Setting the Context: Mexico

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WHY IS HOUSING IMPORTANT FOR MEXICO'S SOCIAL AND ECONOMIC DEVELOPMENT?

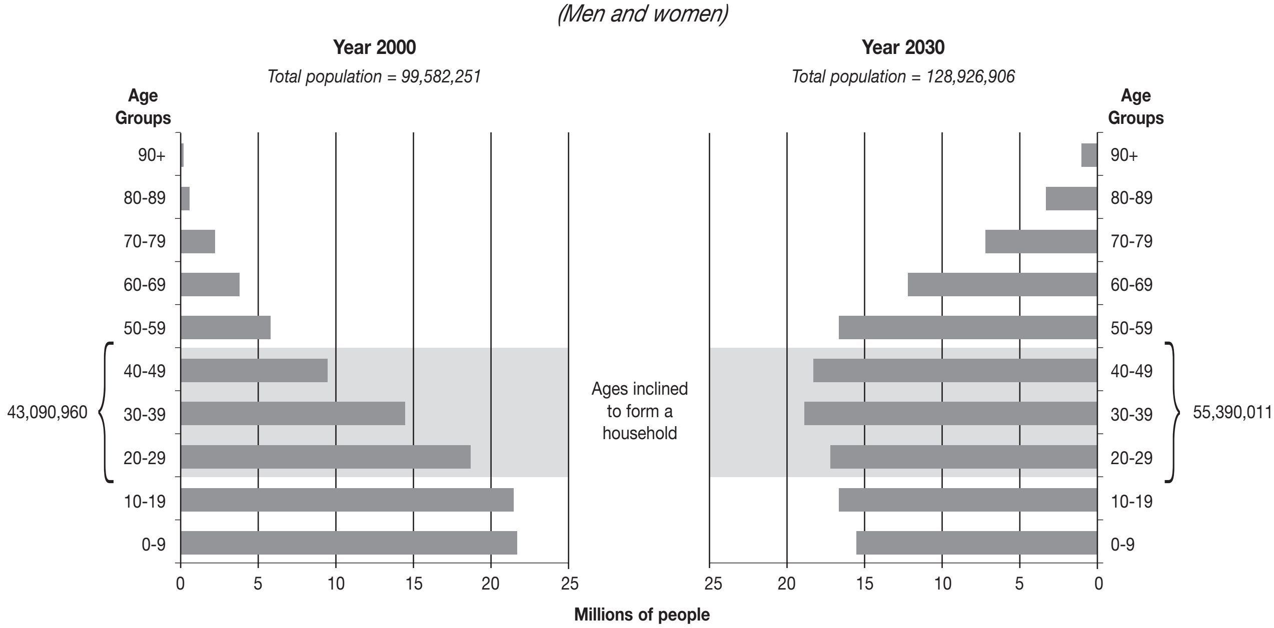
Mexico faces significant challenges in its future housing requirements. Like any nation, Mexico's housing needs derive from its demographic age structure, reflected in its household formation rate, which will see its most significant growth rate in the next 30 years. However, housing demand is not only a function of household formation, but of the households' inherent purchase capacity driven by income levels. In both instances, with rising household levels and overall low average income levels, Mexico faces pressures that compromise the overall living standards of the population and its socio-economic development.

Despite the reduction in population growth rates observed in the past 40 years (going from 3% per annum in the 1960s to around 1% in 2002), the coming of age of the country's "baby boom" (born in the 1960s, 1970s and 1980s) will accelerate the pace of new household creation. Thus the Country's number of households will double again by 2030 and lead to a very significant growth in the demand for housing and basic services in our territory. This demand will increase at even higher rates in cities as the country continues to urbanize (today about 66% of the population lives in urban centers and 80% of GDP originates in cities).

With such an impressive household growth outlook, housing (specifically affordable housing) and the related land, urban development, infrastructure investment and services availability (water, electricity and waste management [solid and liquid]) represent crucial challenges for Mexico at this point of its development. Access to housing and urban services strongly supports economic growth and poverty reduction. Socially, a house is the place where family members interact and develop their basic social manners; it is also their source of safety and peace and is the base for their development. Meanwhile, a house becomes the basic source of savings for any household economically, and thus, for the economy, while its construction constitutes an engine for both employment and industrial growth. Therefore, given the contribution and impact housing has on the social and economic wellbeing of the

Population Pyramid by 10 year generations

(Men and women)



country, it must now become part of our National Agenda.

WHAT ARE MEXICO'S PRINCIPAL HOUSING PROBLEMS?

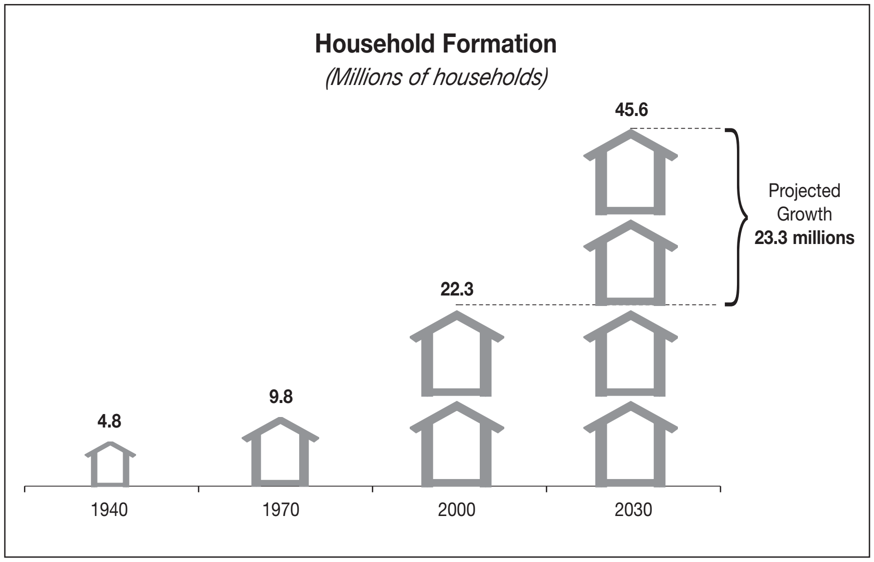
Mexico's housing problems mostly derive from an historical lack of focus on housing development. The country's housing focus began in the 1970s when two leading housing finance organizations (both worker housing savings funds) were created: INFONAVIT (private sector workers) and FOVISSSTE (government workers). While these organizations continue to be the leading mortgage finance institutions in our country, they unfortunately were not effective (and probably never attempted to be) in fostering the comprehensive development of our housing sector (their focus was mainly on their own agenda, which unfortunately included inefficient practices for several years). Such circumstances created a vacuum in the federal government's (leadership included) attention to housing. This vacuum, when combined with a series of deep economic and financial crises (1972, 1976, 1982, 1987 and 1995), their ensuing high inflation and real rates of interest, and a fragile and convoluted land property system, made it extremely difficult for housing to flourish in the country.

Today conditions have improved. Nevertheless, the country still faces multiple challenges, including:

1. A still highly fragmented command and communication structure both among the federal, state and municipal authorities and within the federal government's housing institutions.

2. A restricted availability of private territory, given that nearly 50% is still subject to a "common" ownership scheme ("ejido property").

3. A shortage of developed land supply, given the structural problem referred to above and the very limited investment in infrastructure and services by both the state and municipal authorities.



4. A limited participation of the private banking system in the housing finance market (in 2004 banks accounted for less than 10% of total mortgages).

5. The limited purchasing power of about 40% of all Mexican households, which earn less than $150 dollars per month and which, statistically, require an equivalent share of all housing needs (see Appendix 1, chart 3).

6. A lengthy and uncertain (at least with respect to time) housing project authorization process, where multiple windows for licenses, permits and authorizations prevail both at the state and municipal levels, and where each municipality (there are over 2,000) has its own discretionary procedures.

WHAT BUILDING BLOCKS ARE ESSENTIAL TO DEVELOP MEXICO'S HOUSING MORTGAGE AND CAPITAL MARKETS?

1. *National prioritization.* Housing must be a top national ("state") priority, with a comprehensive strategy for its development.

2. *Clear leadership*, direction and unified command of all government agencies.

3. Holistic development approach. Housing must develop comprehensively as a sector comprised of all the elements and processes required in its production chain:

   - Land, permits, materials, construction process and accessories ("Housing Production or Supply")
   - Financing availability to support the one time purchase capacity of households through mortgages and/or subsidies ("Sale and Demand")
   - A secondary home market where families can buy or sell their existing home to upgrade their living conditions, achieve mobility, or liquefy their equity investment.

Only by working through all the previous aspects in a concerted and parallel manner can Mexico achieve a housing production process that supplies homes at the required volume and price for all households (demand). So far Mexico has failed to do so. Today we produce homes that only two thirds of the new household population can buy; thus one third of new households – or around 200,000 – cannot buy a house, either because they are not credit worthy or because they do not have access to the formal financial system. Such a demand/supply disconnect requires further government intervention and more private sector participation that leads to an orderly and effective housing market in all the key processes described above. Specific measures include:

- On the Supply front: enhance land availability (reducing its cost), increase investment in infrastructure and services, and reduce transaction costs (including licenses and permits and the cost of notaries and public registry), all of which can lead to lower average prices of housing units.

- On the Demand side: increase the "one-time" purchase capacity of households, particularly low income ones, to help them buy their first house by: i) budgeting more resources for subsidies and ii) improving the efficiency of the mortgage market. Developing a more effective mortgage market is fundamental to lowering interest rates, increasing housing affordability and achieving a healthy housing market. Subsidies, on the other hand, are understood as direct budget transfers to support the purchasing capacity of the lowest income population (who cannot access a loan), and their availability is subject to government finances.

- Finally, regarding the secondary housing market: we need to create an efficient secondary market for houses where individuals can easily buy or sell their property. Such a market would allow households to both "monetize" the value of their home and/or to upgrade their living conditions as the family evolves through its life cycle.

WHAT STRATEGIES OR ACTIONS HAVE BEEN SUCCESSFUL?

The Government of Mexico is responding for the first time to the challenge by giving housing the highest federal priority. President Fox launched a bold housing program to double production by 2006 (and match the household formation level), and implemented major actions to give housing a new comprehensive strategic vision. With these measures, the government placed in motion reforms to support housing development, targeting the lower income population segments and generating economic growth.

The strategy is focused on expanding formal housing production (doubling production by 2006). It is based on the premise of a decentralized urban development function and on strengthening the market-based approach to housing development.

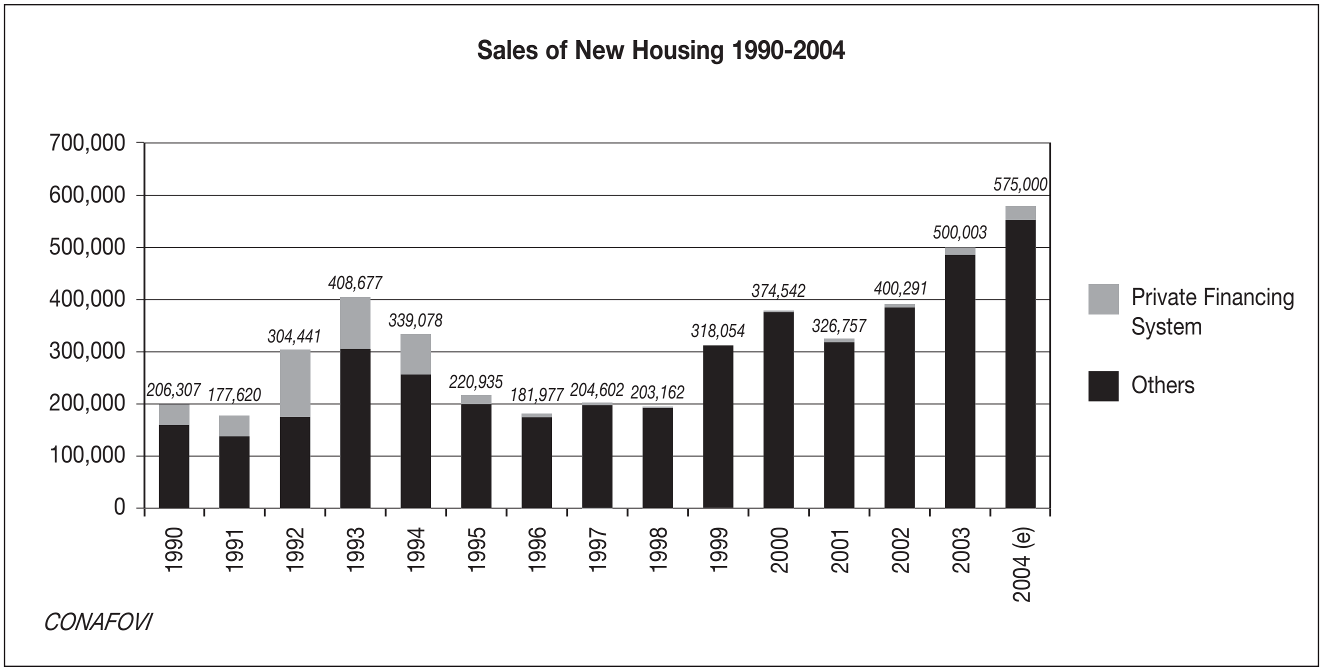
The adopted measures can be grouped into three categories:

1. **Strategic Actions:** In 2001 Mexico implemented several measures to change the structure of its housing sector, particularly with respect to its governance and leadership. These included:
   i. designing a deep and thorough strategic plan reflecting the National Housing Program;
   ii. creating two new entities to lead, coordinate and integrate all activities in the sector: a federal agency called the National Housing Commission (CONAFOVI) and the National Housing Board (CONAVI), a multidisciplinary governance group headed by the President;
   iii. launching two new financial development agencies to finance the purchase of homes via both mortgages – with the Federal Mortgage Society (SHF) – and subsidies for low income families through the National Housing Fund for Economic Support (FONAEVI).

2. **Operating measures:** these include activities taken to improve the supply of and the demand for housing such as:
   i. designing and implementing co-financing programs between government sponsored mortgage companies and private sector financial intermediaries
   ii. integrating all subsidy programs under one homogeneous promotion program called "Tu-Casa" ("Your-House");
   iii. the tax deductibility of mortgage interest rates;
   iv. the signing of housing specific promotion agreements among the federal, state and municipal governments; and
   v. integrating a national housing supply database and a web-site in "micasa.gob.mx," supported by the public finance organizations.

3. **Efficiency measures:** these relate to actions implemented by each publicly sponsored mortgage organization to enhance their institutional effectiveness. This category includes:
   i. a comprehensive loan recovery program at INFONAVIT, modernized systems using electronic means for granting credit and programs for institutional transparency;
   ii. liberalizing cash resources for more than $20,000 million pesos (about US $2 billion) at FOVISSSTE and for the first time, structuring and using a transparent credit allocation mechanism;
   iii. creating new government guarantee schemes at the Federal Mortgage Society (SHF) and assigning more resources to the mortgage specialized financial intermediaries (SOFOLES); SHF has also incorporated banking institutions to the mortgage market and has finally started a solid primary and secondary mortgage market in the country;
   iv. FONHAPO, the agency focused on the low income non-wage groups, is moving towards a second tier lender and, through the FONAEVI, is turning into the only window for administering new subsidy schemes like the "Tu Casa" program.

All of the previous activities have led to a very significant progress in housing construction and sale, as evidenced by the growth rate observed from 2001 through



2004, when the sale of houses grew by more than 60%, going from 326,303 to almost 575,000 units even with a still limited banking participation.

WHAT STRATEGIES IS MEXICO CURRENTLY CONSIDERING TO MAKE FURTHER PROGRESS?

The commitment of the current administration to housing has given this sector an unprecedented relevance. For the first time, housing is not seen as a part of the construction industry or as an isolated product. Today we begin to see it comprehensively: as an integral sector of utmost importance for the country.

Nevertheless, we are still far from positioning housing at the national priority status it requires: one that leads to a shared "vision of state" by the federal, state, municipal, legislative and executive branches of government, and by the private sector as a whole.

Our delivery capacity is still short of the 750,000 unit target, and the remaining 250,000 units needed are the most difficult ones to build and sell, as for the most part, they represent the units required by the lowest income earning households, which do not have the purchase capacity to contract a loan (at least not for the amount needed to buy a home). Today, the institutional and financial architecture necessary to serve about two-thirds of the families is largely in place. Although not by design, most federal programs now target moderate income households. As a result, low-income families resort to informal settlement and incremental building of their own.

Currently, about one third of all new housing units are produced informally: without support from formal-sector institutions. Such an unsupported and unguided process generates significant public and private costs in the form of insecure tenure, poor construction, low quality, unhealthy environments, and inadequate and costly service provision; prejudicing the country's socio-economic development and these families' life prospects.

Therefore, financial programs and institutions have yet to reach two segments: most significantly, the low/moderate-income market, which as stated generally lacks formal-sector support; but also the well-to-do upper middle class, which also requires the use of mortgages. However, the priority must be in solving the problem of the low-income market. Otherwise the resulting lack of housing will lead to more informal settlements, causing social, economic, environmental, and health problems.

The Government must address these critical problems by taking measures to further reform institutions and policies and to address the key bottlenecks in the sector. These actions include:

i. enhance coordination and strengthen the institutional framework;
ii. reform land markets, urban development, property rights, and infrastructure investment;
iii. increase the efficiency and equality of housing subsidy programs (harmonizing their economics) so that they provide comparable levels of subvention for similar uses and coordinate their administration;
iv. expand and diversify market-rate housing credit.

The following are specific actions:

Consolidate a national housing policy and institutional framework. Until 2001, the federal government lacked an effective vision for reform of the housing sector. Similarly, the federal agencies involved in housing operated with neither an overall strategy nor coordination (see Appendix 2).[1] Today there is one federal agency, CONAFOVI – a member of the presidential extended cabinet – solely responsible for the sector's policy and conduct. However, CONAFOVI's mandate has to be consolidated and strengthened, and housing has yet to become a shared national priority of the legislative branch and of the state and municipal governments. A Ministry of Housing could be a step in this direction.

Increase and homogenize housing subsidies. Over the last few years, Mexico has launched two small-scale (total funding of US$300 million in 2003) upfront housing acquisition subsidy programs: Prosavi, now operated by SHF (previously by FOVI), and Tu Casa (formerly called "VivAh"), now operated by FONHAPO. Until 2002 these two subsidy programs used widely different levels and methods of subvention. The Prosavi program combined a market rate loan with a federal subsidy of approximately US$6,000 for purchase of a unit built by private-sector developers and financed by private-sector financial institutions. In turn, Tu Casa, operated by FONHAPO, delivered only a federal subsidy of US$3,000 (matched by $3,000 paid in kind from local governments, generally as land with services) for a basic unit developed and financed by state and local housing institutes. These initial on-budget federal housing-subsidy programs have proven useful trials, but they must be substantially improved as a pre-requisite for expanding funding to about 10 times its current size, a level necessary to have the needed impact and achieve the government's goal of producing 750,000 housing solutions per year. Until 2002 however, no plan or policy agency had existed for building upon these subsidy experiences or to develop a unified national subsidy program. In 2002 such an agency was conceived, and in late 2003 took form in FONAEVI, a federally mandated trust. However, its participation must be further developed and strengthened, with a clearly defined yearly budget allocation. Recently a public-private partnership, through a private sector non-profit organization called Pro-VivAh, is also participating in subsidy activities.

Mexico must furthermore evaluate and decide how to homogenize the final upfront subsidy program with the imbedded subvention provided by the two housing finance worker funded institutions – INFONAVIT and FOVISSSTE – through below-market rate mortgages. Such subsidies are difficult to assess, however, as they refer to an opportunity cost on workers' pension funds that changes with time, depending on the prevailing market interest rate levels. Furthermore, as all formally-employed households pay into these pension funds, most of the interest-rate opportunity cost subsidy implied in these housing loans has gone to moderate-income households, whose income level allows them to buy a finished, commercially-built unit of the type and cost produced today in Mexico. Because lower income households cannot afford such finished housing – even with subsidized mortgages – INFONAVIT has not served these families.

Land Reform and land availability. Land development is very complex due to the difficulties of "ejido" land (a form of communal landownership dating from the Mexican Revolution). About two-thirds of land on the periphery of medium and large towns consists of ejidos, with large private-sector developers controlling the remainder. The ejido tenure and its complicated legal regimen contribute to making private ownership and rational land development difficult and expensive. Since 1992, ejido lands can be privatized, but the process is cumbersome and centralized under the federal government. Municipalities must get the explicit authorization of the federal authorities –which is often slow in coming – to intervene, raising the cost of subsequent regularization. Most cities in the country show discontinuous spatial patterns as formal development seeks to leap-frog over ejido lands in search of lower-cost parcels, generally far from cities and employment centers, creating higher costs for infrastructure provision and reduced quality of life.

Modernize property registries and rights. Mexico has 32 state property rights registries. Current public registries suffer from: i) lack of agreement on basic legal and administrative principles among state and federal authorities; ii) operational inefficiencies; and iii) antiquated and insecure information systems, all of which help make real private property ownership difficult and expensive. Widespread insecurity of tenure and informal ownership is enhanced by the need of low/moderate-income households to build informally. Modernizing and upgrading these systems is fundamental.

Expand and diversify market-rate housing credit. Today this instance presents the most progress in Mexico. The creation of the SHF as a mortgage market development bank is a major achievement of the Fox housing plan. SHF's move from direct funding to the use of partial guarantees and now to insurance products will further develop both the primary and secondary markets. In late 2004 the growth of the mortgage market was strengthened by the acquisition of the leading specialized mortgage financial intermediaries (or SOFOL) by the largest commercial banks (BBVA – Hipotecaria Nacional). Furthermore, equity investments – both strategic and financial – are flowing to other SOFOLES, making them stronger institutions (Su Casita- Caja Madrid). Growing the mortgage market is a key element of Mexico's future housing program.

[1] FOVI (which has become SHF, and has lead responsibility for development of market-rate housing credit in Mexico), FONHAPO (a federal social housing agency), and INFONAVIT and FOVISSSTE (both off-budget government sponsored workers funds that receive mandatory contributions from, respectively, formally employed private-sector employees and federal-government employees)

APPENDIX 1[2]

Chart 1

Population	97,483,412
Households	22,268,916
Housing	21,954,733
Economically active	34,154,854
Formally employed	

Chart 2: Households, average members and income levels

Total households	22,268,916
Occupants	95,373,479
Occupants per household	4.4
Occupants per room	1.2
Occupants per dormitory	2.2

Chart 3: Households' income levels

Income Groups by monthly income (US Dollars)	Households	Accumulative	%	Accumulative
Without income	8,304	8,304	0.0	
Less than $100	1,748,824	1,757,128	7.9	7.9
From $100 to $200	3,864,725	5,621,853	17.4	25.3
From $200 to $300	3,478,839	9,100,691	15.6	40.9
From $300 to $500	4,993,674	14,094,365	22.4	63.3
From $500 to $1,000	4,929,544	19,023,910	22.1	85.4
More than $1,000	3,214,253	22,238,162	14.4	99.8
No reported	30,754	22,268,916	0.2	100.0
Total	22,268,916		100.0	

Chart 4: Population Age 2000 Distribution and Estimated in 2030

Ages	*2000*[3]	*2030*[4]
0-9	21,952,092	15,693,244
10-19	21,622,208	17,002,285
20-29	18,785,734	17,677,585
30-39	14,635,156	19,004,598
40-49	9,667,070	18,707,828
50-59	5,999,938	16,752,007
60-69	3,827,564	12,822,073
70-79	2,087,573	7,367,245
80-89	813,679	3,091,211
90+	191,237	808,830
Total	99,582,251	128,926,906

[2] Results of the XII General Census of Population and Housing 2000.

[3] CONAPO

[4] INEGI

APPENDIX 2

Housing Finance Market

Mexico's housing finance market is composed of various private and government owned participants. Private participation comes mostly from mortgage non-bank banks called SOFOLES, which in turn are generally funded by the government owned SHF. Banks that left the mortgage market after their mortgage portfolios collapsed in the 1995 tequila crisis are slowly coming back to the market. Therefore, most mortgages today are funded directly or indirectly by two government-sponsored and two government-owned entities.

Government sponsored

INFONAVIT. Governed by representatives of formally-employed workers, employers, and government, this institution gets funding from a governed compulsory contribution of 5% of the salary of private sector workers and applies these monies to extend mortgage finance for housing at below-market interest rates graduated to favor low-income households. INFONAVIT accounts for around 60% of all mortgage finance. In addition to home lending, INFONAVIT forms part of the pension system for its contributing workers.

FOVISSSTE. This institution gets funding from a compulsory contribution of 5% of the salary of federal public-sector workers. It then uses these resources to extend mortgage finance for housing at below-market interest rates graduated to favor lower-income households. FOVISSSTE accounts for around 14% of all mortgage finance. In addition to home lending, FOVISSSTE forms part of the pension fund for its contributing workers.

Government owned

SHF. Created in 2002 as the successor to FOVI, the Federal Mortgage Society enjoys the backing of the faith and the credit of the federal government for 12 years in order to lead the development of primary and secondary market-rate home lending. SHF operates as a second-tier finance institution that provides liquidity and guarantees to first-tier lenders (mainly the SOFOLES currently). SHF accounts for around 11% of total mortgage finance.

FONHAPO. Historically this institution has served as the federal government's main support to low-income housing. Poor repayment on below market-rate loans made by FONHAPO to state and local housing institutes that on-lent these funds to low-income households led to this organization's near bankruptcy, from which it has now recovered. A presidential decree has given the organization – along with FONAEVI – the mandate to develop a unified housing subsidy system. Currently, FONHAPO's main program is Tu Casa.

FONAEVI. A division of FONHAPO. This entity will receive, account for, and disburse funds under the unified housing subsidy system, and currently performs this function for Tu Casa.

Privately owned

SOFOLES Hipotecarias. Following the withdrawal of banks in 1995, these specialized lenders have become Mexico's main source of private home lending. These institutions can make loans and raise debt on capital markets, but cannot accept deposits from the public.

Banks. Banks' participation in mortgage lending has had significant ups and downs. In 1982 the bank's naturalization extracted them from this market. Later, after 1990/1991, privatization came back aggressively, lending for housing acquisition. Thus 1992, 1993 and 1994 were record mortgage years for the banking system. Unfortunately, with the 1995 Tequila crisis, mortgage lending crashed and portfolios had to be significantly reserved. Since then, banks have shunned mortgages. Nevertheless, after the Tequila crisis the banking system became the property of the world's largest players, including Citigroup, HSBC, Scotiabank, BBVA and Santander. Thus attitudes toward mortgages, helped by government intervention, regulatory and tax efficiency measures, are improving.