market is related to this variable.

Figure 7: Time in days to enforce a mortgage loan in selected countries.



Source: Interrnational Finance Corporation

available, lowers interest rates generally, and increases the maturities of loans.[3] In this section we review some of that research and its implications for mortgage lending markets.

[3] See, for example, A. Padilla & A. Requejo, "The Costs and Benefits of Enforcing Creditors Rights: Theory and Evidence," in Marco Pagano (ed.), *Defusing Default: Incentives and Institutions*, (Washington, DC, Johns Hopkins University Press, 2001); T. Japelli, M. Pagano & M. Bianco, "Courts and Banks: Effects of Judicial Enforcement on Credit Markets," Working Paper No. 58, Center for Studies in Economics and Finance, University of Salerno, April, 2002; B. Balkenhol & H. Schutte, "Collateral, Collateral Law and Collateral Substitutes," Working Paper No. 26, International Labor Office, Geneva; Mark Meador, "The Effect of Mortgage Laws On Home Mortgage Rates," Journal of Economics and Business 34, 1982.

Empirical Studies

Modern studies have demonstrated a significant relationship between the quality of laws, the efficiency of law enforcement concerning creditors' and contract rights and the availability and cost of credit to businesses and households. Using statistical techniques, economists have been able to show with a high degree of confidence that there are lower levels of bank lending to businesses and households and higher interest rates in countries that score poorly on the strength of protections for creditors' rights in the laws and a low efficiency of law enforcement in the courts. While much of this initial research focused on the laws themselves, it became clear that the quality of the laws and quality of enforcement can be independent variables – in the words of some authors, complements and not substitutes – and that good laws will have more effect when they are efficiently enforced.

The literature on the relationships between efficient court enforcement of contracts and creditors' rights and the availability and cost of household credit is extensive and growing. A few examples of these findings include:

- In a 2004 study of loans to legal entities in 48 countries ranked on the basis of the strength of creditors' legal rights, Bae and Goyal found that Banks lend more, over longer terms, and charge lower rates on loans to borrowers in countries where creditors' rights are well protected and efficiently enforced.[4] Though the study was concerned with lending to businesses it is indicative of the effects that laws and the ability to efficiently enforce contracts has on the availability and cost of credit.

[4] Kee-Hong Bae and Vidhan K. Goyal, Creditor Rights, Enforcement, and Bank Loans 2004, Property Rights Protection and Bank Loan Pricing, Working Paper, Hong Kong University of Science and Technology.

The authors found that although the strong creditors' rights in the laws decreased interest rates, more efficient enforcement of contracts in the courts not only decreased interest rates but increased loan size and lengthened loan maturities as well.

- In a 1990 study of mortgage loan enforcement in the United States, Clauretie and Herzog found that the characteristics of the mortgage law had an effect on the losses incurred by mortgage creditors. Creditors' losses were lower in states that allowed non-judicial enforcement of a mortgage and personal judgments against borrowers for the amounts not repaid from sale of the mortgaged property, and higher in states that established long periods for debtors to redeem the property after foreclosure sale, such as, for example, the one year redemption period presently allowed under the Gaza mortgage law.[5] Similar studies in the US market have found that long redemption periods result in higher average interest rates on all mortgage loans in the jurisdiction in which the long periods apply.

- In a 2005 study using a sample of loans in 43 countries Qian and Strahan estimated how various bank loan terms – including interest rates and maturity - may be affected by a country's legal and institutional characteristics.[6] They concluded from their study that where creditor protections are strong, bank loans tend to have longer maturities and lower interest rates.

[5] Terrence M. Clauretie & Thomas Herzog, The Effect of State Foreclosure Laws on Loan Losses: Evidence from the Mortgage Insurance Industry, *Journal of Money, Credit and Banking*, Vol. 22, No. 2. (May, 1990), pp. 221-233.

[6] "How Laws and Institutions Shape Financial Contracts: The Case of Bank Loans," Journal of Finance, American Finance Association, vol. 62(6), pages 2803-2834, December.

- In a 2007 World Bank study using data on business firms collected through the World Bank's "Enterprise Surveys" for the years 2005 and 2002, Safavian and Sharma tested the hypothesis that availability of bank credit was a function of both the laws and how well the laws are enforced. The data represented over 10,000 firms in 27 countries. Using various indices of the efficiency of contract enforcement, including for example "Court Time," or the average amount of time taken in calendar days to resolve a court case, as well as indicators of public confidence in the courts' ability to resolve disputes, the data showed that "(i)n countries and regions with very poor court enforcement, reforms in creditor rights [in the laws] have relatively little impact on bank lending to firms [but] such reforms have a remarkable effect on bank lending *where court enforcement is efficient."* The conclusion of the study was that not only the laws, but how they are enforced, has an effect on access to credit.[7]

- In a 2008 study which focused on legal development in 12 Eastern European countries in transition from socialism, Haselmann, Pistor and Vig showed that the strength of laws on collateral, including the ability to efficiently pledge and register a pledge of real and personal property, significantly affected the quantity of credit available in those countries, and suggested that the increase in lending was greater for ordinary households than for business enterprises. The authors speculated that this result arises because more efficient collateral laws allow creditors

[7] Mehnaz Safavian & Siddharth Sharma, When Do Creditor Rights Work?, Policy Research Working Paper 4296, The World Bank, August 2007.

to compensate for the lack of clear information regarding the credit worthiness of individual households.[8]

- In a 1991 study, Xavier Freixas showed that in Europe the average cost as well as the duration of judicial procedures required to repossess pledged assets are inversely related to the amount of funds available to finance consumption and housing acquisitions by households.[9]

- A 2009 study by the World Bank showed that the costs of enforcing a pledge of real property are directly related to whether judicial procedures are required or creditors may proceed without court involvement (See Figure 8), and that the availability of mortgage credit increases with the ease of mortgage registration and enforcement.[10]

- In a 2000 study, Padilla and Requeno used indicators of the strength of creditors' rights against debtors in bankruptcy proceedings, as well as "Rule of Law" indicators based on perceptions of the efficiency of judicial enforcement of contracts, to show that the strength of legal protection of creditors' rights is significantly related to the level of real interest rates.[11]

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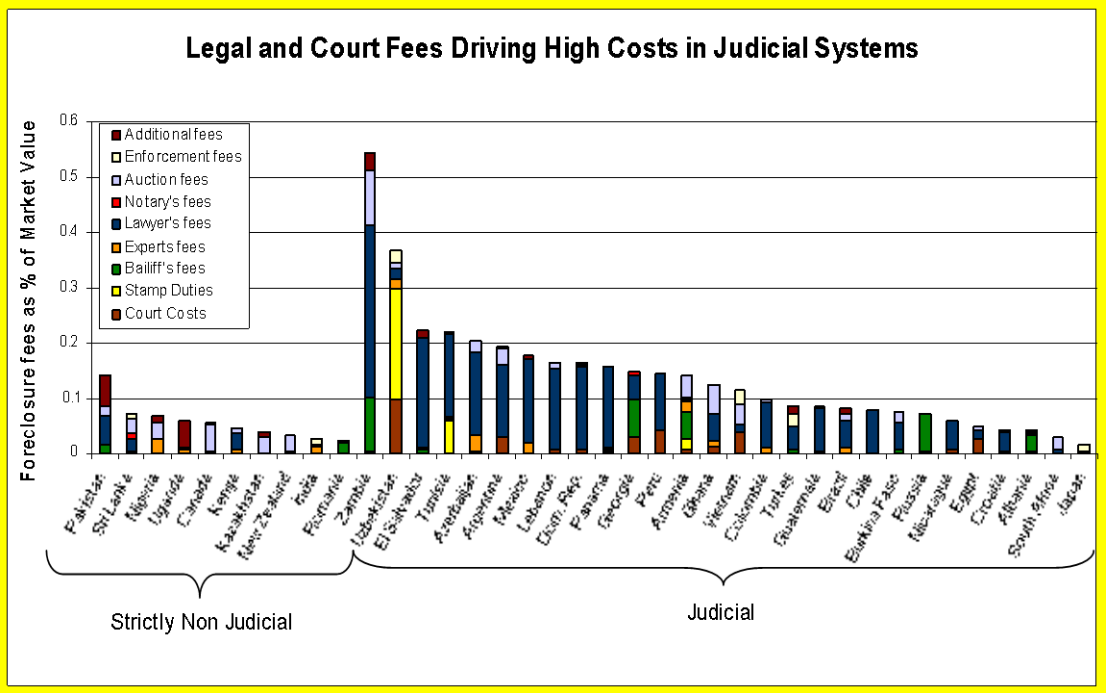
[8] Rainer Haselmann, Katharina Pistor and Vikrant Vig, How Law Affects Lending, Columbia law and Economics Working Paper 285, August 2008.

[9] Freixas, X. *El mercado hipotecario español: Situación actual y proyecto de reforma*, Madrid, Spain: Fundación de Estudios de Economía Aplicada, 1991.

[10] Butler, Stephen, Kravkova, Mariya, & Safavian, Mehnaz, Mortgage Registration and Foreclosure Around the Globe: Evidence from 42 Nations, *Housing Finance International*, June 2009.

[11] Atilano Jorge Padilla and Alejandro Requejo, The Costs and Benefits of the Strict Protection of Creditor Rights: Theory and Evidence, Interamerican Development Bank, May 2000.

Figure 8. Legal and Court Fees for Mortgage Enforcement in Selected Countries as a % of Property Market Value: Judicial and Non-Judicial Enforcement Procedures



Source: Butler, Stephen, Kravkova, Mariya, & Safavian, Mehnaz, Mortgage Registration and Foreclosure Around the Globe: Evidence from 42 Nations, Housing Finance International, June 2009

- In a 2003 study for the World Bank Laeven and Majnoni investigated the effect of judicial efficiency on banks' interest rate spreads for a large cross section of 106 countries. They defined the interest rate spread as the difference between the average lending rate of the banks and the average interest rate the banks paid their depositors. They compared the interest rate spreads with standard indicators of judicial efficiency and the quality of the rule of law, including an index that takes into account the time taken to deliver judicial decisions. They found that after controlling for a number of other country characteristics, judicial efficiency, in addition to inflation, is the main determinant of interest rate

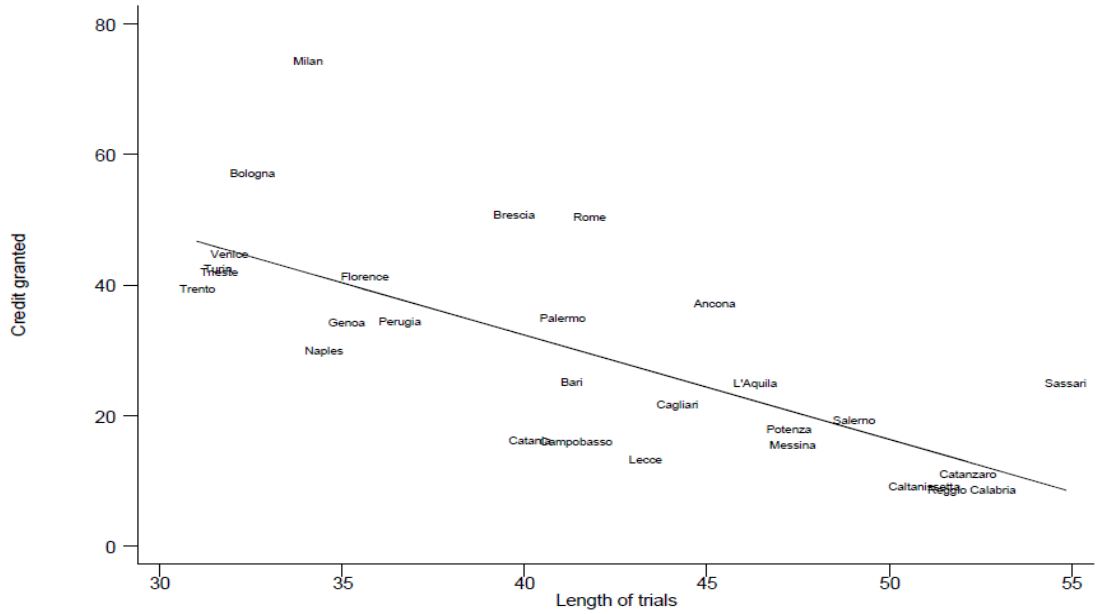
spreads across countries. That is, the perceived performance of the judiciary as measured by various indicators contributes directly to the difference between the interest rate banks borrow at and the rate they lend at. Poorer performance on the judicial efficiency indicators led to higher relative interest rates. They concluded that in addition to improving the overall macroeconomic climate in a country, judicial reforms, through better enforcement of legal contracts, are critical to lowering the cost of bank credit for households and firms.[12]

- Studies indicate that even within a single country, financial outcomes vary across regions that have the same laws but different court efficiency. Bianco et al. (2005) found that in Italian provinces with longer trials or larger backlogs of pending trials, credit is less widely available than elsewhere in Italy and the interest rate spread between bank lending rates and deposit rates is greater.[13]

[12] Luc Laeven and Giovanni Majnoni, Does Judicial Efficiency Lower the Cost of Credit? World Bank Policy Research Working Paper 3159, October 2003.

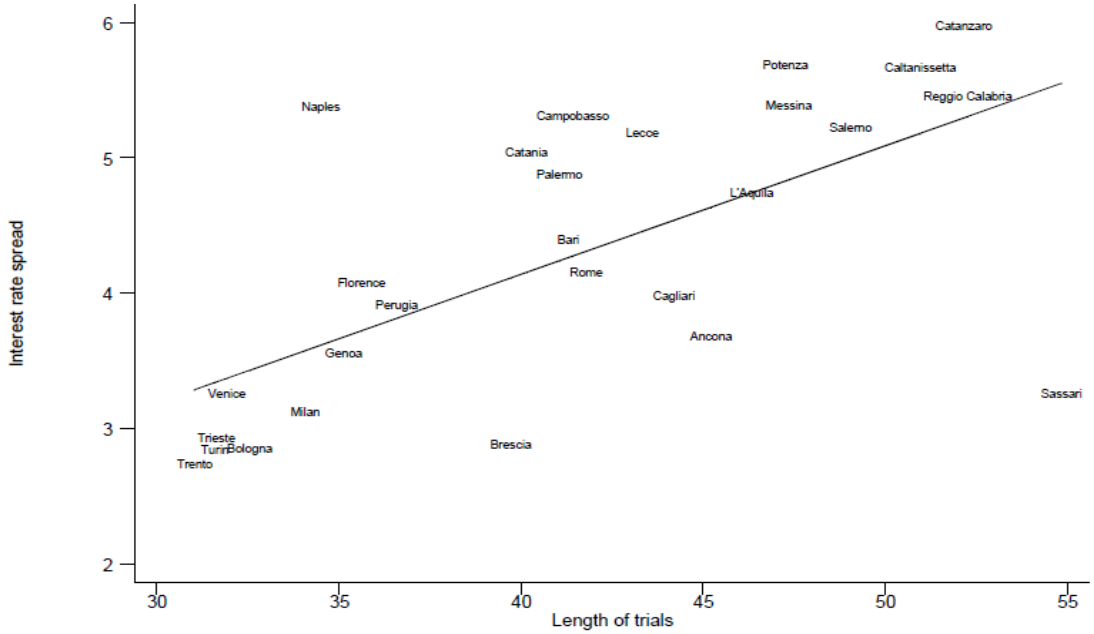
[13] Magda Bianco & Tullio Jappelli & Marco Pagano, 2001. "Courts and Banks: Effects of Judicial Enforcement on Credit Markets," CSEF Working Papers 58, Centre for Studies in Economics and Finance (CSEF), University of Naples, Italy, revised 09 Apr 2002.

Figure 9: Relationship of Length of Trials to Amount of Credit Granted by Banks in Regions of Italy



Source: Bianco et al., "Courts and Banks: Effects of Judicial Enforcement on Credit Markets"

Figure 10: Relationship of Length of Trials to Interest Rate Spreads in Regions of Italy



Source: Bianco et al., "Courts and Banks: Effects of Judicial Enforcement on Credit Markets"

- In a study of bank lending in Latin American markets Galindo found that the average impact of increasing creditor protections in Latin American and Caribbean countries could increase the ratio of outstanding credit to Gross National Product from 35% of GNP to 56% of GNP, a 59% increase in the ratio. In other words, the average size of credit markets could increase by over half if creditor protection were to be enhanced.[14] This study suggested that in countries characterized as having very poor creditor protections the effect of increasing both creditor protection and the quality of law enforcement simultaneously could be to nearly double the size of the credit market. In conclusion the researchers offered that *"(O)ur results suggest that most of the difference between the size of credit markets in Latin America and developed countries comes from institutional issues."*

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[14] Arturo Galindo, Creditor Rights and the Credit Market: Where Do We Stand?, prepared for the seminar "Towards Competitiveness: The Institutional Path," Annual Meetings of the Board of Governors, Inter-American Development Bank and Inter-American Investment Corporation, Santiago, Chile, March 16, 2001

VI. PALESTINIAN MORTGAGE LAW AND PRACTICE

Rules of originating and enforcing mortgage loans in the Palestinian Territories

Mortgages in the Palestinian Territories are currently governed by two sets of laws that apply in the West Bank and the Gaza Strip. These laws are: 1) Law 46 of 1953 on Mortgage of Real Property in Satisfaction of Debt, applicable in the West Bank; and 2) Ottoman Law of 1331 Hijri on Mortgages of Immovable Property as a Security for a Debt, as amended by the Laws on Mortgages No. 49 of 1920 and No. 9 of 1929. Though subject to different laws the procedures applicable in the West Bank and Gaza are substantially in accord.

Establishment of the mortgage

Though subject to different laws the legal requirements for establishing a valid mortgage are essentially the same in both West Bank and Gaza. The essential conditions of a valid mortgage in the Palestinian Territories include:

Principal obligation.

A mortgage is ancillary to an underlying principal debt or obligation; it cease to exist if and when the obligation ceases to exist. [Art. 8 Law of 1331]. [Art. 11 Law 46/1953]

Property subject to mortgage.

Any real property may be subject to a mortgage. Real property includes land, buildings, and leasehold improvements. [Art. 1 Law of 1331]. [Art. 2 Law

46/1953] In Gaza a lease interest in real property can be mortgaged [Art 9 Law 25/1933] but not in the West Bank (Law 25/1933 repealed by Law 51/1958)

Parties.

The maker of the mortgage can be the owner of the mortgaged real property, either the obligor of the principal obligation or a third party. On the West Bank the beneficiary of a mortgage can be any natural or legal person on the condition that they are licensed to operate within Palestine. [Art. 3 Law 46/1953] In Gaza mortgages can be registered to the benefit of a trust, a bank, or a company only on the condition that they are licensed to operate within Palestine. [Art. 2 Law of 1331]. It is possible to mortgage property belonging to a minor pursuant to a *Sharia* Court decision given upon the request of the legal guardian. The property must be owned as freehold by the minor.

Writing.

All mortgage contracts are subject to the formalities governing land conveyances. Mortgage contracts must conform to the standard format and once duly executed are deemed to be stand alone documentary evidence (executive documents) and can be used in courts of law and official government offices without additional proof of the obligation established by the mortgage. [Art 4. Law of 1331] [Art. 7 Law 46/1953] A standard format for the mortgage document is used both in the West Bank and the Gaza Strip and the form is usually available at the Land Registry offices. The basic elements of the document are:

- name and address of the debtor;
- name and address of the creditor;
- amount of the debt, including interest rate;

- description of the property (details as to block and parcel number, area, value, shares subject to the mortgage, boundaries, class of mortgage (first or subordinated), and a description of prior mortgages, if any);
- special conditions (the parties can include any special terms/conditions of their agreement consistent with the law);
- date of execution;
- notes, if any;
- amendment section;
- provisions for conveyances in the event of death;
- record of conveyance transactions;
- space for release of the mortgage upon satisfaction of the debt;
- and space for registration of future sale of the property, if any.

Principal obligation.

The principal obligation must be a fixed, liquidated sum or an obligation that can be expressed as a fixed, liquidated sum. The amount of the principal obligation must be fixed at the time of creation and registration of the mortgage. As a matter of practice, increases in the principal obligation of a registered mortgage are not permitted, and can be accomplished only by rescission of the existing mortgage and execution and registration of a new mortgage for the increased amount, which would not enjoy the priority of the prior mortgage. [Section 11 D of internal Registrar regulation 88 issued by the assistant Registrar on 14/08/1958.]

Interest rate.

Interest rates may be fixed for the term of the mortgage or adjusted periodically in accordance with the terms of the contract. Under Article 2 of the Amendment to Law of Compound Interest 1929 there has been in effect a restriction stating that the total interest paid on a loan may not exceed the amount of the original principal obligation. A regulation [Regulation 04/2009] of the Palestinian

Monetary Authority purports to abolish that restriction with respect to loans made by banks under its jurisdiction.

Registration.

While an unregistered mortgage contract may be enforceable between the parties to the contract, to be opposable against the interests of third parties and establish the creditor's priority against other creditors the mortgage contract must be registered with the Land Registry. The Land Registry Departments in the West Bank and Gaza have jurisdiction over registration of mortgages. All mortgages are recorded as debt contracts at the Land Registry Department in a separate mortgage registry. On the West Bank to register the mortgage contract both the creditor and the debtor must submit the request to the Land Registry in person in the presence of witnesses. [Art. 6 Law 46/1953] [Art. 4 Law of 1331]).

Before the Land Registry will accept a mortgage for registration, documentation from the municipality or a public notary must be provided showing whether the mortgaged property is subject to any existing right or encumbrance, such as a leasehold. If so, the term of the leasehold becomes a controlling factor. Should the leasehold term be longer than the intended term of the mortgage, then two options are available to continue the process: 1) the leaseholder must agree in writing to vacate the property at the end of the mortgage period, or 2) the creditor must agree in the mortgage contract not to sell the property before the end of the term of the leasehold. [Art. 5 Law 46/1953]

There are two categories of title deeds against which a mortgage can be registered:

1) Property having a title deed issued by the Land Registry. In this case the documentation required to register a mortgage is the standard mortgage contract described above and a dated official title deed.

2) Property having a beneficial ownership record issued by the Treasury (tax record). In this case the documents required for registration are:

For property within municipal boundaries:

1. a recently [valid for one year] issued treasury record;
2. a description of the property within municipal boundaries. In Gaza a declaration is needed from the municipality describing the mortgaged property and its legal status, including whether there are underlying rights or encumbrances such a leasehold, the term of which must be stated when the mortgage is registered. [Art. 3 Law of 1331]; and
3. treasury registrar requests confirmation from the municipality.

For properties outside municipal borders:

1. a recently issued treasury record;
2. description of the property within municipal boundaries; and
3. treasury registrar requests confirmation from the public notary if there are any transactions recorded in relation to property subject to the mortgage.

Once all conditions for registration are met, the Land Registry notes the mortgage date and specific contract number in the notes section of the Mortgage Deed. When a mortgage is registered, four (4) copies of the document are issued as follows: 1) to the creditor; 2) to the debtor; 3) a copy for the central administrative office of the Land Registry; and 4) a

copy for the records department of the issuing (local) office. [Art. 6 Law 46/1953]

Amendments to Mortgage Contract.

Completed mortgage contracts may be amended to:

1. change the conditions section of the mortgage agreement in full or in part;
2. extending the maturity date (date of redemption); or
3. change the interest rate, on the condition that it not surpass the maximum legal interest rate.

The Registrar is not permitted to increase the principal obligation of an existing mortgage agreement, and if presented with such a request the Registrar must start proceedings to initiate a second mortgage agreement for the new debt, which will remain subject to the first mortgage and any other intervening interests which have been registered before it.

Any amendments to a mortgage agreement should be noted in the specified field in the registered agreement, and amendments must be witnessed and then signed by the Registrar.

Enforcement of the Mortgage

There are three types of legal actions that a mortgage creditor may take against a debtor:

1. enforce the mortgage and sell the mortgage collateral;
2. pursue a court judgment against the borrower personally on the principal obligation, in which case the creditor will have the right to claim against all of the debtor's assets; or,

3. seek an involuntary insolvency and liquidation judgment against the debtor in court [Regulation concerning selling of Immovable property in payment of debts 1288 Hijri].

Choice of a personal judgment or an involuntary insolvency proceeding is exclusive – that is, the creditor may not subsequently seek to enforce the mortgage contract. Foreclosure of the mortgage does not preclude a later suit against the debtor for any amount of the debt which is not repaid from sale of the property.

While options 2 and 3 (personal judgment and involuntary insolvency procedures) must be done through court action, in the Palestinian Territories there are two parallel systems for enforcement of a mortgage and sale of the mortgaged property:

1. a judicial procedure in the court of first instance for the jurisdiction in which the property is located, or
2. an administrative sale of the property handled by the Land Registry.

In practice, in both West Bank and Gaza mortgage foreclosure procedures, either judicial or administrative, predominate over personal judgments and involuntary insolvency proceedings. With regard to mortgage enforcement, there is some evidence that West Bank creditors prefer administrative foreclosure and sale by the Land Department while creditors in Gaza use primarily judicial procedure.

Unlike the laws of many other countries, Palestinian laws do not allow a creditor to exercise “self-help” and seize and dispose of the property. In addition, the laws generally provide for procedures that ensure that

“commercially reasonable efforts” are taken to sell the property in a manner that will result in fair value being realized from the sale. [Art 13 s. 3 Law 46/1953] and Gaza. [Art.10 Law of 1331]

Enforcement through Personal Judgment

Under Civil Procedures Law No. 2/2001, applicable on both the West Bank and in Gaza, if a creditor decides to seek a personal judgment on the debt it may first seek to have the court attach the debtor’s assets to prevent the borrower from liquidating them. This request may be made and granted without prior notice to the borrower, provided that the creditor is given only eight days from the date the court issues the order of attachment to commence a legal action against the debtor on the debt. Otherwise, the creditor is deemed to have forfeited its rights under the injunction and the injunction is canceled. [Arts. 266, 267] The debtor may apply for a lifting of the attachment and the court has discretion to lift the attachment order with or without a bond posted by the debtor. [Art. 271]

Unlike administrative foreclosure and sale of the mortgaged property, a personal judgment against the debtor is a binding court determination by a court of the fact and the amount of the debtor’s liability to the creditor. As such it gives the creditor access to other assets of the debtor in addition to the mortgaged property, as well as other tools of enforcement such as the judicial discovery process which allows the creditor to identify all of the assets of the debtor. On the other hand, the creditor now becomes an unsecured creditor and seeking a court judgment on the debt will likely elicit defenses and counterclaims from the borrower. Borrowers defenses that have been presented in court have included:

- that it has or can satisfy the obligation;
- that the mortgage agreement is void ab initio for failure to adhere to formal requirements;
- procedural requirements for enforcement of the mortgage were not followed by the creditor;
- the creditor misrepresented the terms of the loan to the borrower (fraud);
- the creditor verbally agreed to modify or waive the terms of the agreement;
- breach of the creditor's obligations under the loan agreement; and
- accounting errors in the creditor's claim.

Upon obtaining a personal judgment against the debtor the creditor may have all of the collection tools usually available to judgment creditors, including garnishment of wages; seizure of money or other assets belonging to the debtor but held by a third party; and levy or seizure of property of the debtor and sale through public auction.

Attaching and Enforcing Judgments Against Property of a Debtor

In its petition against the debtor, the creditor asks the court to grant it a judgment in the amount of the debt, seize the debtor's property, sell it at public auction, and use the proceeds to pay off the judgment. If the creditor prevails, execution of the judgment against the debtor's assets by the court's Enforcement Department is identical in West Bank and Gaza. Procedures in both the West Bank and Gaza are governed by the court pursuant to Enforcement Law No. 23 of 2005.

The laws governing court supervised enforcement of judgments describe different requirements for sale of real and moveable property of the debtor.

Real Property

Enforcement of the judgment against real property entails the following steps:

- The court's enforcement department notifies the debtor by registered mail that it has seven days from receipt of notice to pay the balance of the debt in full, plus interest and fees. [Art.9].

- If the debtor fails to pay, the execution judge presiding over the matter seizes the property by attachment and sends another notice to the borrower to pay, and payment must be made within one (1) month [Art. 112] If the borrower fails to pay, the court commences a two-phase auction process that is essentially the same in Gaza and West Bank and entails:

    - The court publishes notice of a 30 day preliminary or temporary auction period in the appropriate journal. All bidders must provide a down payment of 10% of the amount of the property's value [Art. 98]estimated by a professional appraiser upon the request of the court at the outset of the 30-day temporary auction period.
    - A 15-day permanent auction period begins after the close of the temporary auction, with a starting price equal to 105% of the highest bid made during the temporary period.
    - At the close of the permanent auction period, if no acceptable new bids are received, the court accepts the highest bid from the

preliminary auction, and declares it a permanent auction, or the highest bidder in the second or permanent auction is declared the winner.

- The presiding judge of the Enforcement Department must order one last auction period of 45 days if he determines that the highest bid at the end of the permanent auction is too far below the property's appraised value. At the end of this last period the property is transferred to the highest bidder. [Art. 131]

- The debtor has fifteen (15) days from the date it receives notice from the court of the outcome of the final auction to pay the debt in full, without any further redemption period. If during this 15-day period a new bidder offers to pay 110% of more of the highest bid price the court reopens the bidding between this new bidder and the former highest bidder. [Art. 133] New bids must be submitted within three [3] days of the request from the court and at the end of this period the property is awarded to the highest bidder.

Moveable Property

Should the mortgage creditor decide to rely on a personal judgment enforcement of a judgment against movable assets of the debtor involves the following steps:

- The Enforcement Department notifies the borrower that it has seven days to pay the debt in full. With regard to summary matters the borrower has only 24 hours to pay. In both cases, however, the Enforcement Department may grant a longer period if the debtor provides a strong rationale. [Art. 9]

- If the debtor does not pay, the Enforcement Department seizes the property to be auctioned. [Art 85]

- The Enforcement Department of the court notifies the borrower of the seizure within 3 days of the seizure [Art 87]. If the borrower does not pay within seven days in [Art. 97], the Enforcement Department will proceed with the auction. The auction involves a public notice announcing the auction date and a description of the property to be auctioned. [Art 98]

- At the end of the auction period, the property is transferred to the highest bidder, free of any further claims by the creditors. The debtor and creditor are not required to be present at the auction. [Art. 100]

Distribution of Proceeds of Sale of Assets in Court Proceedings

Expenses and other obligations of the debtor must be satisfied in the following order of priority from the proceeds of sale according to Chapter 4 of the Enforcement Law:

1. taxes and fees owed to the government on the property which was auctioned;
2. lease and rental obligations, including storage costs related to the auctioned assets;
3. payment of all costs and expenses incurred by the Enforcement Department in attaching and enforcing the judgment
4. Secured Mortgage

5. maintenance payments for the benefit of the debtor's wife, children, and parents;
6. all other taxes and fees, direct and indirect, owed to the government;
7. secured debts (other than the mortgage of the judgment creditor);
8. unsecured debts. Unsecured debts are paid in priority order, established by the date the debt was incurred, so the judgment creditor may not be repaid until superior unsecured claims are satisfied. [Art. 143] Moreover, if auction proceeds remaining after payment of all superior claims are insufficient to satisfy all unsecured (ordinary) creditor claims, they are distributed pro rata to all unsecured creditors.

The auction stops once sufficient assets are sold to cover all debts, and the remaining assets are returned to the borrower. [Art 145]

Administrative Execution through the Land Departments

Foreclosure procedures through the Land Department in the West Bank are covered under Law 46/1953 on Mortgage of Real Property in Satisfaction of Debt. The Gaza procedures are substantially the same and are governed by Ottoman Law of 1331 Hijri on Mortgages of Immovable Property as a Security for a Debt, as amended by the Laws on Mortgages No. 49 of 1920 and No. 9 of 1929. The procedure is essentially:

- The creditor must make a written demand on the debt for satisfaction of the debt, to be delivered in registered form. Proof of demand is a condition of applying for administrative foreclosure and sale.

- The creditor submits a petition (in the form of an electronic submission completed at the Registrars office) to the regional Land

Department outlining the default and its claim on the collateral. The petition is accompanied by the mortgage document and proof of demand.

- Written notification by registered delivery is provided by the Land Department to the borrower of its intent to sell the property unless payment is made in full within one week of receipt of the notice. [WB: Art. 12-13/1 Law 46/1953; Gaza: Art 11-10 Law of 1331] Within the seven day period after receipt of notice of the auction, or such longer period as the court may allow, the debtor may petition to the court to stay the auction procedure on the grounds that (i) the debtor has the demonstrated ability to satisfy the debt, or (ii) the sale of the property will cause a serious hardship to the debtor. For either of these reasons, the court may, for one time only, stay the auction for a period of two months only. If at the close of the two month period the outstanding balance, including interest and fees, is not paid in full the creditor may demand that the Land Department proceed with the auction. [WB: Art. 13/2]

- Unless stayed by the court, the Land Department commences the property sale procedure, which is carried out in a two-phase auction.

    - The particulars and terms of the auction must be published in the local newspaper and/or specialized journal . The content of the notice of auction are specified by law. [Art 98 Law 23/2005]

    - A first or preliminary auction is conducted for a period of 45 days from the date of first publication. There is no mandatory starting price in the preliminary auction. During the 45 day preliminary

auction period additional legal notices of the auction must be published in appropriate journals every 15 days.

- Upon close of the preliminary auction period a second and final (permanent) auction is noticed in the appropriate journal and conducted for a 15 day period, with an opening price equal to the 103% of the highest bid of the first auction period.

- At the close of the permanent auction period, If no acceptable new bids are received, the Land Department accepts the highest bid from the preliminary auction, and declares it a permanent auction, or the highest bidder in the second or permanent auction is declared the winner.

- The highest bidder pays the creditor and receives conditional title to the property, and in the West Bank this is subject to the debtor's one-year right of redemption. The auction purchaser's conditional title may be registered as such in the Land Registry. [WB: Art 15]

- The Land Department deducts administrative costs before distributing the balance of the auction proceeds to creditors according to the priorities of their claims. [WB: Art. 13-14; Gaza: Art. 10-11]

In the West Bank the debtor has the right to redeem the property for a period of one year from the date title is transferred to the auction purchaser, who during this period is subrogated to the rights of the foreclosing creditor. To redeem the property, the debtor must pay to the

purchaser the balance due on the original debt plus accrued interest, which continues to accrue during the one year period, and fees. During this one year period the auction purchaser is forbidden by law from selling or mortgaging the property. [WB: Art. 15]

Judicial Foreclosure of Mortgages

Procedures to enforce mortgages on immoveable property through judicial process are set out in Enforcement Law 23 of 2005, applicable in West Bank and Gaza. This law governs court execution procedures against both real and personal property. The key steps in this process include:

- The creditor must acquire an order of the Enforcement Department of the court of first instance for the jurisdiction in which the property is located to enforce the mortgage agreement after default, which must be initiated in the same manner as any suit on an unpaid debt.

- Upon receipt of the court judgment the creditor must request execution by the court's enforcement/execution department.

- Thenceforth the procedures for auction sale of property are the same as described under the section dealing with enforcement of a personal judgment against the debtor.

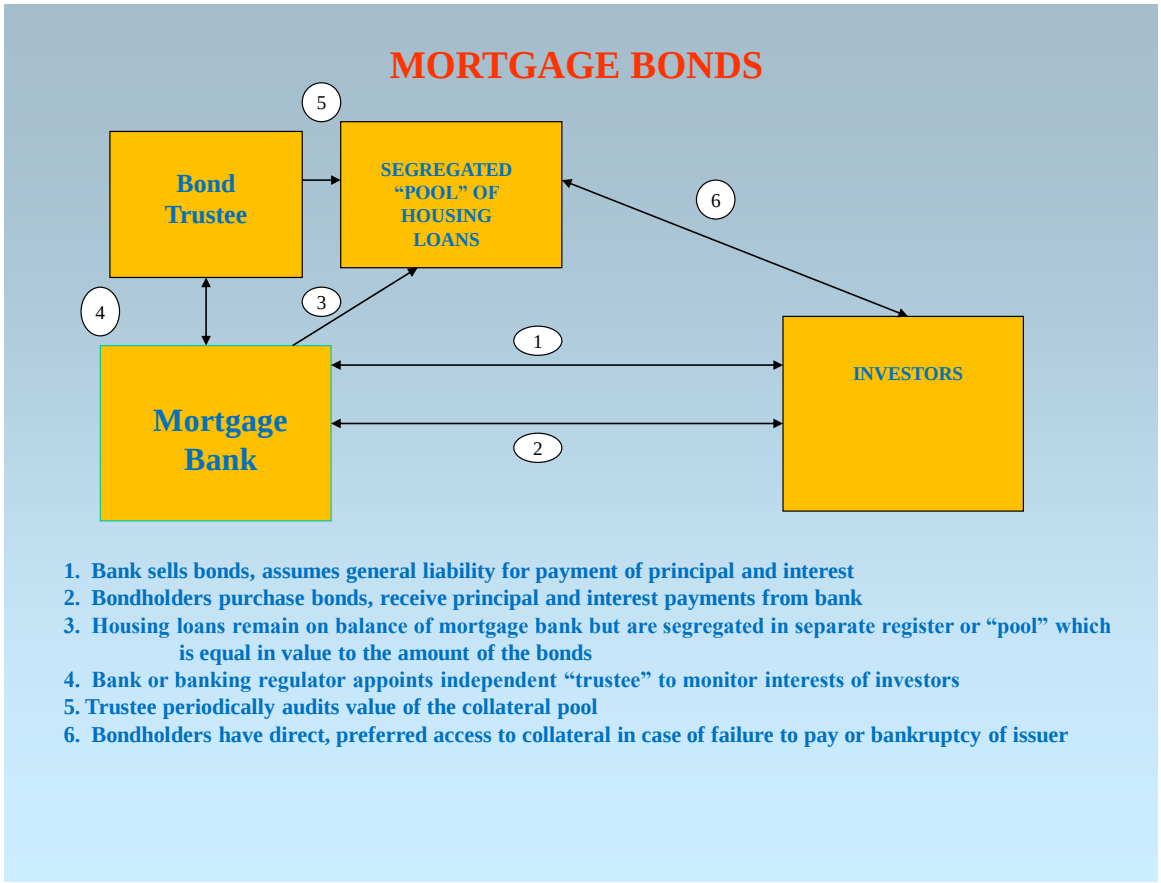
VII. MORTGAGE SECURITIES

It was noted above that a determinant of the term or maturity of mortgage loans is the availability to banks of long term funding that they can lend to borrowers. Because of strict banking supervision that requires a close matching of the maturities of bank assets (e.g. mortgage loans) and liabilities (e.g. bonds or deposits) banks may be able to offer only shorter term loans to borrowers. As shown above, the length of the loan maturity greatly affects the size of the required monthly payment and therefore the ability of ordinary people to borrow to acquire and improve housing.

Financial institutions have different ways to extend the duration of their funding and thereby the maturities of loans to customers. One of the most prevalent today in established mortgage markets is mortgage securities – capital markets instruments secured by a pledge of some or all of a creditor's mortgage loan portfolio. This device is becoming more common in emerging markets as well. Mortgage securities allow financial institutions to refinance their mortgage portfolio with long term funds, thus facilitating lending at long maturities. The key to successful mortgage securities markets is the presence of long term investors such as pension funds, insurance funds and other collective investment vehicles that seek secure investments for a long term. Residential mortgage loans have until recently been viewed as very secure investments.

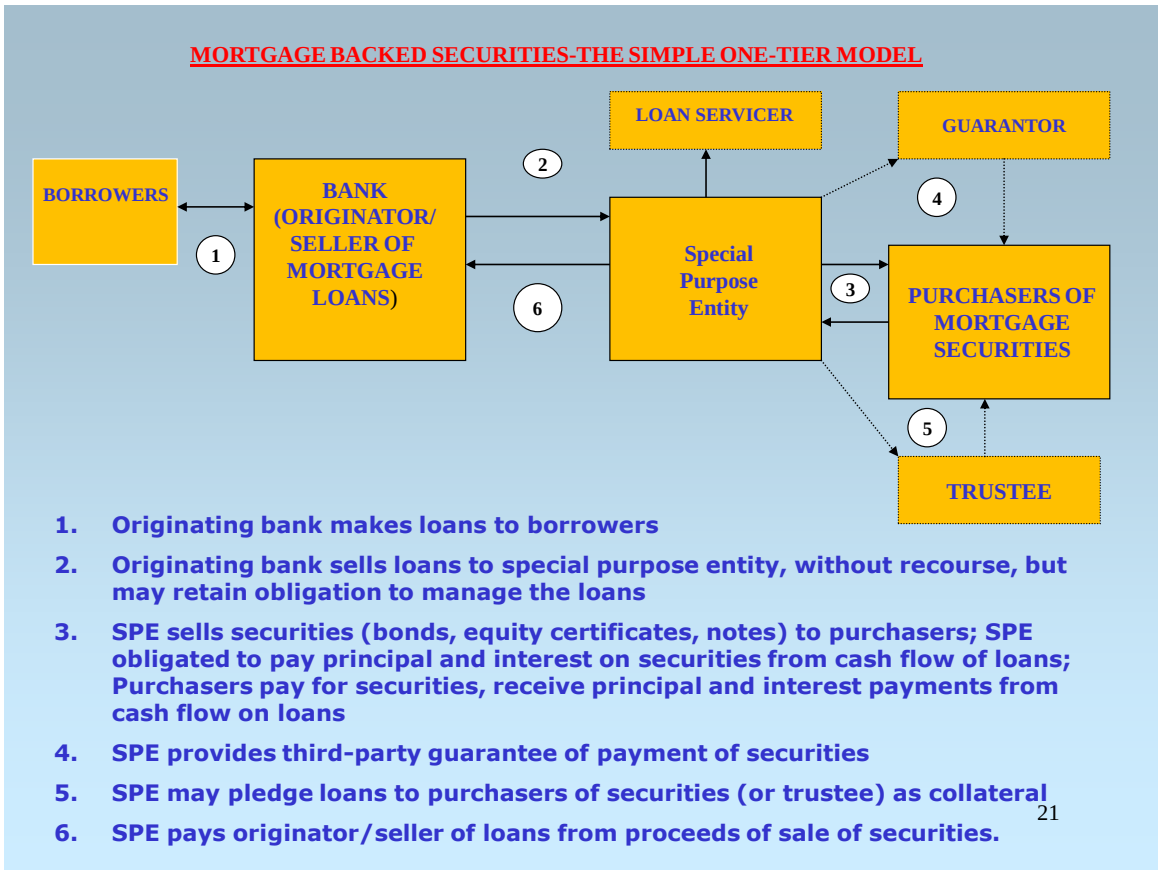
Mortgage securities today fall into two main classes: mortgage bonds and mortgage asset backed securities.

Mortgage bonds. Typical mortgage bonds are general obligations of the issuer secured by a first lien pledge of the issuer's mortgage loan assets. The mortgage loan assets remain on the balance of the issuer subject to a pledge for the benefit of bond holders. In the event of the bond issuer's failure to pay the bonds as due the bond holders have a first priority right to seize the mortgage loans and sell them to repay the bonds. Mortgage bonds may be issued under the general principles of secured transactions and capital markets regulation or under special laws, increasingly common in emerging markets, that establish rules for bond issuance that assure



safety and security for investors. The mortgage bonds issued by the Jordanian Housing Finance Agency are examples of simple mortgage bonds.

Mortgage Asset Backed Securities. Mortgage asset backed securities typically are structured as a sale of mortgage assets by a mortgage creditor to investors through an intermediary legal entity called a "special purpose entity" the sole purpose of which is to hold the mortgage assets and issue the mortgage securities to investors. The structure results in a "true sale" of the assets from the originating institution to the investors and therefore removal of the assets from the balance sheet of the loan originator. Investors may hold an undivided ownership interest in the mortgage assets, not a mere security interest, or in some cases a security interest in the mortgage loan assets that is structured to be superior to the



claims of any other creditor and protected against the possible bankruptcy of the loan originator and seller. In the absence of specific laws governing the issuance of mortgage asset backed securities their issuance is highly

dependent on complex international accounting rules that allow the necessary degree of investor protection to be structured.

Though not yet used in the Palestinian Territories, there is no reason why simple mortgage bonds and mortgage asset backed securities could not be implemented under the current laws. The main legal issues affecting issuance include:

Borrower consent. In some counties it has been necessary to obtain the borrower's consent to pledge or transfer his loan to another creditor or legal entity such as the special purpose entities use in mortgage backed securities, which has effectively forestalled development of mortgage securities markets. This is not an issue under the Palestinian law, where loan assets are freely transferable without the consent of the borrower, but notification of the transfer to the borrower may be required to assure that payments are properly made to the new owner of the loan.

Registration of pledge or assignment of mortgage loans. To facilitate transfer or pledge of mortgage loans in support of mortgage securities it is highly desirable to a land registry that will register a pledge or assignment of mortgage loans efficiently and at low cost. Cumbersome and expensive mortgage registration systems have been an impediment to creating mortgage securities markets.

Registration of security interests in moveable/personal property. Modern systems of mortgage securities often rely on pledge of rights to intangible contractual rights (loan assets) and therefore require an efficient system for registering pledges and establishing

creditor priorities. While this can be done by establishing pledge procedures under comprehensive laws on mortgage securities, in the absence of such laws a good secured transactions registry is desirable.

Capital markets regulations. Mortgage securities are complex financial instruments that should be regulated by the Capital Markets Authority.

It is more likely that market factors will determine the development of these instruments in an emerging market such as the Palestinian Territories. Key market factors include:

Bank needs. Mortgage securities meet a need of banks to access longer term capital so that they can increase lending and extend loan maturities. Many Palestinian banks today tend to be well capitalized and have sufficient access to long term funding from foreign parents so that selling mortgage loan assets by issuance of mortgage securities is not a pressing need, and many would prefer to hold well performing mortgage loan assets in portfolio. This picture may change as demand for mortgage loans increases.

Presence of institutional long term investors. The key factor in the development of mortgage securities markets has proven to be the presence of institutional investors with long term perspectives, including pension funds (state and private), insurance companies, and collective investment vehicles.

Improvements in the underlying primary mortgage market. Mortgage loan investors are interested in the quality of the underlying mortgage loan assets, and never more so that after the recent financial crisis which was, essentially, induced in large part by sub-standard mortgage loans. Investors in mortgage securities will want to see not only prudent mortgage underwriting standards, but also good mortgage laws and reliable enforcement.

VII. Glossary of Mortgage Lending Terms

Adjustable-Rate Mortgage (ARM): A mortgage with an interest rate and periodic payment that change periodically over the life of the loan based on changes in a specified financial index.

Adjustment Date: The date the interest rate changes on an adjustable-rate mortgage

Amortization: The process of repaying the mortgage loan. The loan payment usually consists of a portion that will be applied to pay the accruing interest on a loan, with the remainder being applied to the principal. Over time, the interest portion decreases as the loan balance decreases, and the amount applied to principal increases so that the loan is paid off (amortized) by the specified maturity date. Many home mortgages are fully amortized in 15, 20 or 30 years.

Appraisal: An estimate of a property's value as of a given date, usually determined by a qualified and licensed professional appraiser. The value may be based on the replacement cost of the property, recent sales of comparable properties or the property's ability to produce income. In residential markets the comparable sales method predominates, sometimes with supplementary information form replacement cost analysis. Income analysis is largely reserved for commercial and investment properties.

Appraised Value: An opinion of a property's fair market value, based on an appraiser's knowledge, experience, and analysis of the property. Since an appraisal is based primarily on comparable sales, and the most recent sale is the one on the property in question, the appraisal usually comes out at the purchase price.

Appraiser: An individual qualified by education, training, and experience to estimate the value of real property and personal property. Although some appraisers work directly for mortgage creditors, most are independent.

Appreciation: The increase in the value of a property due to changes in market conditions, inflation, or other causes.

Balloon Mortgage: A mortgage loan that requires the entire remaining principal balance be paid at a specific point in time. For example, a loan may be amortized as if it would be paid over a thirty-year period, but requires that at the end of the tenth year the entire remaining balance must be paid. Or, a mortgage loan may require that only interest payments be made, with all principal repayment made at maturity.

Bank Capital. The unencumbered and highly liquid funds held by the bank as a protection against losses, usually consisting of a first tier of cash or cash equivalents and a second tier of less liquid funds including subordinated debt and loan loss reserves. Minimum capital is required by banking regulators both as a condition of licensing and as a specified percentage of bank assets, meaning that lending may increase only as capital increases.

Borrower's Equity or Equity. The difference between the market value of the property and the outstanding balance of the mortgage loan(s) on the property.

Capital Costs. The return on investment that must be provided to the bank's common and preferred shareholders. The broader definition of capital costs can include the weighted average return to all borrowings both equity and debt.

Certificate Of Title: A document showing ownership, usually of real property, an automobile, or recreational vehicle, giving a description of the thing owned and any liens against the property

Charge-Off: The portion of principal and interest due on a loan that is written off for a loss when the loan is deemed by the creditor to be uncollectible. Most banking regulators impose strict rules on when a loan must be charged off and a loss taken.

Credit-Related Losses: The sum of foreclosed property expenses plus charge-offs.

Credit Risk. The risk that a borrower will not repay his loan. Determined by creditors on the basis of past credit history and performance, employment, assets and liabilities. Also determined probabilistically in developed markets on the basis of statistical analysis of borrowers demographics and experience with loan products.

Credit Scoring: A process that uses recorded information about individuals and their loan requests to assess - in a quantifiable, objective,

and consistent manner - their future performance regarding debt repayment.

Default: The failure of a borrower to comply with the terms of a loan or mortgage.

Default Costs. The cost incurred by a creditor if a loan is not repaid, including lost principal and interest, court or other administrative costs, legal fees, and expenditures for property maintenance such as repairs and taxes.

Delinquency: A mortgage loan on which a payment has not been made by the due date.

Encumbrance: Any legal interest that affects or limits the fee simple title to a property, such as mortgages, leases, easements, or restrictions.

Equitable Right of Redemption: A right under the law of a borrower to redeem his or her property up to the date of the sale of the property by paying in full the outstanding mortgage debt plus other outstanding amounts. Redemption periods can extend beyond the date of sale of the property, in which case a purchaser is deemed to be a creditor of the defaulted borrower.

Eviction: The lawful expulsion of an occupant from real property, if necessary, by force.

Executive document/contract. A legal document executed with certain legal formalities, such as notary certification, that eliminate the need for

further proof of the matters recited in the document and in the case of mortgages may allow the creditor to proceed directly to an action in the execution/enforcement department of the court.

First Mortgage: The mortgage that is in first place among any loans recorded against a property. Usually refers to the date in which loans are recorded, but there are exceptions. Also called a senior mortgage

Fixed-Rate Mortgage: A mortgage loan in which the interest rate does not change during the entire term of the loan

Forbearance: The creditor's postponement of legal action when a borrower is delinquent. An option, not an obligation of the creditor, it is usually granted when a borrower makes satisfactory arrangements to bring the overdue mortgage payments up to date.

Foreclosure: The legal process by which property that is mortgaged as security for a loan may be sold to pay a defaulting borrower's loan.

Funding Costs. What a creditor must pay to depositors – including retail savings and checking depositors, term depositors, and holders of the creditor's bonds or commercial paper - to obtain the funding with which to make loans. It is the largest single component of the interest rate a bank charges to borrowers.

Housing Expense to Income Ratio. The ratio of a borrower's total housing expenses – including loan payments, taxes, insurance and other housing costs – to his gross income; usually calculated as a monthly ratio.

Used by creditors to evaluate a borrower's ability to repay a loan. Most creditors look for a ratio between 30% and 40%.

Interest rate spread. The difference between the average interest rate a creditor pays on its funding (funding costs) and the average interest rate on its loans to customers. The size of the spread reflects actual costs (servicing costs) and the risks associated with lending that must be anticipated and spread over the loan portfolio.

Level payment amortizing mortgage loan. A loan on which the entire principal amount is repaid over the term by periodic payments of equal amount of which a declining portion is allocated to interest and an increasing portion is allocated to principal as the principal balance is repaid.

Liquidity Risk. The risk of a mismatch in the cash flows of a creditor's assets and liabilities to the extent that the creditor is unable to meet its obligations as due (technical insolvency).

Loan origination. The act of reviewing, approving and disbursing a mortgage loan.

Loan Origination Costs. The costs of originating a mortgage loan, including normal staff and overhead costs, document preparation, legal and registration costs, costs of credit review and credit reports (credit scoring), and property appraisal. Loan origination costs are typically passed directly through to the borrower and paid in cash at the time the loan is disbursed.

Loan provisioning. The act of setting aside a portion of loan loss reserves for a specific loan because of late or missed payments, prior to declaring the loan uncollectible and charging it off against reserves; distinguished from the bank practice of establishing general loan loss reserves to cover anticipated losses on its entire loan portfolio. Provisioning is required by financial accounting rules and banking regulations.

Loan Servicing: The tasks a creditor performs to protect a mortgage investment, including collecting monthly payments from borrowers and dealing with delinquencies.

Loan Servicing Costs. The bank's costs of keeping the loan after origination, including accounting costs, document maintenance and retrieval, periodic reporting to borrowers, responding to borrower's inquiries, and the costs of loan enforcement.

Loan-To-Value (LTV) Ratio: The ratio of the amount of a borrower's mortgage loan to the appraised value of the mortgaged property.

Loss Given Default. A creditor's estimate of the amount that the creditor will lose in the event that a borrower fails to repay a loan, calculated as a percentage of the loan value, and equal to the costs of enforcing the loan less the amount the creditor will likely collect from sale of the mortgaged property.

Market (interest rate) risk. The creditor's risk that market interest rates will increase after a loan is made thereby devaluing the mortgage loan asset which it holds and threatening a negative interest rate spread and

cash flow losses because the rates demanded by depositors and bondholders exceed the rates on bank assets. Market risk is generally associated with fixed rate mortgage loans.

Mortgage: A legal document that pledges property to a creditor as security for the repayment of the loan. The term also is used to refer to the loan itself.

Mortgage-Backed Security: A security that represents an undivided ownership interest in a group of mortgage loan or is secured by a pledge of mortgage loans. Principal and interest payments from the individual mortgage loans are may be paid through to the security holders.

Mortgage Term: The length of time that a mortgage is scheduled to exist. Example: a 30-year mortgage term is for 30 years.

Mortgagee: The institution, group or individual that lends money secured by pledged real estate; the creditor. See mortgagor.

Mortgagor: The owner of real estate who pledges the property as security for the repayment of a debt; the borrower. See mortgagee.

Negative interest rate spread. A situation in which the average interest rate earned by a creditor on its assets is lower than the average interest rate it pays to its depositors (funding costs), leading to losses.

Non-judicial enforcement of mortgage. Any procedure to sell mortgaged property and collect on a debt without obtaining a court judgment on the merits of the mortgage holder's claim. Non-judicial

enforcement procedures are typically permitted with respect to executive documents. A procedure is considered to be non-judicial if a creditor may proceed directly to a section of the court responsible for execution of claims against property.

Nonperforming Asset: An asset such as a mortgage that is not currently accruing interest or on which interest is not being paid.

Periodic payment. The amount a borrower must pay towards his mortgage loan periodically, usually monthly, over the life of the loan. Under the most common form of mortgage loan periodic payments are identical (constant) over the life of the loan consisting of changing portions of interest and principal.

Portfolio Risk. The risk that a creditor's loan portfolio will be concentrated in a physical location that experiences extraordinary economic events, such as natural disasters or industry obsolescence.

Prepayment. Refers to the act of repaying a loan either entirely or in part prior to its maturity. The right to prepay a loan at any time is usually granted to borrowers but may be subject to a prepayment penalty to compensate the creditor for any losses or revenue imbalances it may incur. Prepayment of large numbers of loans in a declining interest rate environment could lead to a severe mismatch between a creditor's assets and liabilities and negative interest rate spread. Prepayment is a main cause of a creditor's market risk.

Pre-foreclosure Sale: A procedure in which the borrower is allowed to sell his or her property – sometimes for an amount less than what is owed on

his mortgage loan - to avoid a foreclosure sale. By agreement of the creditor and borrower this sale fully satisfies the borrower's debt.

Prior Lien: A mortgage or other claim that ranks legally ahead of another lien for purposes of distributing proceeds of a foreclosure sale.

Probability of Default. The probability that any given borrower will not repay his loan. Usually estimated by a creditor on the basis of past performance of the creditor's loans of a similar type. When applied to the estimated loss given default the probability of default is a main determinant of the size of the "risk premium" that a creditor must add to each mortgage loan to assure that the costs of default over the entire loan portfolio are covered.

Registration. The act of registering a legal instrument such a deed or mortgage in the land registry to provide legal publicity and establish legal priorities.

Repayment Plan: An agreement between a creditor and a borrower who is delinquent on his or her mortgage payments, in which the borrower agrees to make additional payments to pay down past due amounts while still making regularly scheduled payments.

Risk-Based Capital: The amount of capital a bank must maintain to absorb losses throughout a period of time specified by the banking regulator.

Satisfaction Of Mortgage: A legal instrument given by the creditor and subject to registration that evidences payment in full of the mortgage debt.

Secondary Mortgage Market: The market in which residential mortgages or mortgage securities are bought and sold by investors.

Total Debt to Income Ratio. The ratio of a borrower's payments on total indebtedness, including housing and consumer loans as well as other recurring legal obligations, to the borrower's gross income. Usually calculated as a monthly ratio. Used by creditors to determine a borrower's ability to repay a loan. Most creditors will look for a debt to income ratio of not more than 50%, and banking regulators in a number of countries have established ratios of 40%.

Underwriting: The process of evaluating a loan application to determine the risk involved for the creditor. It involves an analysis of the borrower's ability and willingness to repay the debt and the value of the property.