

AN INVESTIGATION OF SELF-SUSTAINING FINANCE SYSTEMS FOR PROPERTY DEVELOPMENT IN NORTH CYPRUS

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Since the outcome of the Annan Plan 2001 for the resolution of the Cyprus Issue and accession of the island to the European Union in May 2004, there is a potential growth of the real estate market due to ever increasing of private housing demand. The successful development of efficient and stable mortgage finance systems is now of global importance. Thus creation of self-sustaining finance systems to meet the need for affordable finance of the people when purchasing, building or improving their dwelling units has been an important component of national and local policies for the achievement of the goal of shelter for all. The main objective of this research is to analyze the real estate development activities, the structure and performance of the private sector housing market and investigate self-sustaining finance systems for property development in North Cyprus. A questionnaire survey, which was administered to the construction organizations and real estate agencies in the industry, has been used in conducting the survey. By analyzing development potentials and prospects of the market toward the long-term sustainable development, the paper also indicates the opportunities for foreigners in the areas of real estate financial services and building technology. The research concludes with an indication of the future challenges to the housing market in North Cyprus.

Keywords: self-sustaining, mortgage financing, property development, North Cyprus.

INTRODUCTION

Creation of self-sustaining finance systems to meet the need for affordable finance of the people when purchasing, building or improving their dwelling units has been an important component of national and local policies for the achievement of the goal of shelter for all. Under stable economic conditions with low levels of inflation and interest rates, housing finance systems work well, and although much variation is observed between countries, middle and higher income groups use most of the mortgage credits. In inflationary economies, particularly in developing countries, affordable housing credit is difficult to obtain even for middle and upper-income groups. Many developing countries have therefore set up public sector housing finance institutions. These usually provide loans at interest rates below the market or even the inflation rate, using funds from budget allocations and captive savings in the public sector, such as reserves of insurance institutions and pension funds. The contribution of mortgage credits to housing acquisition in developing countries is

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much smaller than in industrialized ones, as households in the former rely predominantly on their own savings often supplemented by informal loans from friends and relatives. There are two kinds of factors limiting the broader use of mortgages in developing countries. The first is the regulatory process of registering and transferring the mortgages, which often has a local law component. The second is the development of the credit assessment skills and capital market access that lenders require to do profitable mortgage lending. Mortgage financing in the transition economies often lacks many of the characteristics found in more developed markets (sound long-term capital market, effective legislative base, and sophisticated method of assessing real estate). The problems which are more general to all transition economies: i) Imperfection of legislative base ii) Presence of contradiction in laws iii) Instability of the financial markets iv) Backwardness of long-term crediting v) Presence of high risk for participants of the mortgage market vi) A low degree of purchasing capacity of the population and vii) High interest rates.

Evidence currently indicates that a dominant proportion of housing in developing countries is accounted for by informal non-institutional sources but it has been increasingly strongly argued that development of a formal institutional housing finance system is indispensable for effectively addressing the quantitative and qualitative housing inadequacy problem (Okpala, 1994). The provision of housing finance in developing countries is often problematic because of volatile macroeconomic environments and the lack of legal, technological, and regulatory frameworks to support collateralized lending (Lea and Bernstein, 1996). From a policy point of view expanding the use of housing mortgages in developing countries would provide additional credit to residents and may increase real estate related and other business activity as well. For bankers it is obviously a way to invest, earn fees and build traditional banking relationships. Mortgage financing is of course much more common in developed countries, partly because of government policies, including tax incentives that have encouraged their use (Mintz, 2003). A barrier to improving and developing a solid financial market infrastructure and indirectly to the development of housing finance can be the presence of an oligopolistic and politically influential traditional banking industry that is rent seeking and may successfully lobby the government to limit the entry of new financial intermediaries in order to protect high margins. In such environments of rationed finance, established preferred borrowers may also lobby to protect their relationships with these banks (Rajan and Zingales, 2003 and Bossone et al., 2003). The lack of financial services in developing countries has a significant negative impact on the efficiency of urban investments, of which housing constitutes probably, form about 60 percent if the experience of advanced economies is any guide. Comparative financial development studies in developing economies have made important advances in the last decade, especially regarding the positive causal impact of financial development on economic growth (Renaud, 2004). Many plans to develop mortgage securities markets in emerging economies face serious pricing issues in terms of interest rate levels and volatility, which negative consequences for the price of the retail mortgage loans to be funded by these securities. However, a given emerging economy can greatly improve its position on the global financial markets over time through its demonstrated ability for sustained macroeconomic management and effective control of inflation. In today's competitive market Mortgage Banks need to continually strive to improve margins but high transaction and processing costs are undermining these efforts. The standardisation of loan

applications, credit policy, property valuation and loan underwriting is fundamental to lowering these costs. Moreover, if a regional approach to mortgage intermediation is adopted, primary market standardisation becomes paramount, and additional challenges may include managing currency risk and integrating monetary policy (Ondruskova, 2005).

The Case: Overview of the Property Sector in North Cyprus

There's a wide variety of property for sale in Northern Cyprus and many think that it's just a matter of time until the market erupts. Foreigners buying property in the North are still outnumbered by those buying in the South, but low prices and lack of development in the region have begun attracting investment. The potential for growth is massive and Cyprus' accession to the European Union on May 1st 2004 will undoubtedly further stimulate interest. The traditional focus for home-buyers has been Kyrenia and the surrounding coastal villages, but now people are beginning to look further a field. Much of the property for sale in Northern Cyprus is antiquated and it's easy to find an old-world apartment oozing Ottoman charm or an isolated mountain hide-away in need of restoration. Construction work is feverishly trying to match the anticipated housing boom, adding new developments to North Cyprus' impressive property portfolio. Many investors are interested in the possibility of using rental income to offset their mortgage payments. At present North Cyprus tourist trade seems to favour all-inclusive package visitors (rather than independent self-caterers), although how this will pan out in the future is anyone's guess. Northern Cyprus property prices are currently about half that of the South, but this may not last as this unspoilt corner of the Mediterranean is finally beginning to attract the attention of British investors. In the past the Turkish Republic of Northern Cyprus's position as a pariah state has kept both tourists and potential home-buyers away, but the accession of the island to the European Union May 1st 2004 looks likely to open the region up. In the last five years two thousand foreigners have bought property in Northern Cyprus, and while this is a fraction of sales in the South; demand looks set to soar. There are a number of different types of title deed in the TRNC and it's important to know which category the customers' potential purchase falls into. Freehold properties are classified as either Foreign or Turkish Title and can be bought with few complications (after approval from the Council of Ministers). Things generally get more complicated with Leasehold Titles previously owned by Greek-Cypriots as additional rubberstamps are needed from the Ministry of Tourism. Once an offer is being accepted, a contract agreeing the price, timescale and any special conditions are needed to be driven up. Then it's a matter of paying a deposit and applying for a purchase permit from the appropriate authority (either the Council of Ministers of the Ministry of Tourism). Then it's simply a matter of settling the remaining balance, transferring the title deeds and moving in. Theoretically this process should take three to six months.

The main objective of this research is to analyze the real estate development activities, the structure and performance of the private sector housing market and investigate self-sustaining finance systems for property development in North Cyprus. The primary objectives of this study are to a) Identify the various factors affecting the performance of real estate developers and design-build contractors, b) Analyze development potentials and prospects of the market toward the long-term sustainable development, c) Assess the existence and severity of barriers to implement efficient and stable mortgage financing system and d) Propose solutions for

overcoming common barriers and establishing a well-built mortgage financing system in housing market.

RESEACH METHOD

To meet the objectives of the study, a meeting was organized by the EUL Civil Engineering Department Research Group and representatives from all sub-sectors of the North Cyprus construction industry, related institutions, chambers, miscellaneous firms etc. were invited to discuss the housing market, mortgage financing and real estate development activities under changing economic conditions. Then the empirical data was collected through structured interviews within the main large private sector construction organizations. Sixty key people from Senior managers, IT Managers and Quantity Surveyors of sixty real estate investment companies and building contractors were conducted during the interviews. The outcomes from the meeting and interviews constitute the basis of the main structure of the questionnaire. The paper deals with the results of a survey conducted by research members on self-sustaining finance systems for property development in North Cyprus. Main topics in the questionnaire were as follows:

- i. General information about organizations
 - General functions of service areas
 - Size of organizations
 - Work capacity
 - Firms' turnover
 - Work force information
 - Human resources development & motivation
 - Target group of customers
- ii. Overview of the Housing Finance: Self-sustaining Finance System
 - General Outlook
 - The Overall of the Property sector and Housing Finance
- iii. Required Legal Changes for the Self-sustaining Finance System
 - Encouragement about Taxes
 - Referring to Court of Bailiff & Bankruptcy
 - Saving the Customers/consumers Rights
 - Financial Leasing
 - Regulations for Mortgage Financing and Loan Management
 - Regulations for Evaluation of Real Estate Properties
 - Regulations for Banking System
 - Establishment of Housing Finance Corporation
- iv. Applicability and Sustainability of the Mortgage System
 - Factors affecting the self-sustaining finance system life-cycle

Literature Review

This stage involves a thorough review of literature about the real estate development activities, the structure and the performance of the private sector housing market and investigation of self-sustaining finance systems for property development in North Cyprus considering the changing economic conditions. The intensive literature review resulted in the identification of 34 variables classified under 9 categories affecting the performances of the real estate developers and design-build contractors during the processes of *Project Development, Feasibility, Design, Close-out, Operation, re-mortgage* in self-sustaining finance system life-cycle. These categories are as follows:

1. Physical and financial characteristics of the real estate property
2. Customers' creditability, affordability, satisfaction, demands and reliability
3. Real estate financial corporation approaches and reliability
4. Financial criteria of mortgage financing
5. Economical conditions and global competitiveness
6. Housing demand and sustainability of market
7. Required legal changes during transition process of the Self-sustaining Finance system
8. Applicability and sustainability of the mortgage system
9. Benefits, challenges and opportunities of the system

Data Collection

The second stage involved the collection of data. A questionnaire, which was administered to almost all the firms registered to the Association of Building Contractors and Association of Real Estate Investment Companies has been used in conducting the survey. The survey includes four main types of information involving *Organizational structure, Overview of the Housing Finance: Self-sustaining Finance System, Required Legal Changes for the Success of the Self-sustaining Finance System* and *Applicability and Sustainability of the Self-sustaining Finance System*.

1. **Organizational structure:** General company characteristics were sought which include the general functions of service areas of the organizations, size of the organizations involving the production, firms' turnover, number of permanent employees, human resources and development and target group of customers.
2. **Overview of the Housing Finance: Self-sustaining finance system System:** This portion of the questionnaire was used to have a general outlook of the property sector and housing finance considering the global competitiveness and changing economic conditions.
3. **Required Legal Changes for the Success of the Self-sustaining Finance System:** This portion of the questionnaire was used to analyze the encouragement provided to the users of housing credit, corporation of housing finance, Law of bankruptcy and legal action for collection of a debt, opportunities for credits with varying interest rates, saving the customers' rights law, financial leasing method inclusion to the system, regulation of

Public Finance and Loan Management, regulations about valuation of real estate properties and Banking regulations.

4. Applicability and Sustainability of the Mortgage System: Factors affecting the self-sustaining finance system life-cycle were analyzed. 34 factors categorised under 9 headings were analyzed in terms of level of importance they have on the processes of *Project Development, Feasibility, Design, Construction, Handover, Operation* and *Re-mortgage*.

The questionnaire was designed using a nominal scale for the real values of the independent variables. In evaluating the dependent variables, a scale of 4 intervals (with a '0' value given to no effect, '2' to a middle value, and '4' given to maximum effect). The respondents were asked to check a number on the scale, which reflects their assessment regarding the different factors. A list of all contractor organizations and Real Estate Investment Companies within the construction sector was obtained from the Association of Building Contractors Association of Real Estate Investment Companies. The list consisted of a total of 70 organizations. An attempt was made to contact every single organization. During the survey 60 organizations were contacted and 40 (66%) of these questionnaires were evaluated. Contact personnel in the companies for the questionnaire survey were either the top management or senior management in their respective departments, therefore their level of knowledge expected to provide responses was acceptable for the purpose of validity of the survey results.

FINDINGS

This section of the study discusses the analysis of the real estate development activities, the structure and performance of the private sector housing market and investigation of self-sustaining finance systems for property development in North Cyprus.

Determination of Importance Indices

The participating contractors provided numerical scoring expressing their opinions on the significance of each variable and process in determining the impact of the

MEAN IMP INDEX	RANK	Process	IMPORTANT INDEX VALUES						
			Project Development	Feasibility	Design	Construction	Handover	Operation	Re-mortgage
11.400	5	Physical and financial aspects of the Real Estate Property	28.50	28.50	57.00	42.75	42.75	14.25	14.25
13.538	2	Customer's creditability, affordability, satisfaction, demands and reliability	42.75	28.50	57.00	42.75	42.75	28.50	28.50
10.688	6	Real Estate Financial Corporation approaches and reliability	28.50	28.50	42.75	57.00	28.50	14.25	14.25
12.113	4	Financial criteria of Mortgage Financing	14.25	28.50	57.00	42.75	42.75	28.50	28.50
12.825	3	Economical conditions and global competitiveness	42.75	57.00	42.75	42.75	28.50	14.25	28.50
14.250	1	Housing demand and sustainability of the housing market	57.00	42.75	42.75	42.75	42.75	28.50	28.50
6.413	8	Required legal changes during the transition process of the self-sustaining finance system	14.25	14.25	28.50	14.25	28.50	14.25	14.25
6.413	7	Applicability and sustainability of the self-sustaining finance system	14.25	14.25	28.50	28.50	14.25	14.25	14.25
6.413	9	Benefits, future challenges and opportunities of the system	14.25	28.50	14.25	28.50	14.25	14.25	14.25
		RANK	5	4	1	2	3	7	6

Table 1. Matrix showing the variations in the level of Importance Indices of the variables

scheme on real estate development activities and mortgage financing in housing market under changing economic conditions.

The weighted average for each factor was calculated and then it was divided by the upper scale of the measurements in what is referred to as “importance index” therefore the level of importance of the twenty factors of the nine performance indicators were calculated

using the formula (Kish, 1965):

$$\text{Level of Importance (Index)} = [\Sigma(aX) \times 100] / 4$$

a= the score given to the factor by each organization (varying from 0-4)

X= n/N

n= Frequency of organizations

N= Total number of participant organizations

Table 1. shows a matrix of variations in level of importance indices of the variables and processes during real estate development activities and mortgage financing under changing economic conditions. The X-axis of the matrix indicates the processes in the self-sustaining finance system life-cycle. The 34 variables classified under 9 categories believed to have influences on real estate development activities and mortgage financing processes were listed in the Y-axis of the matrix with their index values. The matrix also includes the rank orders of all the phases of the process listed at the bottom of X-axis with their index values. Studying the matrix the first three variables carrying the highest level of importance are; *Housing demand and sustainability of the housing market*, *Customers' creditability, affordability, satisfaction, demands and reliability* and *Economical conditions and global competitiveness*. In observing the three highest ranked phases of the processes, it can be noted that all these phases carry almost similar level of importance. These are; *Design*, *Construction* and *Handover*. Overall, the factors have the highest importance indices in the phase “Design”. The factors carry the lowest level of importance indices in the phase “Operation”. The Level of Importance Indices for the variable “Housing demand and sustainability of the housing market” is shown in Figure 1.

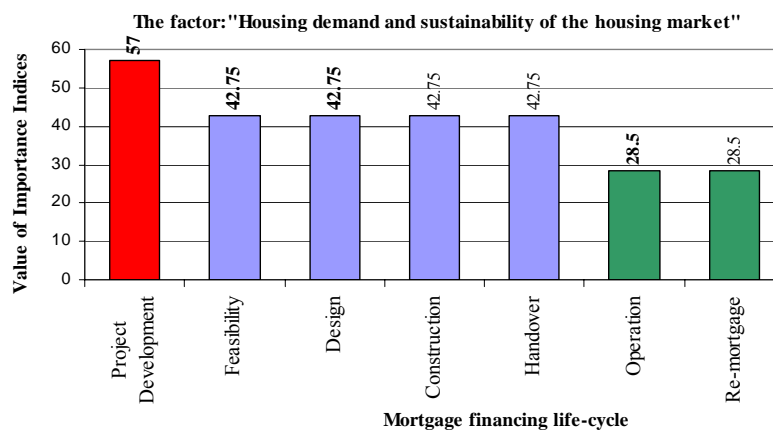


Figure 1. Level of Importance Indices for the variable “Housing demand and sustainability of the housing market”

Discussion of the Survey

Both the structured interviews conducted to senior management in their respective departments and as well as the construction site observations conducted by research members during the survey study were relied on for the purpose of validity of the survey results.

The factor “Housing demand and sustainability of the housing market” is ranked #1 and is perceived by respondents to have an influence on the phase “Project development” with a value of importance index 57. “Feasibility”, “Design”, “Construction” and “Handover” are the phases which have the second highest value of importance index 42.75. The interviews and observations highlighted that social, political and economic shifts in recent years have brought about some changes within the housing market and the dynamic of the market itself reflects the changes in the demand for housing – in overall numbers, in tenure, in type and in location. The real estate developers and contractors (design-build-sell) actively taking part in the housing market are trying to meet the housing needs of both local and foreign people. In fulfilling this role, they are tasked with a more strategic, long-term view of housing demand and sustainability of the housing market during the implementation phases of project development, feasibility, design, construction and handover.

The factor “Customers’ creditability, affordability, satisfaction, demands and reliability” is ranked #2 and is perceived by respondents to have an influence on the phase “Design” with a value of importance index 57. “Project development”, “Construction” and “Handover” are the phases which have the second highest value of importance index 42.75. The interviews and observations highlighted that the initial ability to purchase a property and the ability to sustain mortgage can be defined in terms of customers’ creditability, affordability, satisfaction demands and reliability. Depending on the significant costs associated with house buying, these factors can reflect the financial commitment of the customers. Thus the developers have to arrange the prices, interest rate loans and monthly instalments according to the customers’ profiles (income level, satisfaction etc) during the implementation phases of design, project development, construction and handover.

The factor “Economical conditions and global competitiveness” is ranked #3 and is perceived by respondents to have an influence on the phase “Feasibility” with a value of importance index 57. “Project development”, “Design” and “Construction” are the phases which have the second highest value of importance index 42.75. The interviews and observations highlighted that the real estate sector has been a major source of strength for the global economy since the most recent boom in construction sector in terms of production. The movement of the real estate prices upwards and its interaction with the financial sector and the macro-economy is an indication of an increase in global competitiveness in property sector. This issue has been sensitively taken into consideration by the property developers during the implementation phases of feasibility, project development, design and construction.

CONCLUSIONS

This paper commences on the analysis of the real estate development activities, the structure and performance of the private sector housing market and investigation of self-sustaining finance systems for property development in North Cyprus and the opportunities for foreigners in the areas of real estate financial services and building technology.

The opportunities of self-sustaining finance systems for property development in North Cyprus considering the changing economic conditions were identified based on the analysis of the variables. It was found that the factors “Housing demand and sustainability of the housing market”, “Customers’ creditability, affordability, satisfaction, demands and reliability” and “Economical conditions and global competitiveness” hold the highest level of importance. From the processes of the self-sustaining finance system life-cycle point of view, “Design”, “Construction” and “Handover” are the three phases which the interviewees believed would highly be influenced by the variables mentioned above.

It is clear from the findings that the relationship between housing prices and household incomes, regulatory and legal frameworks concerning mortgage credits, the degree of competition between lenders, and government policies to support home ownership and encourage foreign investors are the major factors that affect the real estate development activities in North Cyprus. Successful functioning of the self-sustaining finance system requires a confluence of three factors: the level of income of social strata, the market value of real estate that is affordable to this category of people, and availability of financial resources within the economy at affordable rates and terms of maturity.

Despite the uncertainty over the legal status of the lands holding some buyers back, North Cyprus remains a popular tourist destination for millions of British holidaymakers every year and lots of British people have already bought their property and started living in the island. Buying property in Northern Cyprus is a relatively straightforward process and there's the additional incentive of being allowed to live on the island for a large part of the year without being taxed which makes North Cyprus ideal for second homeowners. The popularity of the region means that: despite the fact that new properties are constantly being built, prices continue to rise. While property could still be considered cheap by UK standards, it is no longer the bargain of yesteryear.

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