

ARAB REPUBLIC OF EGYPT

AFFORDABLE MORTGAGE FINANCE PROGRAM DEVELOPMENT POLICY LOAN (LOAN NO. 7747-EG)
TRANCHE RELEASE DOCUMENTRelease of the Third Tranche - Full Compliance

1. In line with the World Bank's operational policy on *Development Policy Financing* (OP 8.60), disbursement of a multi-tranche loan is conditioned on: (a) satisfactory implementation of the program supported by the loan, including compliance with the program's tranche release conditions; and (b) maintenance of a satisfactory macroeconomic policy framework. This document summarizes the progress made under the Affordable Mortgage Finance Program Development Policy Loan (DPL) to the Arab Republic of Egypt.

2. The three-tranche US\$300 million loan was approved by the Executive Directors on September 24, 2009. The operation was signed and declared effective on December 12, 2009 and April 27, 2010 respectively. The Affordable Mortgage Finance Program has been progressing on track, and all the required institutional and policy measures have been achieved. Accordingly, the first tranche of US\$100 million was released on April 27, 2010, and the second tranche was released on July 28, 2011.

3. The three conditions for the release of the third and last tranche of the Development Policy Loan (DPL) outlined in the Loan Agreement have been met by the Borrower. Compliance with the conditions for the release of the third tranche was verified by the World Bank supervision mission (January 25-29, 2015), which received and reviewed the necessary evidence to confirm compliance. In addition, the Bank finds the macroeconomic policy framework of the Borrower satisfactory and consistent with the objectives of the Program for the purposes of releasing the third and last tranche of this loan.

I. Background

4. The DPL supports the Government of Egypt in implementing its Affordable Mortgage Finance Program. The main policy areas which the loan supports are: (i) strengthening the legal, regulatory, and institutional framework for the mortgage finance subsidy program to be effectively operated by the Guarantee and Subsidy Fund (GSF); (ii) developing an effective and efficient mortgage finance subsidies mechanism that will expand mortgage lending and therefore housing affordability for low and middle income groups; and (iii) improving the institutional framework to enhance transparency and targeting of housing subsidies, moving away from supply side and official budget implicit subsidies to a more efficient demand side system.

5. The Program's objective is to expand the residential mortgage market and to increase access to mortgage loans for low and middle income households in order to improve housing affordability. Through this Program, the direct subsidy to the housing developer is eliminated and instead a transparent direct subsidy is issued to qualifying beneficiaries through the GSF, the Program's implementing agency.

6. While the subsidy is administered by the Government, it is delivered in partnership with private sector lenders. This allows the Government to focus on its regulatory and supervisory role while the private sector (developers and lenders) provides the housing units and the financing through mortgages. The subsidy is split between down-payments and buy-down monthly installments during the first seven years of a mortgage loan with the parameters and subsidy amount varying according to the beneficiary's income level.

7. This Program also offers a number of benefits, which include:
- Decreasing the per unit amount currently needed to provide housing for underserved low and middle income households.
 - Opening access to housing to a broader category of the population, whilst at the same time deepening the financial sector.
 - Allowing government funds to leverage private sector capital in the form of mortgage loans.
 - Enhancing the efficiency of the use of government funds combined with the private sector, allowing the freeing up of some fiscal resources that had been used in the past for low and middle income housing, to be re-directed for those with lower incomes who would not be creditworthy enough for a mortgage loan.

8. This operation was highly relevant before the 2011 revolution but has become particularly important and timely post-revolution. Affordable housing continues to be a priority sector for the Government of Egypt given that it is the most visible indicator of social wellbeing. The housing sector plays an important role in the Egyptian economy. National accounts show that the Egyptian economy has been investing on average 1.8 percent of GDP in housing over the past two decades. In addition, the housing sector has a strong multiplier effect.

II. Macroeconomic Policy Framework

9. The macroeconomic policy framework can be considered satisfactory for the purpose of disbursing the third and last tranche of this Development Policy Loan, notwithstanding considerable external and fiscal vulnerability and uncertainty about the details of the authorities' policy plans and implementation capacity. The Government has initiated an ambitious fiscal adjustment program and the Central Bank of Egypt (CBE) has started allowing for increased exchange rate flexibility while the Egyptian authorities are seeking additional external financing in the context of the planned economic conference in Egypt in March 2015. However, the conference is likely to focus on securing project financing, and the challenge of identifying financing to close the balance of payments gap is likely to remain. The Government is also pursuing reforms across a number of important areas, including in the energy sector, infrastructure, and business environment, while taking steps to strengthen the social safety nets. Further clarity about policy plans are expected after the Parliamentary elections planned for March-April, the final milestone in the political transition process.

10. On January 28, 2015, the IMF concluded the long overdue Article IV consultation with Egypt, and both staff and Directors expressed broad support for the Government's adjustment and reform program, while pointing to the external vulnerabilities and stressing the need for steadfast implementation of the authorities' program. In particular, they pointed to continued large balance of payments financing gaps through the medium term and urged the authorities to aim for a more ambitious international reserve target and allow for greater exchange rate flexibility. The current environment of low international inflation is particularly favorable for exchange rate flexibility, which is needed to improve external competitiveness given the current overvaluation of the currency. Inflationary pressures would also be lower if the authorities stick to their fiscal consolidation plans.

11. Egypt's economy is showing signs of recovery following several years of subdued growth in the aftermath of the 2011 revolution. Real GDP growth picked up to 3.7 percent in the last quarter of FY14 and 6.8 percent in the first quarter of FY15 after being stuck at around 2 percent over the preceding three years. The pick-up in growth has been driven by a large fiscal stimulus program (amounting to about 3 percent of GDP) and some recovery of confidence and investment—helped by a low base effect—while net exports remained weak and continued to be a drag on growth. Growth is expected to reach close to 4 percent in FY15 and strengthen further to 5 percent over the medium term.

12. The fiscal position remains precarious but is set to improve. The underlying fiscal deficit (excluding grants etc.) increased to 17.5 percent of GDP in FY14, though the headline deficit remained similar to the year before at 13.8 percent of GDP reflecting large exceptional financing (mainly grants and in-kind aid) from Gulf Cooperation Council countries (Saudi Arabia, UAE, and Kuwait) in the order of US\$20 billion (about 4 percent of GDP). While social and capital spendings are being increased, the deficit is expected to decline to 11 percent of GDP (including Gulf grants of about 1 percent of GDP) in FY15 reflecting the pick-up in growth, ongoing tax reforms (notably increased property and wealth taxes and planned VAT introduction), and a significant reduction in energy subsidies (arising mainly from domestic price increases in July 2014 but also from the decline in international energy prices). Meanwhile, public debt reached over 90 percent of GDP in FY14 and is projected to decline slowly to around 80 percent of GDP by end-FY19.

13. Inflationary pressures remain sizeable due to energy price increases and continued shortages in commodity markets but should begin to ease slowly. Inflation peaked at 11.8 percent in October 2014 and is expected to remain above 10.5 percent in FY15-FY16. Continued energy price increases will have transitory effects but may not necessarily affect the end-period inflation if second round effects are controlled (in particular through monetary action). Meanwhile, high nominal interest rates discouraged credit demand, and high-yield government securities created little incentive for banks to lend to the private sector. Access to finance also remains an important constraint to growth, with slow private sector credit expansion, especially to small and medium enterprises. At the same time, aggregate financial soundness indicators point to the system's resilience despite the prolonged economic difficulties. Initiatives are under way to develop the financial sector and enhance financial inclusion, including revisions to the regulatory and supervisory framework to support mortgage finance.

14. Egypt's external position remains highly vulnerable. The external current account deficit (excluding grants) increased to 5 percent of GDP in FY14, significantly above the norm. While gross international reserves have stabilized at around 3 months of imports after declining to perilously low levels in FY13, an increased buffer would be prudent to protect against both external and domestic shocks. Despite an assumed recovery in remittances, tourism, and FDI, external financing gaps remain large—some US\$36 billion through FY19. The real exchange rate appreciated by 18 percent from June 2013 to November 2014, and though the nominal exchange rate has depreciated in early 2015 it has so far only been enough to offset about one-fourth of the earlier real appreciation. A parallel foreign exchange market persists with a spread of around 7 percent, and Fund staff estimate that the real exchange rate remains overvalued (the estimate varies widely from 3-28 percent).

15. Social vulnerabilities remain high. Unemployment is showing early signs of improvement but poverty has increased. The unemployment rate declined marginally to 13.1 percent in September 2014 after rising steadily since 2011, and is expected to continue declining but only at a slow pace. Youth unemployment remains high. Of the current 3.6 million unemployed people, some 65 percent are 15-29 years old. Poverty increased to over 26 percent in FY13 (according to data from CAPMAS, the Central Agency for Public Mobilization and Statistics), with approximately as many non-poor living close to the poverty line and highly vulnerable to falling into poverty. Poverty is concentrated in Upper Egypt and rural areas.

16. There remains some uncertainty about the details of the Government's policy plans and implementation capacity, in addition to the important question of how financing gaps will be closed. On the fiscal side, importantly, there is uncertainty about the pace and nature of energy subsidy reform, the timing of VAT introduction and the rate to be applied, the nature and impact of ongoing wage bill reform deliberations, and how non-priority spending would be cut. On monetary and exchange rate policy, it remains unclear to what degree and in what timeframe the authorities would allow for a more market-based setting of the exchange rate and elimination of the parallel market rate. On broader structural

reforms, a better assessment of ongoing and planned mega projects is needed, and more specificity will be needed regarding reform plans in key sectors. Finally, even with the implementation of the envisaged fiscal, monetary and exchange rates measures, additional balance of payments financing is likely to be needed, and the sources of such financing have not yet been identified.

III. Program Implementation, including Progress against Tranche Release Conditions

17. The overall Program implementation remains on track, and the Program proved to be closely linked to the strategic twin goals of the World Bank Group. The Program currently serves households with incomes between LE 1,000 and LE 2,500 per month, reaching just below the 20th percentile of the income distribution, and with a median beneficiary income of LE 1,750 per month—which lies in the third income decile. Therefore, more than half of the beneficiaries are poor. Approximately 23 percent of beneficiaries are female-headed households (above the national average).

18. The transparent and targeted subsidies reduce the down-payment requirement and monthly payments for income-constrained households. The subsidies are set to increase with decreasing income levels, and are linked to a maximum affordable mortgage loan by a financial institution of the beneficiary's choice. The underreporting of income has a negative impact on the affordable loan amount, and thus affects the type and price of the house that can be acquired. In May 2014, the CBE initiated a LE 20 billion stimulus package for the housing sector, lowering the banks' cost of funds and allowing them to on-lend to qualifying low income households under the Affordable Mortgage Finance Program. Currently fourteen banks are partaking in this initiative. The average subsidy is in the order of LE 19,000 per household. Prior to the announcement of the CBE stimulus, 14,000 subsidies were provided by this Program through the market rate mortgage channel. After the CBE stimulus was announced, the GSF received 155,000 applications, and an additional 10,000 subsidies were issued by the end of 2014. The GSF is the administrator of the program, and coordinates banks' enrollment in the Program and the allocation of funds.

19. Since 2008, the Bank has provided technical support to the GSF to strengthen its monitoring and evaluation systems, improve data quality and management, and update of program parameters including beneficiary qualification criteria. The Program is implemented in accordance with a comprehensive Procedure Manual, making use of IT systems and procedures that have been tested to handle a large volume of applicants. The system is set up to generate monitoring reports that include information on households, loan and subsidy level information, and lender information. In addition, the GSF conducts a thorough process of screening beneficiary's applications. The GSF also keeps comprehensive records of rejected applications with information on the reason for rejections (such as not meeting the program thresholds, and falsified information on residence or income). The GSF receives complaints through its websites. Its manual requires handling complaints within 48 hours of receipt.

Condition 1: Strengthening of the legal, regulatory and institutional framework for the Mortgage Finance Subsidies Program by introduction of a mortgage insurance or guarantee function.

20. **The condition has been met.** Two insurance companies on April 2013—Iskan Insurance and Misr Insurance—have been operational and offering mortgage insurance to low income beneficiaries, defining the rates at which the insurers provide mortgage insurance to the GSF mortgages. The quotes include both upfront and annual fees for mortgage insurance with different levels of coverage. The GSF's Board discussed those offers on April 23, 2013; and approved the use of this mortgage insurance product as documented in the GSF Board Decree no. 5/69 of 2013.

Condition 2: Further development of an effective and efficient mortgage finance subsidy mechanism through taking into account the results of the first impact evaluation.

21. **The condition has been met.** The parameters of the Program are continuously being adjusted given changing macroeconomic conditions, changes in incomes, prices, and interest rates, and the need to lower down-payment amounts, as well as changes in the legal and policy framework. Long-awaited amendments to the Real Estate Finance Law 148 of 2001 have been ratified in April 2014.

Condition 3: Improvement of the institutional framework to enhance transparency and targeting of housing subsidies through expansion of the housing market information database, by inclusion of a house price list by sector in main urban areas.

22. **The condition has been met.** A key measure of this operation is to expand housing market information databases, including a house price list by sector in main urban areas. The Housing and Development Bank has developed the first House Price Index (HPI) in Egypt. This leads to the improvement of the institutional framework to enhance transparency and targeting of subsidies. Developments related to the HPI include proposed contribution of data on urban indicators, including housing stock data needed for statistical weighting of HPIs, by the General Organization for Physical Planning (GOPP) within the Ministry; as well as the computation of data from the private sector.

23. There are no outstanding audits or accountability issues.

IV. Conclusion

24. In view of satisfactory implementation of the Program supported by the loan, including compliance with the third tranche release conditions as described in Schedule I, Section I, Part C of the Loan Agreement, as well as maintenance of a satisfactory macroeconomic policy framework, the Bank has informed the Borrower of the availability of the third tranche in the amount of US\$100 million equivalent.