The Mortgage Industry in Peru: Entering the New Millennium

by Alex Niezen

MORTGAGE INDUSTRY OVERVIEW IN THE YEAR 2000

The mortgage industry in Peru is still incipient, in the initial stage of its life cycle. It could be said that it has recently been born (or reborn) after decades of collapse when hyperinflation, terrorism, and widespread social and economic turmoil hindered development and growth. In the late 1980s and early 1990s, long-term financing was not available, and mortgage loans were mainly private, with maturities of three to five years, at extraordinarily high interest levels. At the end of 1999, the mortage stock at financial institutions was estimated at US$1.04 billion.

Peru has had more than its share of difficulties in recent years, suffering from climatic phenomenon such as "El Niño," the global financial crisis (coming first from Asia, then Russia and Brazil) which reduced the availability of credit lines and increased the perception of country-risk. However, currently with a continuity of structural (second generation) reforms, the maintenance of sound fiscal and monetary management with inflation under control, in a normal year Peru should produce around US$220million to US$250 million per year in mortgage loans for the top three economic groups, which corresponds to family incomes above US$1,150 per month (see Table 1). Longer term loans are available with terms up to 15 to 20 years.

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Table 1 Peru's Income Distribution Median Averages Estimated as of 1997 in Lima (Estimates by APOYO Consultants)

Socioeconomic Stratum	*Monthly Income Range ($US)*	*Percent of Population*
A1	2,854 +	1.25
A2	901 – 2,853	2.88
B1	778 – 900	8.63
B2	419 – 777	11.25
C1	313 – 418	15.5
C2	222 – 312	22.87
D1	179 – 221	32.0
D2	0 – 178	5.62

Through the housing program Mivivienda, the government hopes to attend the socioeconomic middle economic sectors (B2 and C1), which would cover the population segment with monthly incomes between US$330 to US$1,150. This program funds mortgage loans for real estate priced under US$29,000, up to 90% loan-to-value, for 20 years, at less-than-market interest rates, in foreign and local (adjusted for inflation) currencies. Even though the interest rates charged are 1% to 2% below market, they still are quite high, reaching 13% in U.S. dollars and 11.5% in local currency–adjusted for inflation rates.

The government has also formulated a series of legal decrees aimed at jump-starting the depressed housing and construction sectors. Such reforms include the Securities Market Law, Investment Fund and Securitization regulations, the recently-enacted Security Titles law and the Edification Regularization laws. Also, two financial instruments have been created for the purpose of developing capital market funding for housing: the mortgage bond and the endorsable mortgage credit note.[1] These instruments have been passed by the Congress and approved by the Bank Superintendency and CONASEV (equivalent to the Securities and Exchange Commission in the U.S.) and unofficially endorsed by the Ministry of Finance and Economics.

The cumulative housing deficit in Peru has been calculated at 1,500,000 units (counted as complete lack of housing and/or inadequacy of functional characteristics such as electricity, availability of water and sewage, etc.) by independent poll and consulting companies, such as APOYO CONSULTORIA, Capeco (Construction Trade Chamber), and Instituto para la Construccion y Desarrollo. This deficit increases by 100,000 units annually, reflecting urban demographic growth. Total housing construction has reached 30,000-35,000 units per year, including the informal "self-construction" characteristic of the shanty towns at the lowest quality levels, with no technical monitoring or control. Such uneconomic construction produces inefficient and unplanned city growth, creating inadequate and even dangerous living conditions.

The condition of the housing market in Peru illustrates the potential for growth at the highest, middle and low end of the markets. The demand grows exponentially, but the offer of construction products and its financing has been absent from the market in the past 20 years. This situation needs to be reversed to assure the opportunity for Peruvians to own a suitable and worthy house.

Products/Services Offered

Mortgage lenders (banks and finance companies) in Peru today offer retail real estate loans for the A and B socio-economic segments of the economy. They also fund real estate construction loans and bridge loans for housing projects, which can be subrogated into the individual retail loans once the housing projects are completed and the purchase and title transfer takes place.

The Mivivienda government scheme is being offered for the B2 and C socioeconomic segments, which could not get real state finance from the conventional market before this government effort. Mivivienda is a governmental fund made up of mandatory payroll accounts from the extinguished FONAVI, or National Housing Fund. This mandatory tax has been reduced to 5% of payroll with a ceiling, and has changed its name to Extraordinary Solidarity Tax, and is due to be eliminated by the end of year 2000.

The Mivivienda program attempts to close the housing gap by providing to qualified financial institutions the funds for new real estate purchases priced below US$29,000, within certain guidelines. The requirements include not being a real estate owner, having contributed to the FONAVI (National Housing Fund) mandatory payroll tax for 36 consecutive or 60 non-consecutive months, and being credit-worthy. These funds have a cost of 8% in U.S. dollars or 6.5% in local, inflation-adjusted currency.

Since the fund´s inception in July 1998 it has only funded about 250 loans (as of May 2000), for a total of about US$5 million. It has failed to provide a solution to the growing housing deficit. Middle- and low-income Peruvians still regard the dream of owning a house as unreachable. Ironically, the fund´s proceeds, about US$500 million, are periodically invested in bank deposits (auctioned to the banks with most of the financial institutions participating) until better use for this "Housing Fund" is found.

In the near future, newly created securitization institutions will provide a continuous funding source for the originators, securitizing and servicing Mivivienda and other portfolio real estate loans. A significant opportunity exists for mortgage securitization through the pension funds (US$3 billion in portfolio and growing exponentially), life insurance reserves and mutual funds. Origination outsourcing will be offered to banks either from another bank, or from a securitization/servicing facility, so as to avoid direct competition in the retail market.

Real Estate Market Size and Trends

The total housing supply of a city is comprised of completed stock, as well as units under construction (finished building and under-construction inventory). The total or potential housing demand is comprised of all households and individual persons (the total market).

The particular real estate market structure in Peru is characterized by the lack of a developed mortgage market, which produces a lot of informal and self-construction, since there are no developed housing commercial solutions.

The lack of sound urban development, of the non-commercial type, has caused havoc in a city with seven million people, producing urban chaos, reflected in deficiencies in basic services, transportation and other unmet needs.

The real estate construction sector is dependent to a large extent on overall macroeconomic development. In Peru, the housing sector is the most important component of the construction sector. Commercial construction, infrastructure and other construction usually lag behind the development of housing progress.

It should be noted that in 1999, the construction sector reported a contraction of 12.3% in its production statistics, after growing more than 18.9% during 1997 and decreasing by 2.3% in 1998. The reduction in the sector is basically explained by the fall in the domestic demand in the local market, which translates in a reduced dynamism.

The reduction in private consumption and the reduction in the purchasing power of the population, was a result of the economic slowdown caused by the fall in the international export prices and the drop in the direct foreign investment, due in large part to the exogenous crises (Asian, Russian, Brazilian) that have haunted the Peruvian economy until the 1999-early 2000 period.

Lima in the year 2000 has a population of about seven million people, accounting for roughly 30% of the total 24 million people in Peru. The urban growth in the capital has brought about a multiplication in services demand, among other phenomena, like vehicle fleet renovation, and a growing demand for economic, modern, reliable and safe housing. In the last decades, multi-family housing construction has grown more than the single-family building, as most investment centered around the high and medium-high socio-economic stratus. Project development has materialized mostly in the so-called "prime" areas (A and B sectors), namely, San Isidro, Miraflores, La Molina, Surco, Bararnco, Chorrillos and San Borja.

Lately, construction efforts have attended supply of apartments in lower-segment areas, such Jesus Maria, San Miguel, Pueblo Libre, destined to satisfy the medium-low stratum of the population. However, the demand far outstrips the available supply.

Demand for Mortgage Credit

In Peru the overwhelming majority of real estate transactions require bank financing. Even though less than 1% of the real estate stock in Peru has mortgage credit, the total stock of real estate loans extended through financial institutions reached US$1.04 billion at year-end 1999. The construction, as well as the purchase, of new real estate determines a high flow of financial resources which are channeled through banks. The development of the housing construction sector is intimately related to the availability of mortgage credit supply.

Mortgage credit is crucial for the development of this market, as purchasers seldom have the total resources required for cash sales in this market. With mortgage credit, the potential purchase price is then maximized.

One of the main reasons for the shallow development of the real estate industry in the 1980s was the lack of adequate housing finance programs for low- and medium-income sectors of the economy. There were no effective financing programs (the weak performance of the Mivivienda program shows that it is still in need of some reform and re-focus), no adequate financing vehicles, no financing instruments. Finally, the housing financing programs for the higher socio-economic sectors were mostly financed by short-term deposits and medium-term credit lines, causing dangerous term mismatches. Furthermore, the normal margins of 5% to 6% over the weighted average cost of funds, calculated over the pool of funds at the banks at the time of these disbursements, rendered mortgage rates of 14% to 16% per year. This created a "gap" between what the potential buyers could qualify for and their expectations for a housing "solution."

In the last two to three years, 80% of real estate transactions have involved mortgage credit, a relatively new phenomena in the Peruvian market. This varies according to prices and socio-economic structure, except for the lower prices (under US$20,000), as no financing alternative has been available. Less than 23% of transactions under this range were done with bank financing.

The economic agents that participate in the housing market are heterogenous: in the supply side there are legal variations of private ownership, official government and other forms of an illegal nature (present in the informal, self-construction sector), the product of the households without access to credit markets, which generate the invasions and unauthorized urbanizations characteristic of Lima's urban development.

The demand for mortgages comes from the population (natural persons) and juridical persons, with different motivations to acquire a property—the former typically to attend to a specific necessity and the latter for production reasons or wealth accumulation.

Whereas potential demand considers the absolute need for real estate (quantitavely, the lack of housing solutions, and qualitatively, the actual state of the real estate), the effective demand is more restrictive. Effective demand considers factors such as socio-economic stratum, price of desired housing solution, income, savings for down-payment, and prices in the specific zone or area where they are willing to purchase. Still, this restriction does not consider the possibility to "settle for less" than the desired housing, as a temporary solution, until the conditions (price, income, availabilty of housing in the desired area) improve. That is why the effective demand figure is considered by housing analysts as not reflective of the real housing needs of the population.

The real estate problem in Peru is multifaceted: it depends upon the income level of the population, the financial institutions' credit criteria, the willingness to lend and maintain a position in the Peruvian real estate financing industry, and long-term funds availability. Stability and growth of the economy and opening up new sources of long-term funds suggest a brighter future for the real estate finance industry.

NOTES

[1] The mortgage bond is issued by financial institutions, can be backed by actual or future mortgage credits, and actual and/or future construction projects. The endorsable mortgage credit note follows individual mortgage transactions, and can be put together into a securitization scheme, with the individual risk atomized, permitting credit enhancements and additional guarantees.