

# Evolution of the Mortgage System in Colombia: From the UPAC to the UVR<sup>1</sup> System

by Efraín Forero<sup>2</sup>

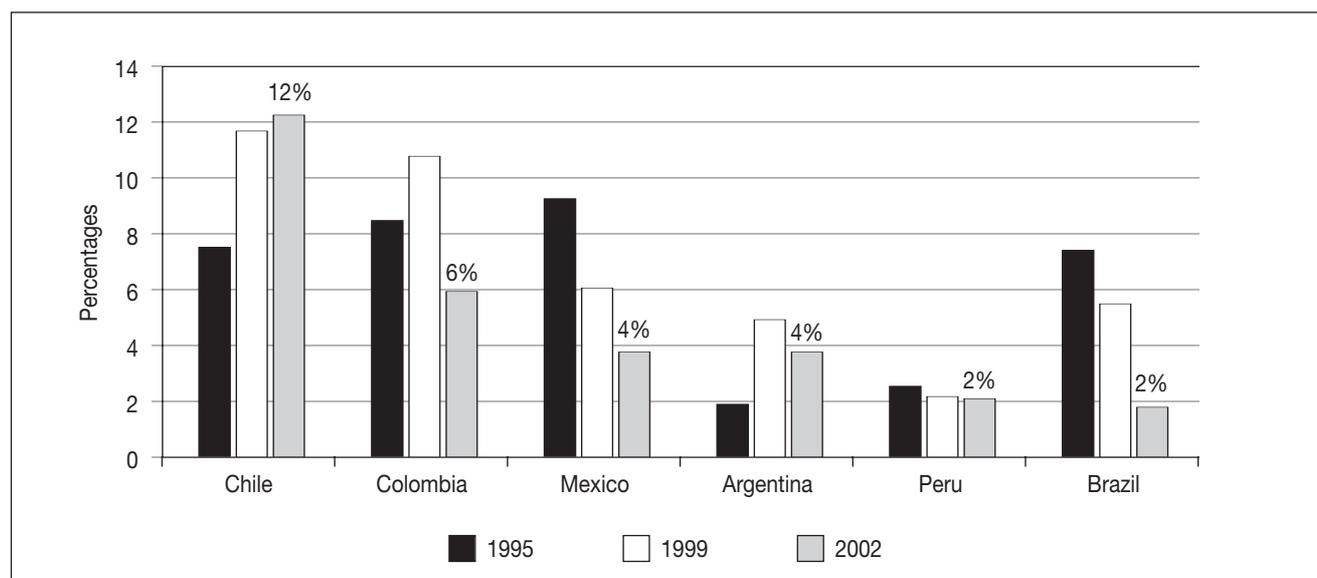
This article provides a brief description of how the mortgage system used to finance housing in Colombia, which has been acknowledged as a model system in Latin America due to its important achievements, has evolved over the last 30 years. We will likewise highlight the periods of crisis affecting the system, particularly in the late nineties, and the possible solutions designed to overcome this crisis.

## 1. CHARACTERISTICS AND ACHIEVEMENTS OF THE UPAC SYSTEM IN COLOMBIA

A mortgage loan system was created in Colombia in 1972 to finance housing, under the name of the UPAC System, involving specialist organisations known as saving and housing corporations (CAV). The UPAC System was a long-term housing loan

system - based on mortgages of up to 15 years - based on monetary unit indexing - Unit of Constant Purchasing Power (UPAC), initially adjusted for inflation. The Law that created this system gave CAVs very special privileges, since they were the only organisations that could grant this type of housing loan, use the indexing unit (UPAC), and pay returns on savings using this adjustment system. Special credit lines

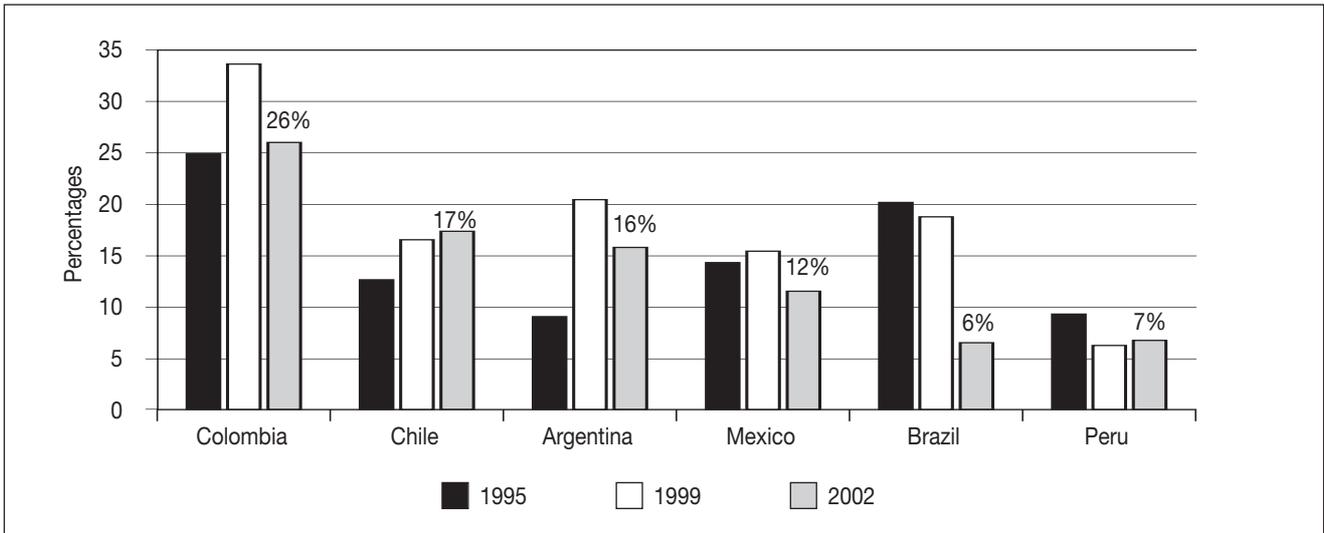
**GRAPH 1**  
Participation of the Housing Portfolio in the GDP of Selected Latin American Countries



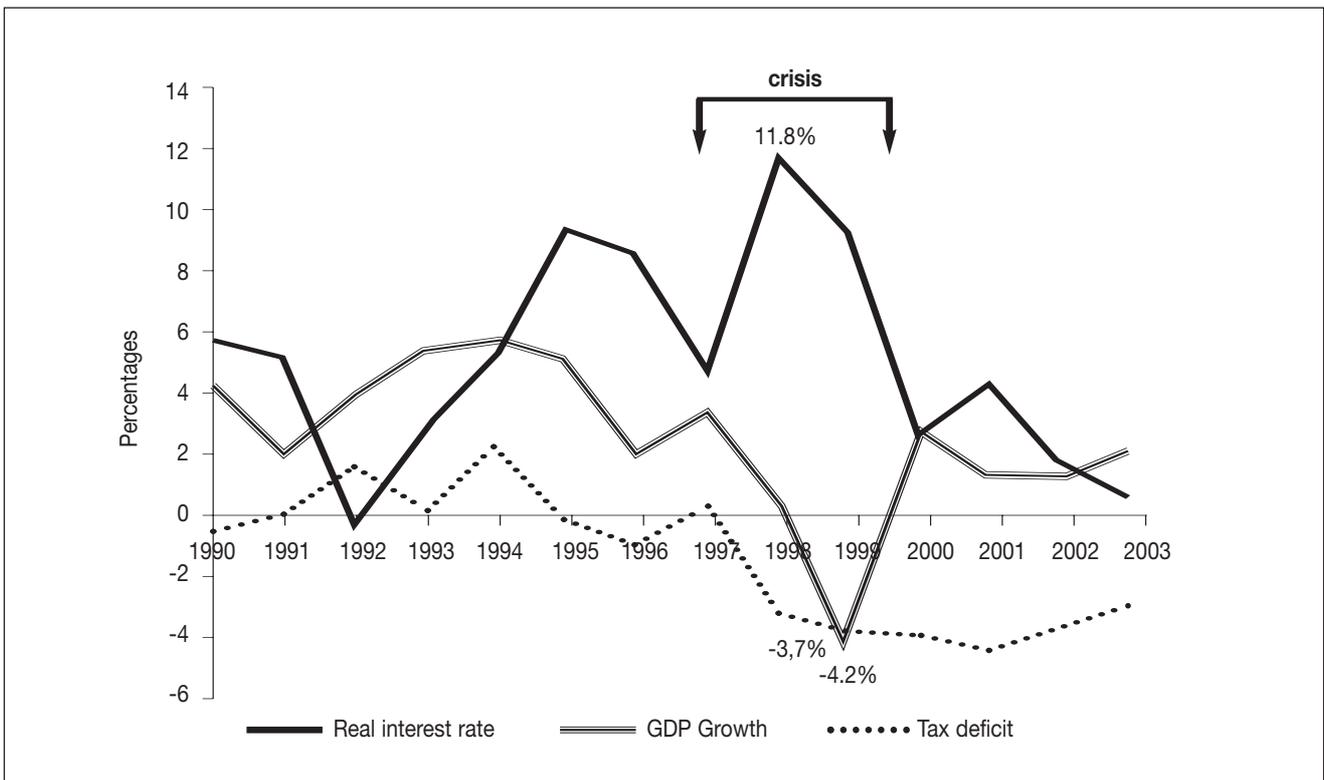
<sup>1</sup> Document presented at the *XLI Conferencia Interamericana para la Vivienda* organised by the *Unión Interamericana para la Vivienda* (UNIAPRAVI) in Panama City from August 11 to 13, 2003.

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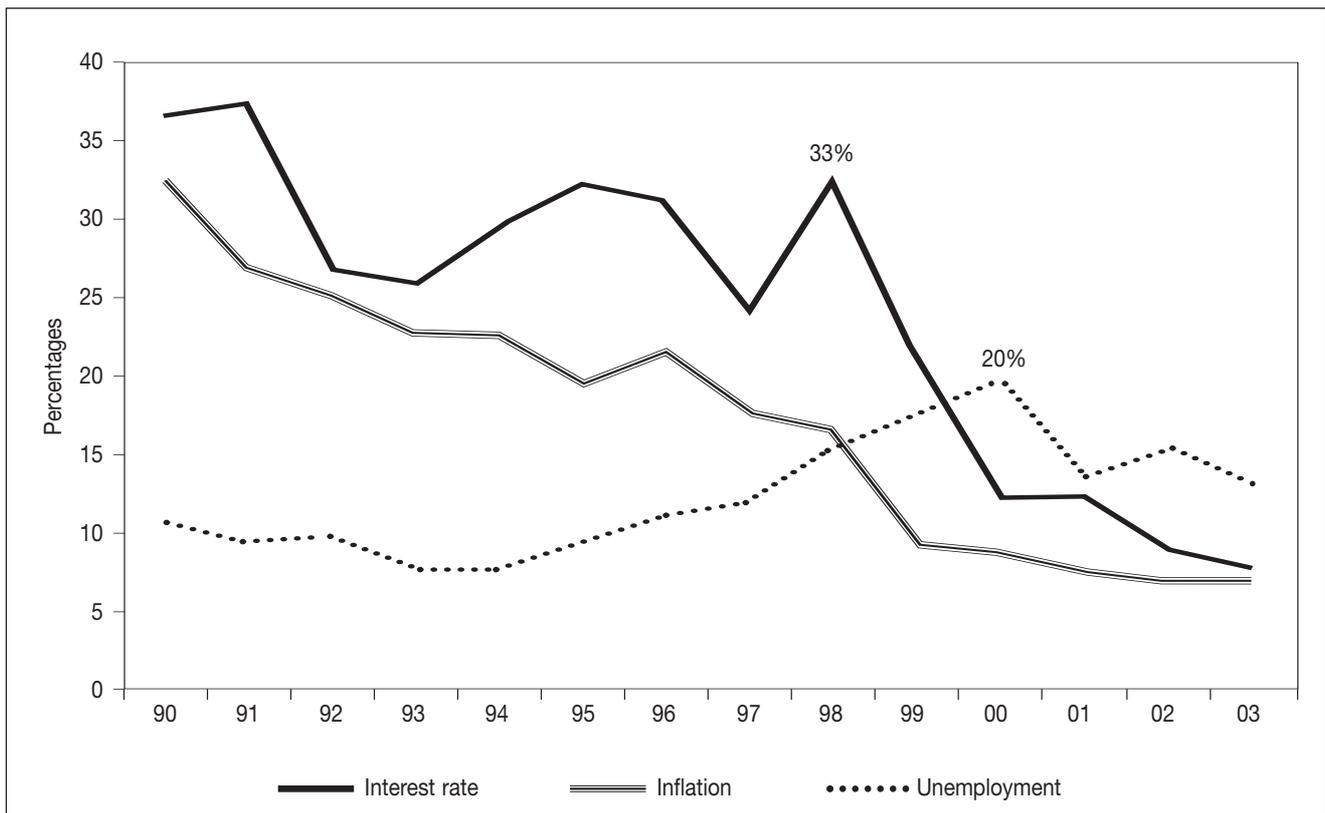
**GRAPH 2**  
Participation of the Housing Portfolio in the Total Loan Portfolio of Selected Latin American Countries



**GRAPH 3**  
Tax Deficit, Growth of the GDP and Real Interest Rate in Colombia, 1990-2003



**GRAPH 4**  
**Inflation, Nominal Interest Rate and Unemployment in Colombia, 1990-2003**



were also created, through which the *Banco de la República* (Central Bank) could automatically provide cash to CAVs, should they experience massive withdrawal of funds for any reason.

Up to the nineties, the CAVs experienced extraordinary growth. The UPAC system represented a revolutionary banking concept in the country, attracting a large number of savers - over 10 million - and at one time they were in control of the equivalent of 35% of the total banking portfolio, all aimed at financing housing. The technologically innovative UPAC system made a huge impression on personal banking.

The achievements of the UPAC System in Colombia are very important. On the one hand, 1.6 million loans were granted in a country with 44 million inhabitants. The

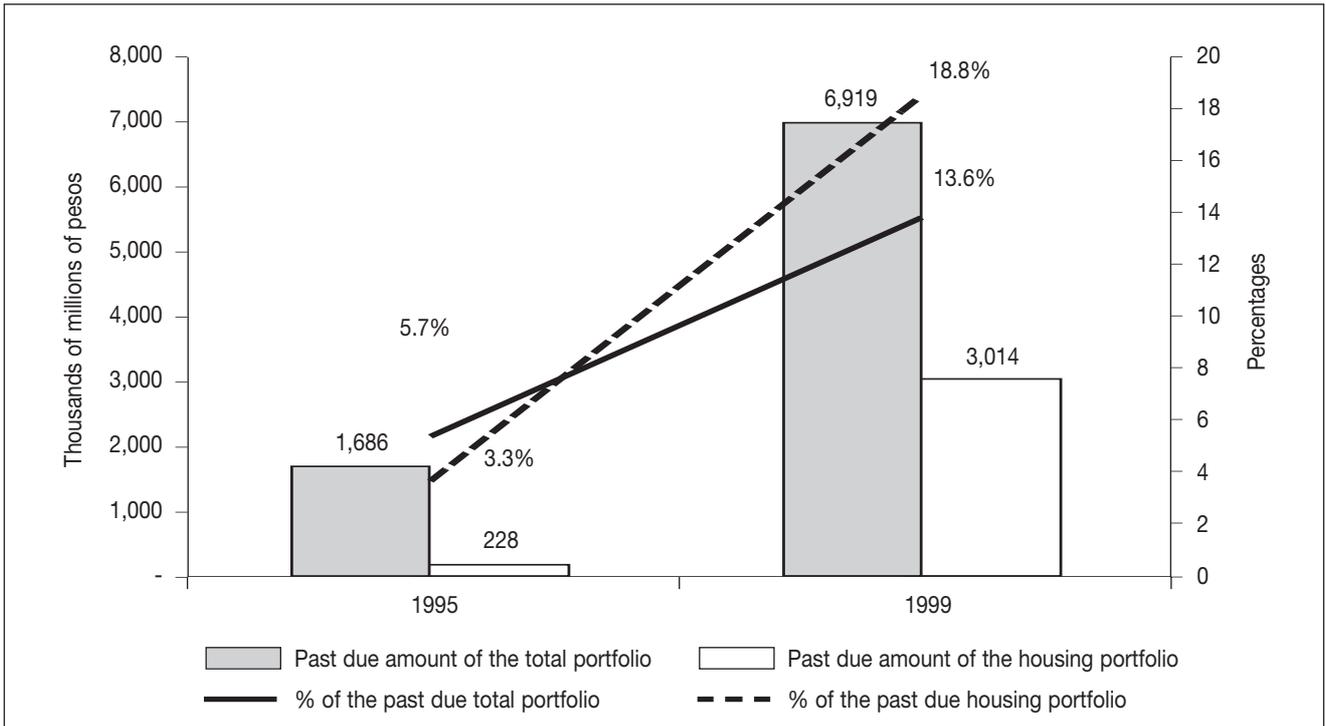
current loan portfolio contains around 700,000 loans valued at around 4,400 million US dollars. The UPAC System provided payback systems which were accessible for families with limited resources, making it of significant interest for financing social housing schemes. In fact, total mortgage loans for such social housing total around 320,000, valued at 1,300 million US dollars.

A comparative analysis of the mortgage loan system in Colombia and other Latin American countries, relating the size of the mortgage portfolio to Gross Domestic Product (GDP), shows us on Graph 1 that, in 1995, this indicator was at 8% in Colombia, higher than in other, even larger, economies. The country experienced a period of considerable growth in the housing loan sector from 1990 to 1999, when the crisis arose. As a result of this, the percentage of

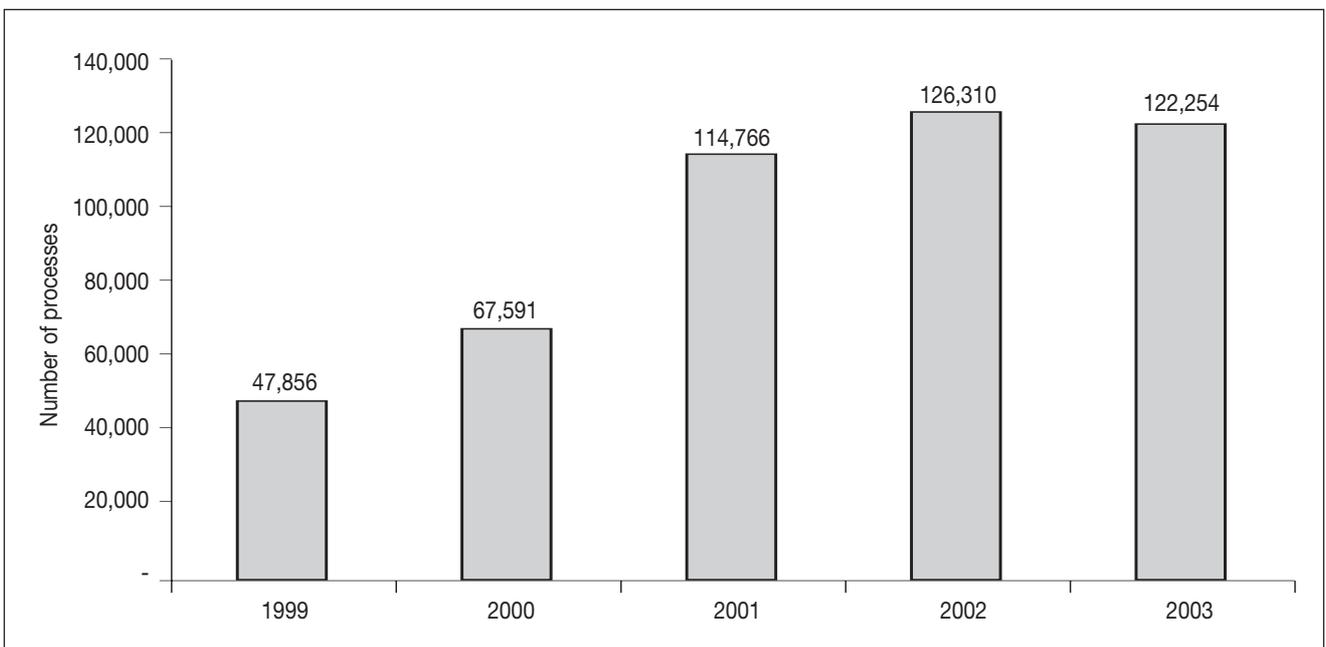
the GDP represented by the mortgage portfolio fell to 6% in 2002. This figure shows that the system not only continues to be strong, in spite of the severe crisis, but also has an enormous potential for growth.

On the other hand, Graph 2 shows the recent evolution of housing loans as a proportion of the total loan portfolio for half a dozen Latin American countries. We can see that, in 2002, mortgage loans in Colombia represented 26% of the total loan portfolio, whereas in the other countries - Chile, Argentina, Mexico, Brazil and Peru - this proportion is considerably lower. However, the financial system in Colombia is less deeply rooted than in countries like Chile and Mexico, and this partly explains the greater relative weight of mortgage loans in the financial sector.

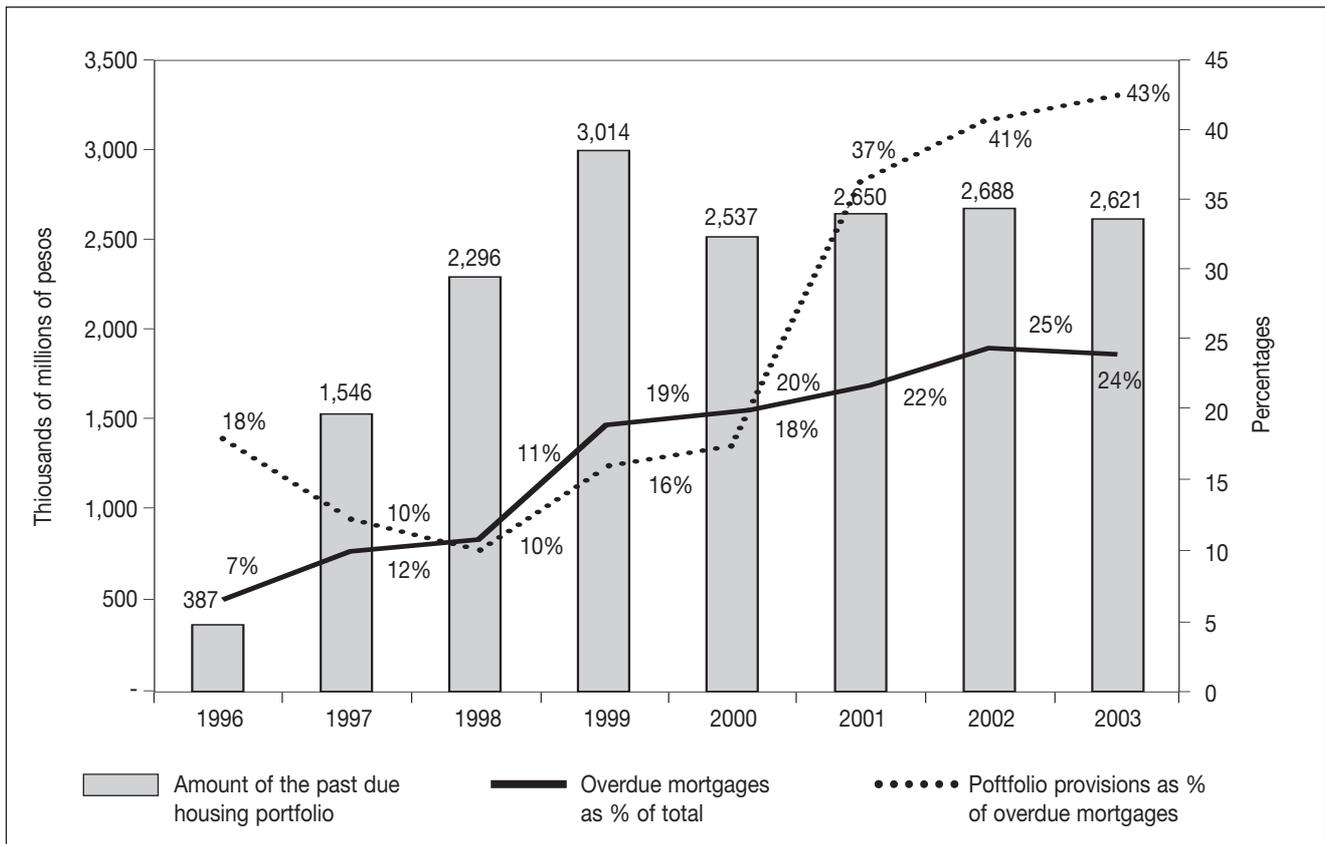
**GRAPH 5**  
**Past Due Total and Housing Portfolio in Colombia, 1995 and 1999**  
 (Amounts in thousands of millions of pesos and percentages of the portfolio)



**GRAPH 6**  
**Number of Mortgage Foreclosure Processes in Colombia, 1999-2003**



**GRAPH 7**  
**Amount of the Past Due Housing Portfolio and Provisions for Bad Debt in Colombia, 1996-2003**  
 (Amounts in thousands of millions of pesos and percentages)



**2. THE ECONOMIC RECESSION AND THE SYSTEM IN CRISIS**

**2.1 Background**

From 1990 to 1994, the government at the time introduced a large number of economic reforms leading to 4-5% economic growth in the period. It is important to note that the Colombian economy had been experiencing positive growth for over 25 years. In 1994, however, serious problems and disorders started to arise in the macroeconomic management of the country (see graph 3). As we mentioned earlier, the UPAC System was created in 1972, with the exclusive right to adjust the monetary value of savings (and loans) to inflation. However, the financial reform introduced after 1990 not only meant that the CAVs were no longer exclusively allowed to manage savings with adjustment

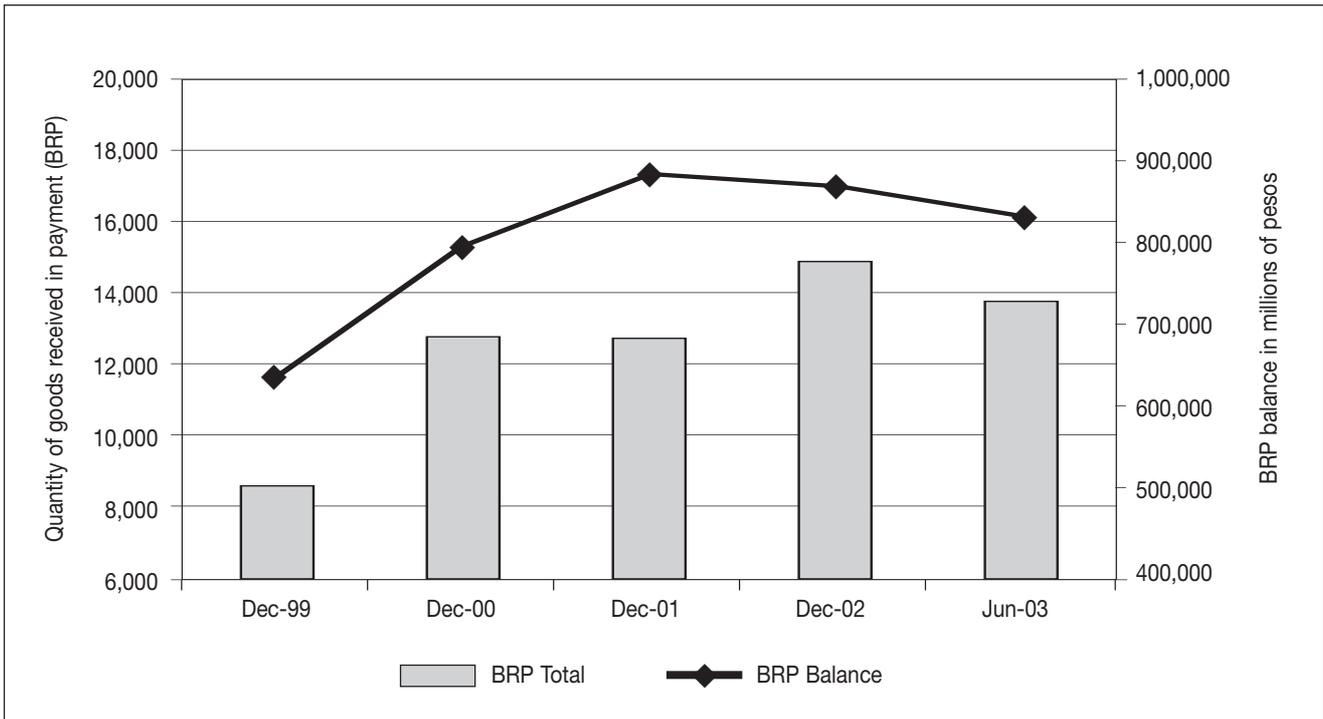
for inflation, but it also altered the way in which monetary indexing was calculated, partly relating it to the fixed term deposit interest rate, a financial market instrument. Later, in 1994, the UPAC ceased to be related to inflation at all, becoming solely adjusted to the fixed term deposit interest rate, by the equivalent to a fraction of this reference rate.

As these changes were introduced, the *Banco de la República* (Central Bank) decided to protect the rate of exchange by increasing both nominal and real interest rates, with real rates reaching an all-time high in 1998 and 1999. In the same period, a tax assignment problem forced the government to indebt itself on the local market to finance the budgetary deficit. When the new government came to power with a mandate for the 1998-2002 period, it

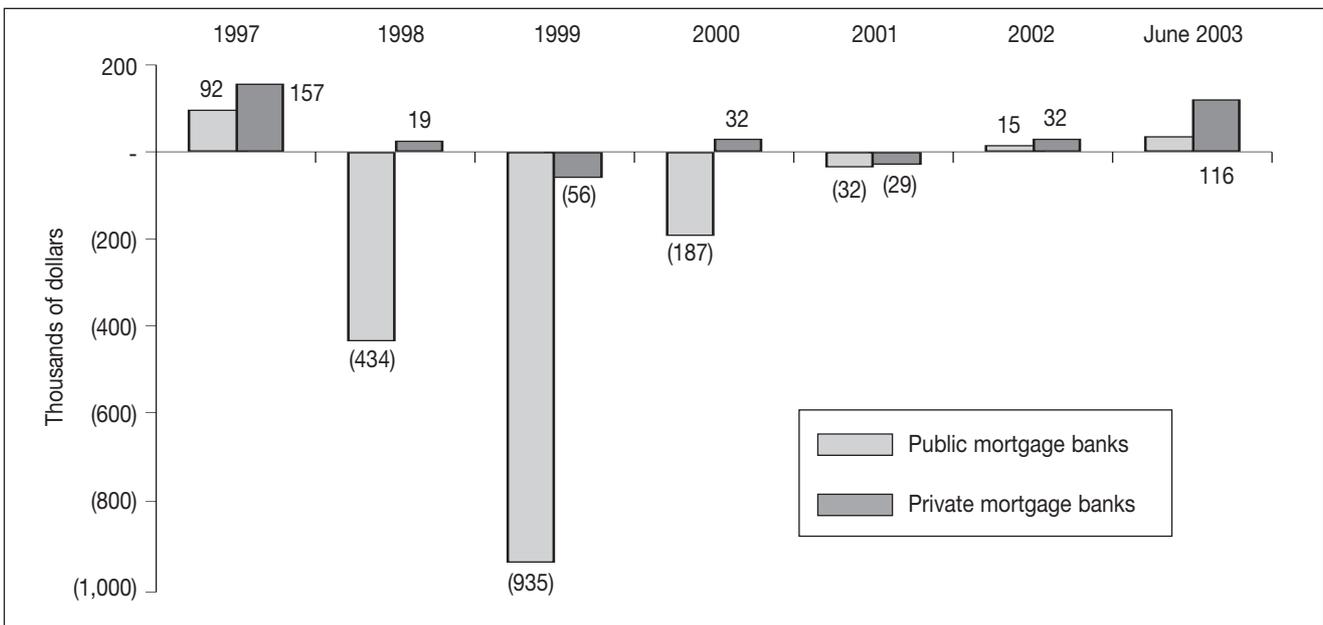
found a country in crisis, not only the financial sector but also several sectors of the economy, and a severe product depression. In view of this situation, the government centred its efforts on controlling growth of the tax deficit and interest rate-related variables, and the economy became significantly more stable.

As graph 4 shows, nominal interest rates reached around 33% in 1998-1999. The UPAC System suffered from the fact that monetary adjustment was linked to liability interest rates, because they deviated a great deal from inflation. In this context housing prices, which had been increasing rapidly before 1998, and the volume of construction, which had been enormous, collapsed immediately. This gave rise, on the one hand, to a huge increase in the liabilities and instalments to be paid by

**GRAPH 8**  
**Contributions in Payment of Mortgage Loans in Colombia, 1999-2003**  
 (Numbers and amounts in thousands of millions of pesos)



**GRAPH 9**  
**Profits of Mortgage Credit Institutions in Colombia, 1997-2003**  
 (In thousands of dollars)



clients and, on the other, to a fall in the price of the housing acting as collateral. At the same time, unemployment in the country was rising.

The evolution of overdue mortgage loans is shown in Graph 5. Before 1995, overdue loans (classified as such four months after the due date) represented around 3-4%; in 1999 this percentage grew to over 18%. Overdue loans overall in the banking system also grew considerably, with the 5.7% default rate of 1995 increasing to 13.6% in 1999, because, in addition to the problems with the mortgage portfolio, there were other difficulties related to municipal and government funding and production sector financing.

## 2.2 The system in crisis: 1999-2001

In 1998, the government declared an economic emergency, acknowledging the problems of mortgage banks - i.e., greater liabilities, smaller portfolio and the inability of many people to meet instalment requirements- and providing relief to debtors, through the *Fondo de Garantías de Instituciones Financieras* (FOGAFIN), by granting loans at subsidised interest rates to people who were up to date with loan payments but whose obligations had increased by over 20% in a given period, whereas people who were behind in payments were provided relief equivalent to six instalments. It will later be shown that this system did not work, and the money was therefore lost. At the same time there was a change of paradigm in CAV operations, with incentives for loan repayment to avoid the extreme option of repossessing the housing acting as collateral. However, in May 1999, the State made it mandatory for CAVs to repossess homes, regardless of the ratio between the value of the housing and the outstanding debt. It also provided for the use of a leasing contract including a purchase option, an interesting idea which unfortunately was not a great success.

However, the situation became even worse in May 1999, when the Constitutional Court, after analysing the regulations applicable to

the UPAC System in relation to a series of court cases, resolved that the formula used to calculate the UPAC was illegal, a decision that gave rise to a large number of problems. Four months later, in September 1999, the Court resolved that the entire UPAC System was illegal, damaging the system's image even further, and it ordered Congress to pass a housing bill, which was finally completed by the end of 1999.

## 2.3 New housing act

The new Housing Act again linked housing loans exclusively to inflation, creating the UVR (Actual Value Unit) System. This system aimed to link mortgages to the financial market, and it established mortgage securitisation and mortgage bond issue mechanisms; it also created important tax benefits for clients, investors and financial institutions. Likewise, it created a Mortgage Portfolio Stability Reserve Fund (FRECH), with a view to providing interest rate coverage due to the disequilibrium created when loans were indexed and liabilities remained in pesos. The Act also forced CAVs to become banks, thus eliminating the country's specialist banking sector. It also provided new relief for debtors.

The new Housing Act introduced new conditions for housing loans. In the first place, all loans were exclusively linked to the rate of inflation, with the UVR established as the monetary unit. Secondly, it established three UVR repayment systems, approved by the Banking Supervision Board, whereas the previous system contemplated a large number of payback schemes. Other relevant conditions were as follows: mortgages could now cover from a five to a 30-year period; the maximum coverage was 80% of the price for social housing (VIS) and 70% for other homes; and the instalment-income ratio was established as a maximum of 35%. Later, the Constitutional Court established that the interest rate for housing loans should be the lowest on the market, reducing them by two percentage points. It also established a maximum of 13.9% for non-social housing and 11% for VIS loans.

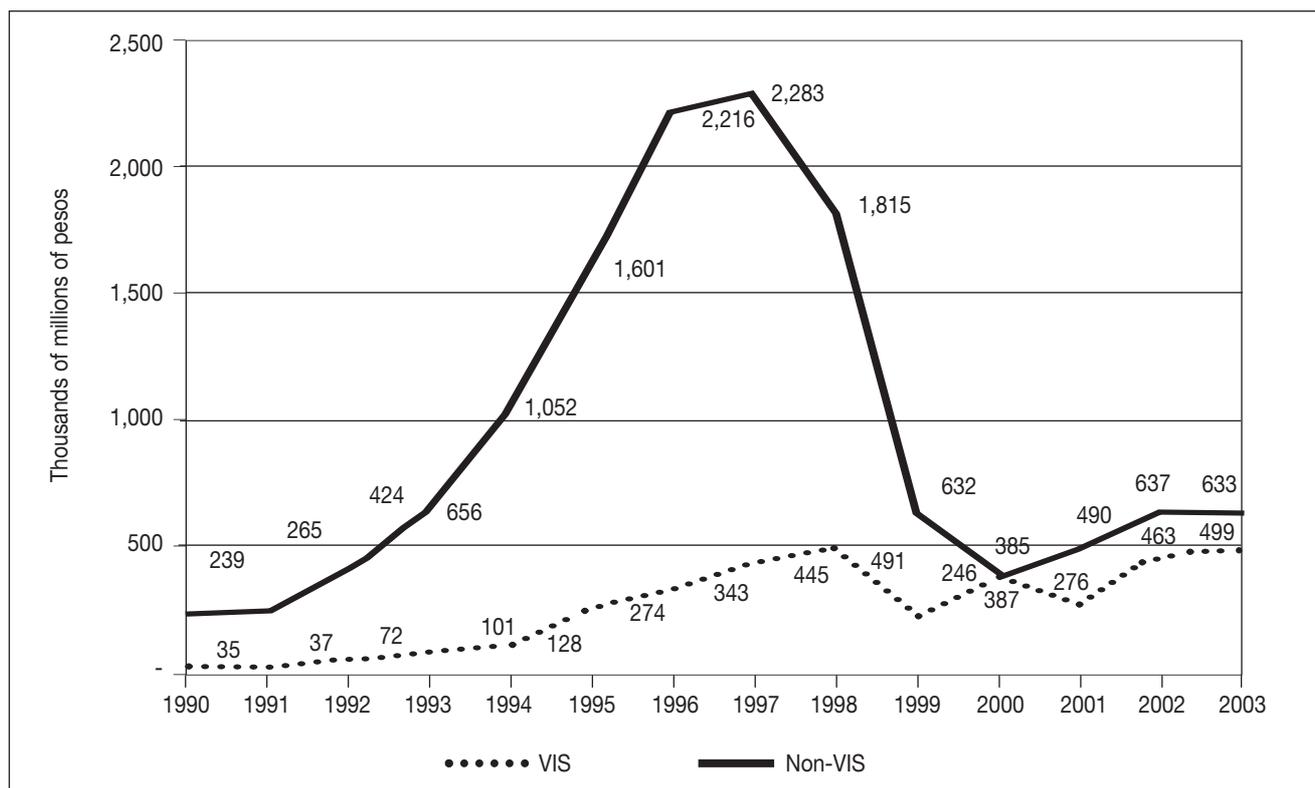
Logically, this made it difficult for the system to evolve and it also damaged how the markets perceived its stability.

## 2.4 New debtor relief and new court claims

In February, 2000, the government, interpreting the Act, attempted to solve the problem which had arisen from linking mortgages to interest rates. Seven years' history of over 700,000 loans was reconstructed to establish the value of the government aid to be granted to each debtor. This resulted in relief consisting of a total debt reduction of 1.9 billion pesos (around \$659 million US dollars), equivalent to an average of 13% of outstanding loans. However, for some debtors, this relief represented just under 5% of their debt, whereas for others it represented up to 35%. This created a great deal of unrest among debtors, and there were a large number of legal claims against settlement processes. On the other hand, following a government mandate, loan conditions in general were restructured to adapt them to the new payback systems, in some cases causing increases in instalments. New legal claims were later presented against the new Act, and all foreclosure processes were suspended, creating considerable uncertainty.

The number of legal claims increased sharply throughout 2001. In the meantime, debtor associations gained in strength and continued to sue financial institutions and the Central Bank. In turn, the Central Bank sued these associations and, finally, the banks sued the government. To summarise, there was a huge increase in lawsuits against default debtors and the courts soon became congested. Graph 6 shows the evolution of foreclosure proceedings, which went from just over 67,000 in 2000 to over 126,000 in 2002. These proceedings took nearly 48 months to repossess homes. This strained atmosphere was used to their advantage by some politicians who tried to take positions with electoral ends, but this situation was fortunately controlled.

**GRAPH 10**  
**Source of Mortgage Loans from Mortgage Banks in Colombia, 1990-2003**  
**(Amounts in thousands of millions of current pesos)**



### 3. EVOLUTION OF THE NEW HOUSING LOAN SYSTEM

Graph 7 shows some indicators of the evolution of the new housing loan system in Colombia. We can see that overdue mortgages represent 25% of the total; however, mortgage banks have made a significant effort to take their total portfolio provisions from 10% to 43% of total overdue mortgages. Comparing 2000, 2001 and 2002, the most recent loans have better performance figures.

However, home repossession should also be considered (see Graph 8). As of December, 2002, nearly 14,000 homes had been repossessed, valued at around \$290 million U.S. dollars (around 700,000 million pesos). In all, in the 1999-2003 period, around 43,000 homes were repossessed, valued at around \$878 million U.S. dollars

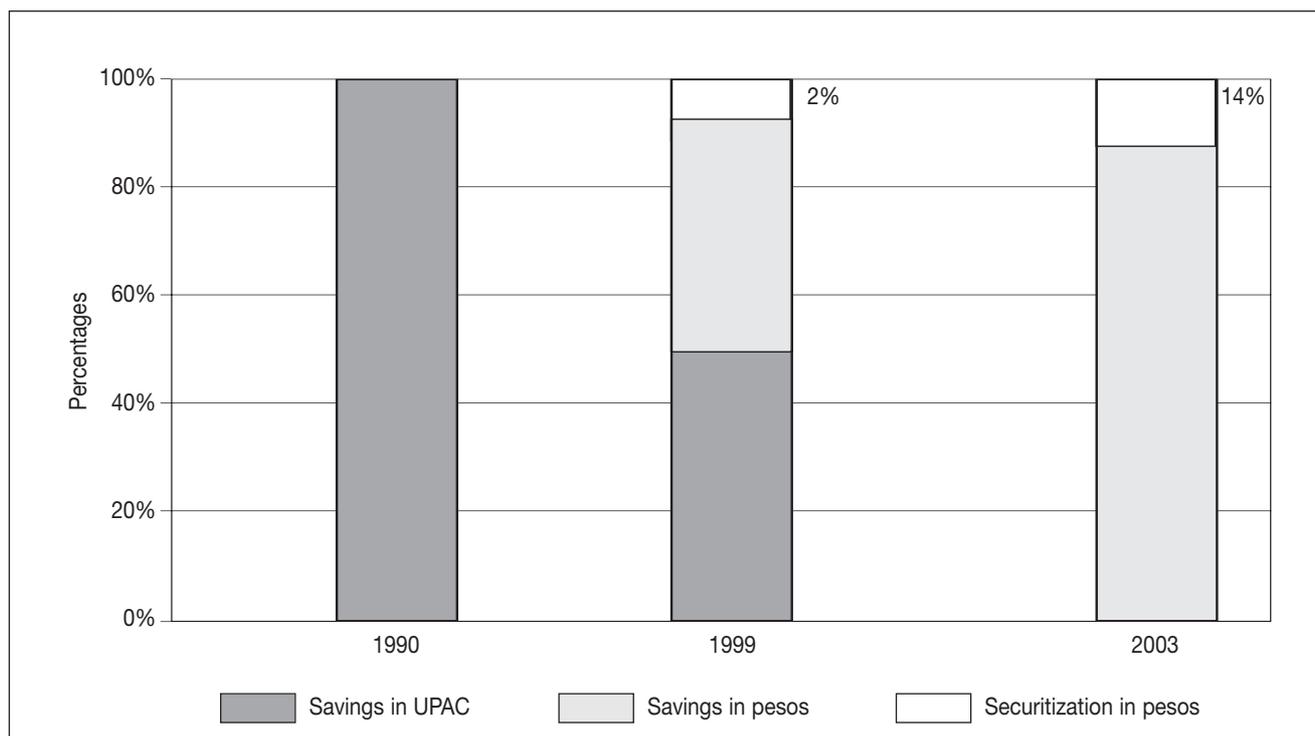
(around 2 billion pesos) and nearly 32,000 homes were sold for approximately \$586 million U.S. dollars (around 1.5 billion pesos), but at an enormous social cost.

There were several significant changes in mortgage banks. In 1998, *Granahorrar*, one of the leading banks, with assets valued at around \$760 million U.S. dollars, was nationalised, and *Concasa*, with assets totalling \$600 million U.S. dollars, merged with *Bancafé*, with \$2,100 million dollars in assets. The *Banco Central Hipotecario* was liquidated in the year 2000. In 2001, rehabilitation and capitalisation lines were established for private banks, with government loans totalling \$360 million U.S. dollars from FOGAFIN; and in 2002, loan risk assessment models involving forecast losses were established. Finally, the specialist banking sector disappeared completely, and the banks continuing in the

mortgage business are going through diversification processes. In other words, they continue to operate on the mortgage market but they are also becoming involved in other businesses, particularly personal banking.

Graph 9 shows the evolution of earnings from 1997 to 2003. As we can see, the crisis and subsequent measures generated heavy losses for mortgage banks from 1998 to 2001; the situation started to turn in 2002, with modest earnings, and in 2003 the improvement is even greater. We should mention that, in 1999, mortgage bank assets totalled nearly a thousand million dollars. A major capitalisation effort ensued later, both in public and private banks, with FOGAFIN resources; nevertheless, as of August 2003, these assets total only \$819 million U.S. dollars.

**GRAPH 11**  
**Composition of Resources Gathered by Mortgage Banks in Colombia, 1990-2003**



Graph 10 shows the evolution of mortgage bank loans granted since 1990. As we can see, non-VIS loans registered a historic high in 1997 and 1998, under the impact of a portfolio war engaged by one government bank (inter-bank portfolio transactions). We are now seeing a recovery of VIS loans, thanks to the country's major effort aimed at maintaining social housing dynamics. In fact, around 53,000 social housing units are expected to be financed in 2003, plus around 9,000 non-social units.

We should also mention here that the building sector, after a severe crisis, has been growing at a significant rate since 2001. The financing system used has changed enormously; most builders pre-sell their projects so that they depend as little as possible on banks. During the crisis the opposite was the case, with builders financing all their projects with bank loans, selling at higher prices after completion.

One very important aspect of the Housing Act was that it changed the origins of the resources to be used for housing loans. As Graph 11 shows, total resources in 1990 were in UPAC units with short-term maturity. In 1999, on the other hand, a significant part of the portfolio was financed in pesos, causing disequilibrium between assets and liabilities. This disequilibrium remains today; fortunately for the system, actual interest rates have been very low, so the adverse effect has not been too considerable.

The principal achievement of the new housing financing model in Colombia is the development of mortgage securitisation. To date, the *Titularizadora Colombiana* has made three security issues since the new Housing Act came into force. Mortgage securitisation is essential for access to the capital markets, and Colombia's experience has been extraordinary. The issues made by *Titularizadora Colombiana* total around \$518

million U.S. dollars, approximately 1.5 billion pesos. Nearly 14% of ongoing mortgages are now securitised. It is estimated that it is feasible to support solid mortgage portfolio growth in this way, considering the growth forecast for pension funds and the resources managed by other institutional investors.

There has been other important progress in the development of the new housing loan system. In 2002, judicial collection procedures were changed by a reform in the Civil Proceedings Code and the Lease Act, and the length of these proceedings is expected to fall from 48 to 18 months. There is also active participation in financing for social housing, backed by an increase in VIS grants. Likewise, the present government has launched an initiative aimed at providing insurance coverage against inflation. Housing leasing has recently been introduced on the market and

these contracts, besides being in pesos, can be securitised. *Davivienda*, the first bank to offer this new housing financing system, has been doing so since July, 2003.

#### 4. FUTURE CHALLENGES

The subject of housing financing in Colombia continues to involve many challenges, including the need to develop access to financial markets, the securitisation of overdue loans, now totalling around \$900 million U.S. dollars, and the issue of mortgage bonds. Coverage is also required for interest rate risks. We are

working with the government on the possibility of offering micro-credit alternatives for homes valued at less than \$15,000 U.S. dollars, with loans of less than \$2,800 to be repaid in up to five years. A great deal of work has yet to be done on reducing interest rates and the inefficiency of the mortgage loan system. A significant degree of responsibility rests with the banks which operate in the system, but is also in the hands of the government, because the interest rates at which the government takes out loans establish a reference for obtaining resources from the financial markets.

Finally, a great deal of work is required to improve the image of the financial and mortgage loan system, because over 40% of the Colombian population either feels affected or knows someone who has been affected by the way in which the system has evolved. In the last few years, the pre-payment rate has risen and there is reluctance to undertake a long-term mortgage loan, thus limiting the sector's growth. However, we are optimistic about the future development of the housing loan system in Colombia, because the country has an extraordinary structure and highly capable builders and financial institutions.