



Home mortgages open doors for investors

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Turkey's new housing finance system has opened up many new opportunities for investment in the country. By Deniz Pekin and Selin Özbek of Özbek

For decades, real estate has been one of the traditional investments for Turkish individuals and corporations. Investors either financed investment themselves or borrowed from relatives to purchase property. Historically, only 3% of real estate investment was financed through finance institutions. High interest rates and a lack of long-term loan options from banks led investors, as well as developers and constructors, to create innovative financing options, such as leasing, building rights, construction in exchange for flats, promises to sell, instalment property contracts and joint ventures.

New housing finance system

The stabilization of the political environment and the economy in Turkey has allowed the introduction of a long-awaited housing finance system. Law 5582 was formulated as a compilation of amendments to various codes and finally entered into effect in March 2007.

The Law introduced a mortgage loan system for housing finance.

Mortgages

Under Turkish Law, a mortgage can only be established by an official transaction before the land registry. The *lex commissoria* prohibition, which only allows the mortgagee to enforce its security interest by using appropriate foreclosure procedures, applies to Turkish mortgages.

Mortgages have been commonly used in Turkey since the mid-1920s to secure repayment of debts, but the long foreclosure periods (up to three years) and transaction costs have been notable drawbacks to this collateral.

Capital markets

The Capital Markets Board (the CMB) led the legislative efforts for the Law. So the skeleton of the housing finance system and its institutions have been defined under the capital markets legislation (the CML), as amended, and the CMB has been authorized to issue necessary secondary legislation.

The Law enables securitization of mortgages and introduces mortgage-covered and mortgage-backed securities, housing finance institutions (HFIs), which will act as originators in mortgage-backed securitizations for housing finance, mortgage finance institutions (MFIs), and housing finance funds.

Under the Law, mortgage-covered securities are defined as debt securities that are general obligations of the issuers and issued under security of the assets in the cover pools. Mortgage-covered securities can be issued by banks and MFIs.

MFIs, which are structured as secondary market institutions in the form of joint stock corporations subject to the CML, will be established solely to take over and assign receivables arising from housing finance, to manage assets composed of the receivables taken over and to provide liquidity facility to primary lenders.

Issuers must register the collateralized assets that are given as security for the mortgage-covered securities in a pool separate from their other assets. The pool may only consist of receivables secured by mortgages on houses and other

immovables holding occupancy licences, substitute assets (for example, cash, domestic public debt instruments) and agreements executed for the protection of these assets against risks. Each of receivables collateralized by mortgages on other immovables holding licence and substitute assets may not be higher than 15% of the pool.

Mortgage-backed securities are introduced within the concept of housing finance funds, which are defined as assets established on behalf of the mortgage-backed securities holders with the principle of beneficial ownership, by means of money collected in return for mortgage-backed securities. Asset-backed securities that were regulated under the CML are re-structured.

The Law requires that the assignment of the loan collateralized by mortgages or receivables arising from financial leasing contracts to the fund portfolio be registered with the annotations column of the relevant land registry.

Under the Law, asset-covered securities are defined as securities that are general obligations of the issuer and issued under the security of the receivables and fixed assets. The details for the asset pools will be further regulated by the CMB.

Until the mortgage-covered securities or asset-covered securities are redeemed, the assets in the pool cannot be disposed of for purposes other than security. They cannot be pledged, used as collateral, attached even with regard to the collection of public receivables, included in a bankruptcy estate or subject to preliminary injunctions.

Most of the Law's novelties will apply to financing properties that are completed or under construction, financial leasing and extension of home equity loans. However, under the Law, pools for mortgage securities can only consist of properties with occupancy licences. About 50% of the properties in Turkey are unlicensed, so there might be a shortage in eligible property for mortgage securities.

Foreclosure in housing finance

The Law increased the penalty applicable to the debtors who unlawfully request cancellation of public auctions arising from property foreclosures, from 10% to 20% of the auction price. The deposit amount required to appeal a decision of the court rejecting the request for postponement/suspension of the foreclosure proceeding has been increased from 15% to 30% of the receivable amount.

According to the Execution and Bankruptcy Code, if a receivable is secured by a mortgage, its mortgagee must first apply for the foreclosure of the mortgage. The Law introduces an exception that grants the right to apply for attachment proceeding as an alternative.

With regard to the collection of receivables, it is stipulated that the appraisal of the real estate should be made by appraisers authorized by CMB. If the debtor requests a second expert examination, the court should appoint the experts from authorized appraisers. Currently, Turkey only has 14 approved appraisal companies. The number is expected to increase as individual appraisers are added to the list.

The courts and execution offices will play an important role for due implementation of these novelties in practice.

Consumer rights

Liability for defective goods is limited only to the loan amount granted and the liability period is decreased from five years to one year after the delivery date. The liability for the default in delivery is limited to the extended loan amount. The Law also includes HFIs as being severally liable for defective goods or default in delivery of goods or services. Under the Law, if the loan is assigned to a third party, the lender HFI (not the assignee) will continue to be severally liable.

Under the Law, if the lender reserves its acceleration right, this right can only be exercised if the HFI duly fulfils all its obligations and the consumer defaults on at least two consecutive instalment payments. The HFI may only use this right if the borrower defaults despite the one-month grace period.

HFIs will be free to offer loans and financial leases with adjustable or hybrid interest rates in addition to fixed rate loans. Adjustable interest rates will be subject to a cap stated in the loan agreement and adjusted according to an accepted index. For fixed interest loans, it will be possible to agree on an early payment fee, which cannot exceed 2% of the amount paid early.

Tax benefits

One of the drawbacks of the Law is the lack of income tax exemption, which was highly supported by the CMB to prevent securitization transactions moving overseas. Once the system is well organized, however, this might change and certain exemptions might be granted.

The Law has decreased the transactional costs for housing mortgages by granting exemptions, such as levies for the establishment of mortgages and transfers of financial leases, VAT, and stamp duty.

Other financing options

Other financing options have started to play an important role in real estate finance, due in part to the scarcity of property for large development projects in metropolitan cities. In general, these concepts are used in combination with other financing devices.

Leases

Ground leases and acquisition leases have commonly been used in Turkish real estate practice for decades. Turkish law permits long-term leases without imposing time limitations, and allows the lessee to claim its leasehold right against third parties, if the relevant lease contract was registered with the land registry before the acquisition of the claimed interest by the third party.

The relationship between the lessee and lesser is extensively regulated in the Turkish Code of Obligations and Law 6570, which governs lease of real property within the boundaries of a municipality, harbour and station. Lease contracts can be freely structured subject to mandatory rules of Turkish law, which generally imposes provisions favourable to the lessee. A notable limitation imposed on the lessee is prohibition against subleasing the real property, unless otherwise stipulated.

Parallel to development in shopping centre business, space leases have started to play a big role in financing. Developers obtain space lease commitments to finance the project from a number of substantial tenants before construction begins. In recent shopping centre transactions in Turkey, the investors enjoyed high profit margins as a result of their success in commercial space leases.

The sale and leaseback structure has started to be used in business finance. These schemes are generally permitted under Turkish law, and complex variations may be formulated to develop attractive opportunities.

The general non-transferable nature of lease contracts prevented the development of a leasehold mortgage concept in Turkey. But, if needed, a leasehold mortgage may be established under Turkish law, if the lease contract is transferable and the mortgagee accepts a leasehold as security.

Building rights

In recent years, building rights have been commonly used for commercial property and shopping centre developments. A building right is a concept regulated as a servitude right established in the name and favour of a real or legal person, which entitles the rightholder to construct on or under the land of another person or maintain an existing construction on the land of that person.

Building rights that are structured in an independent and continuous nature may be registered with the land registry as a separate real property and pledged as collateral. The building right may be deemed as a continuous right only when it is established for a minimum term of 30 years. If the transferable and independent nature of the building right is somehow contractually limited, the right can only be registered as a servitude right and cannot be pledged.

Usufruct right

A usufruct right gives its holder the right to use land, and manage and benefit from its income, just as the owner. The term can be maximum of 100 years for entities and a lifetime for individuals. The right is established by registration with the land registry. In practice, usufructors pay an annual or monthly fee to the landowner and invest in the land using alternative financing structures.

Promise to sell

Promises to sell (PtoS) are binding pre-agreements granting an option to purchase/sale of real property in consideration for an agreed price. The concept is popular both for residential and commercial property development.

The PtoS should be executed in official form before a notary public. The right can be registered with the land registry for a limited time of five years.

Either party may request specific performance of the PtoS through the courts if the other party defaults in its obligations.

PtoS contracts also provide strong protection to foreigners who wish to purchase real property in Turkey and need to wait for the approval of Turkish authorities before closing.

Construction in exchange for flats

This hybrid scheme has been widely used in housing and commercial developments. The landowner's contractual obligation is to transfer a certain portion of the land, over which the contractor will construct and share the ownership of independent units with the landowner, according to the construction agreement. These contracts should be executed in official form before the notary public.

Instalment property contracts

Due to the lack of affordable long-term loan facilities for property finance in the past, instalment contracts were widely used in the market, enabling the purchaser to pay the purchase price in instalments over a number of years (in most cases subject to a down payment). The concept has been adopted both for the needs of developers and end-user purchasers, mostly to develop residential property. By entering into this type of arrangement, parties avoided the involvement of a financial institution or bank.

In instalment contracts, the purchaser may either acquire the title to the property upon signing, or at completion of the instalment payments. Customarily, instalments paid by end-user purchasers were used as construction loans by the developers, who could then market their projects before construction commenced.

PPPs and urban regeneration

Public-private partnerships (PPPs) have become established as a proven procurement method for financing and delivering public infrastructure projects. However, due to the scarcity of available property for development and for urban regeneration needs, the number of PPP projects is expected to increase in housing as well.

Municipalities and the Housing Development Administration (Toki) are leading the PPP projects and urban regeneration efforts.

Toki was originally formed to produce more and better housing for low- and moderate-income families. In 2004, Toki was also authorized to develop land for projects, to expropriate property for investments, and to extend loans to housing and infrastructure developers. Due to unplanned urbanization and the earthquake risk in Turkey, urban regeneration has entered onto the agendas of municipalities and Toki, opening the door for great opportunities. Istanbul is top of the list, and the necessary legal framework to allow this transformation and transfer of development rights is being prepared.

Toki has been even more active in housing development in the last few years and has been also included within the scope of the Law. Consequently, the foreclosure of Toki's pledged receivables will enjoy expedited foreclosure procedures, and it will be possible to finance Toki loans in the secondary markets.

Outlook bright

Although no immediate changes are expected in the market conditions, in the medium term the novelties introduced by the Law are expected to decrease interest rates, to help introduction of more sophisticated products or services in insurance, project and risk management, and brokerage services, to expedite the institutionalization of the market, and to increase the number of foreign investments.

If the political and economical environment remains stable, a more active secondary market and increasing number of securitization transactions will make the Turkey more attractive to investors. Innovative projects involving hybrid methods

will help Turkish players to be leaders in the increasing competition.

Author biographies



Özbek

Özbek is a well-established law firm, founded in 1972. The firm offers a full range of boutique legal services to international and domestic clients, with a special focus on real estate and construction law, commercial transactions, contracts, corporations, civil law, administrative law, mergers and acquisitions, and dispute resolution.

The firm has four partners and seven associates, who are supported by experienced paralegals and staff.

Özbek maintains close ties with lawyers, law firms or professionals specialized in all areas of law in Turkey or abroad and has connections with law firms in central Europe, the US and Latin America. Özbek attorneys closely work with academics and legal experts as outside counsel.



Deniz Pekin

Deniz Pekin, a partner at Özbek, is admitted to the Istanbul Bar Association. She graduated from Istanbul University School of Law and holds an LLM degree from Tulane Law School. She worked as in-house legal counsel of one of the first real estate development companies in Turkey. After working as a senior associate in reputable law firms engaging in international law practice, she joined Özbek as partner. She is specialized in the fields of real estate, mergers and acquisitions, competition, privatization, and arbitration.



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Selin Özbek, a partner at Özbek, is admitted to the Istanbul Bar Association. She graduated from Istanbul University School of Law and holds an LLM degree from University of Pennsylvania Law School. Before joining Özbek, she worked as a senior associate in a reputable law firm and specialized in mergers and acquisitions, banking and finance, capital markets and corporate.