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CHANGES IN THE PRACTICE OF TAKING REAL ESTATE SECURITY IN THE KINGDOM OF SAUDI ARABIA

Following the circular from the Saudi Arabian Monetary Authority (SAMA) issued in May 2017[1] (2017 Circular) directing banks and finance companies to perfect their real estate security under the Real Estate Mortgage Law[2] (REML), SAMA has issued a further circular in March 2018[3] (2018 Circular) clarifying the process of taking and perfecting real estate security in Saudi Arabia. What are the key requirements and what do they mean for the banks/finance companies?

Key issues

- From Ifragh to Mortgage
- Mortgage Registration Requirements
- Key Questions for Financiers to Consider
- Key Implications under REML

FROM IFRAGH TO MORTGAGE

Over the years, *ifragh* (security by taking outright conveyance of the real estate title) has been the method of choice for perfecting mortgages since it was considered to be the most practical and secure method in the circumstances.

Even though REML was issued back in July 2012, for various reasons banks and finance companies (Financiers) did not fully adopt the practice of perfecting mortgages under REML and instead continued to follow the *ifragh* method. The 2017 Circular now requires Financiers to perfect their future mortgage by registration under REML rather than by *ifragh*, and gives Financiers three years from the date of the circular to convert all their existing *ifraghs* to registered mortgages.

We understand from some of the Saudi banks that SAMA has clarified that this requirement does not apply where the real estate is owned by the bank or its subsidiary as part of an *ijara* financing. This clarification has resulted in a number of banks converting to/opting for an *ijara* structure in their existing and new financings.

Pursuant to the 2017 Circular, a Financier is required to appear before the relevant notary, who will transfer the title of the real estate back to the mortgagor and simultaneously register a mortgage in favour of the Financier. This transfer of title and registration of mortgage will be effected as a single transaction without any gaps to address the concern of the banks about the real estate security becoming ineffective while the debt is still outstanding.

[1] Circular number 93810000089828 and dated 26/08/1438H (corresponding to 22 May 2017).
[2] Issued by Royal Decree No. M/49 dated 13/08/1433H (corresponding to 3 July 2012).
[3] Circular number 391000070455 dated 19/06/1439H (corresponding to 7 March 2018).

MORTGAGE REGISTRATION REQUIREMENTS

The initial feedback was that the process was somewhat unclear and that there was little in the way of consistency in the documents required by various notaries and the information submitted by various Financiers. To clarify the process, SAMA issued the 2018 Circular attaching with it a circular[4] issued by the Ministry of Justice (MoJ Circular) to all courts and notaries. The MoJ Circular sets out a list of documents that Financiers are required to produce to the notary to convert *ifragh* to a registered mortgage or to register a new mortgage. The key requirements to note in the MoJ Circular are:

- ***Need for SAMA licence***: A mortgage under REML may only be registered in favour of an entity holding a valid licence from SAMA permitting it to practise real estate financing. A notary we spoke to informally about this requirement confirmed that he would need to see a copy of the SAMA licence for real estate before he would register the mortgage.
- ***Shari'ah compliance***: A Financier must provide evidence that the financing contract signed between itself and the mortgagor is consistent with *Shari'ah* principles. Such evidence shall be in the form of a letter from the *Shari'ah* committee approving the financing product captured in the financing contract (this approval should relate to the product generally and not the financing contract specifically).

KEY QUESTIONS FOR FINANCIERS TO CONSIDER

These key requirements raise some important points/questions to which clear answers are not yet available. For example:

- the requirement that the mortgagee entity must be licensed by SAMA to undertake real estate financing means that a Financier may not use a wholly owned SPV to be the mortgagee (as Saudi banks have historically used for taking *ifraghs*). More importantly, it is not clear how this requirement will affect a Financier that is not licensed to undertake real estate finance activity but wishes to secure its general financing with a mortgage over real estate. Will it be allowed to register a mortgage under REML without holding a real estate finance licence?
- the position of the foreign banks and the ability to appoint a local licenced security agent also remains unclear
- the MoJ Circular states that the letter from the *Shari'ah* committee must confirm that the financing is a product that has been approved by the *Shari'ah* committee (we assume that this is reference to the *Shari'ah* committee of the Financier). It is however not clear what will be the scope of the notaries' review of the financing contract and the *Shari'ah* approval. How minutely will the notaries examine the financing contract to determine whether the product documented in the contract is consistent with the product approved by the *Shari'ah* committee? It is also yet to be seen whether the notaries will require the financing contract, often a voluminous and complex document, to be translated into Arabic for their review (an expensive and time-consuming exercise)?

We expect the responses to these questions will emerge in the coming days through test cases as Financiers seek to register their mortgages.

[4] Administrative circular number 13/T/7233 dated 13/6/1439H (corresponding to 1 March 2018).

KEY IMPLICATIONS UNDER REML

Although REML has been in effect for a few years now, it has not really been applied in the market as Financiers have been taking the *ifragh* route instead. However, a brief refresher on the key points under REML would be timely:

- the provisions in REML specifically state that the mortgagee shall "have priority over other creditors in receiving his debt from the value of the sold real estate in accordance with his ranking" (subject to certain mandatorily preferred claims)
- REML allows the creation of second-ranking mortgages
- any enforcement of the perfected mortgage will be through the enforcement courts[5], which may run an auction process to obtain a fair market value of the asset (though the practice of the enforcement courts and the timelines may vary from case to case)
- enforcement would necessarily involve selling off the mortgaged property and using the sale proceeds to discharge the debt. Any provision in the mortgage agreement allowing the mortgagee to enforce by taking possession or ownership of the property would be void (though the parties may agree that the income generated from the secured property can be received/collected by the mortgagee to settle part of the secured debt)
- REML provides for a "top-up" provision whereby if the value of the mortgaged property falls below the debt due to the misuse of the mortgagor, the mortgagee has the right to call for further security to secure the outstanding debt and to accelerate if this is not provided.

A mortgage under REML would cover existing buildings on the land, and any new buildings on the land constructed after the registration of the mortgage.

CONCLUSIONS

In addition to the key questions in relation to the registration process identified above, the principal questions market participants and observers will be asking include the following:

- In practice, how quickly and reliably will courts allow enforcement of the mortgage?
- How will notaries respond to the new guidance in relation to perfecting mortgage security?

A number of these questions will be answered in test cases in the near future. In any event, the above developments are a step in the right direction both in helping Financiers licensed in Saudi Arabia to register mortgages and in helping to attain maturity in the finance market.

[5] There is some debate whether the jurisdiction over the enforcement of mortgages rests with enforcement courts (which have jurisdiction under Enforcement Law over the enforcement of any enforcement deed, which would include a notarised mortgage) or the *Shari'ah* courts (which have general jurisdiction over real estate matters).

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