

Development of the Market for Mortgage Loans in Chile

by Andrés Sanfuentes V.

CHARACTERISTICS OF MORTGAGE LOANS IN CHILE

The progress achieved in the mortgage loan system in Chile is due to several characteristics that have been shaping the system over time:

1. The early creation of the Readjustment or Indexation Unit, which has allowed the maintenance of the real value of assets and liabilities over long periods of time. As early as 1960, with the creation of the National Savings and Loan System (known as SINAP, its acronym in Spanish) and of the savings and loan associations (known as AAP, their acronym in Spanish), long-term mortgage loans could be granted without suffering the erosion of principal produced by inflation which, for decades, had eroded the effective recovery of the loan amounts. This system has also allowed the attraction of readjustable resources to finance the balanced expansion of the institutions involved.

Over time, the readjustment evolved from an annual basis to ever shorter periods of time. Now there are daily modifications through the so-called "Development Unit"

Andrés Sanfuentes V. is President of the State Bank of Chile.

(known as UF, for its acronym in Spanish), which reflects the inflation of the preceding month.

2. Lags between the terms for assets and liabilities are avoided. In granting most of the mortgage loans, the banks are mere intermediaries. They issue mortgage notes with a pre-established term, on behalf of the mortgage debtor, who sells them on the capital market to various financial agents who have long-term resources available, such as pension funds administrators (known as AFPs) and insurance companies.

In this manner, the problem that generated the collapse of the savings and loan system in the years 1974-1975 has been avoided. At that time, the savings and loan institutions possessed very long-term assets, while their liabilities could be withdrawn virtually on an immediate basis. The crisis was caused by a period of acute recession in the Chilean economy which generated serious liquidity problems for the AAPs.

3. The third characteristic is the existence of institutional savers that hold permanent resources during long periods of time, so as to be in a position to finance long-term loans. This was achieved with the creation of the pension fund administrators in 1981, as well as the entry of life insurance companies into this same field.¹ The quantity of the resources contributed by these AFPs

has been permanent and continues to grow, considering that the system has not yet reached its maturity.

4. The financial intermediation business, carried out mainly by banks, has now been separated from the construction activity *per se*, which has a different nature and risk. The linkage of the two was another of the causes that generated the AAPs crisis in 1975.
5. From the time when the indexation clauses were established, lending institution loans have earned positive real interest rates, both on the asset (mortgage loan) and liability sides. The rates are established mainly by the financial markets. In this way those who formulate and execute the housing and financial policies have prevented mandatory subsidies and undesirable income transfers.

MORTGAGE MARKET PARTICIPANTS

It is necessary to make the distinction between two main segments: Dwellings financed with state support and dwellings financed totally with private funding.

Housing with State Subsidy

This segment represents two-thirds of the total housing units built in Chile. The financing for this program has three components:

1. Savings prior to acquisition: The applicants must save resources over a certain term in special housing savings accounts. The accounts are opened in banks, financial institutions and housing cooperatives in "developing units," and they bear interest.

Number of Existing Housing Savings Accounts: 1,118,176 (Dec. 1995)

Aggregate Savings: US\$574 million (18.7M UFs)

Expected Savings, according to amounts agreed when the accounts were opened: US\$1.4 billion (45.7M UFs)

2. State Subsidy: The subsidy provided by the state is based on social and economic data, and specifically the savings previously set aside by the applicant. This non-reimbursable fiscal contribution finances between 5% and 60% of the house's value, depending on the type of program for which the applicant applies.

The purchaser of Social Housing, which has a maximum value of US\$10,000, is granted an additional long-term loan by the Ministry of Housing.

3. Complementary Mortgage Loans: These loans are requested by those who do not receive direct loans from the Ministry of Housing. They are originated mainly through the banks, and the terms range between 12 and 20 years. Most of these loans are granted by the State Bank of Chile. Because of the relatively small amount of each loan, there has been a lack of interest on the part of the private banks in granting them.

Bank funding is acquired in various forms:

1. By the issuance of mortgage notes for terms that closely match those of the loan extended. The notes are traded on the

Stock-Trade Exchange and are acquired mainly by the pension fund administrators and by insurance companies. This permits the matching of the banks' assets and liabilities, attenuating the funding risk. However, late payment by the borrower directly affects the results of the lender.

2. Sale of endorsable mortgage loans on the financial market, when the operation adopts this form.

Private Housing

There is no state intervention for upper- and middle-income housing financing. This activity is performed mainly by the commercial banks. The mortgage loans are granted by the banks through endorsable long-term mortgage notes issued by the financial institution itself. The credit risk remains with the bank during the whole term of the loan. The debtor sells the mortgage notes on the Stock-Trade Exchange at a price that depends on the market interest rates, as well as on the interest rate at which the notes were issued. The mortgage notes are purchased by institutional investors (AFPs and life insurance companies), as well as by other interested parties.

CHARACTERISTICS OF THE MORTGAGE LOAN PORTFOLIO

A brief summary of the existing mortgage loan portfolio in Chile can be made, based on certain indicators:

Average Value of Mortgage Loans:
US\$ 21,900

This total corresponds to 404,000 existing loans, covering a wide range from loans granted to high-income sectors through those houses acquired with state subsidies for low-income segments. The average value excludes loans channeled directly through the Ministry of Housing.

Terms for the Loans:
10, 12, 15 and 20 years

Types of Mortgaged Property

There are two types: for housing, with a mortgage on the house as collateral; and for general purposes, such as industrial or agricultural lands, offices, multiunit housing or similar properties.

Currency in Which Loans Are Granted

Development Units (UFs). The value of the Development Unit in November 1996 was 1 UF = US\$31.9.

The indexation or readjustment of the mortgage balance and of the mortgage notes value is performed on a daily basis and depends on the variation in the Consumer Price Index for the preceding month.

Loan to Value

In general, this ratio is 75%. This is the norm for the loans that complement the housing subsidy. Some banks finance up to 90% of the value of the house or asset to be acquired when its cost exceeds US\$65,000.

Delinquency Ratio

At present, the past-due installments (over 90 days overdue) based on the total outstanding balance of the mortgage portfolio reaches 0.3%. This indicator only includes those unpaid installments and not the total balance of the past due loans. This figure excludes operations partially financed with state subsidies, where the delinquency ratio is higher.

In the case of the State Bank, which accounts for nearly 40% of the investment in housing finance through the issuance of mortgage notes, the amount of unpaid installments reaches UF 1,494,224 on a grand total of mortgage placements of UF 63,810,483 (2.3%).

POTENTIAL GROWTH OF THE MORTGAGE MARKET

The total housing deficit according to the 1992 census was 740,000 houses. This deficit comprised 540,000 families that lived in rented housing, plus 200,000 that lived in housing with serious deficiencies.

In 1991, a process was started aimed at an absolute reduction of the deficit, by building more houses than the annual estimated growth in the number of families, which at present stands at around 88,000. The number of houses built during 1995 reached approximately 125,000 (see Table 1).

Table 1. New Construction

Year	Number of Units	% Change
1989	89,981	
1990	78,904	-6.0
1991	88,481	12.1
1992	105,669	19.4
1993	117,392	11.1
1994	118,627	1.1
1995	124,828	5.2

Source: National Statistical Institute

In the housing sector, various structural changes have been implemented or are in the process of being introduced. Those changes are expected to have a great impact over the long term. Among these changes, the most important include:

- Introduction of the Housing Leasing System in 1996, which is expected to provide a housing solution for those families with limited savings capabilities. It is estimated that this system will have a significant impact on the housing sector level of activity over the next few years.
- Extension of the state subsidies for used-dwelling purchase, given that previously

these were only applicable to the acquisition of new housing.

- Implementation of a new Institutional method as of 1996 which permits the Housing Ministry borrowers to sell their house and purchase a new one by transferring the mortgage guarantee to the new house without having to prepay the debt.
- The extension of the state insurance coverage for maximum loss to all subsidized programs.
- The opening of refinancing lines for private non-banking entities. This has started with a pilot program with AID funds.
- Legislation and complementary norms for the development of the mortgage securitization industry.
- Gradual replacement of the program of "basic dwelling," where the real estate activity is carried out by the state, with another program in which beneficiaries are free to select their housing solution and where the construction is done by the private sector.

The projections for the building of new houses for the 1996-2000 period are shown in Table 2.

If one takes into account the recent evolution in the mortgage market system through mortgage notes, one can observe a rapid growth. In fact, mortgage loans expressed

as a percentage of total loans granted in the banking system increased from 15.8% in December 1993 to 20.1% in December 1995. These figures include both loans for housing purchases, and loans granted for general purposes.

SECONDARY MARKET

In Chile, securitization is just beginning. The legislation for this business was approved in March 1994; the first securitization company was established in mid-1995.

The instruments currently authorized to be purchased by the securitization companies are: (a) mortgage notes and the mortgage loans, authorized by Federal Decree Number 252 issued in 1960; and (b) endorsable mortgage loans authorized by Legislative Decree Number 3,500 and Federal Decree Number 251. Also authorized are real estate lease contracts with purchase agreement (part of the housing leasing program) and other securities which may be authorized by general regulations.

The main source for mortgage financing has been the mortgage note. Although the law permits the securitization of this type of instrument, the feasibility of this procedure is not clear, given that these instruments—issued and guaranteed by banking entities—are directly purchased by the institutional investors. For this reason, securitization would not contribute additional value.

The potential in the mortgage market is associated with larger loans (on average,

Table 2. Projection for Housing Construction 1996-2000

	1996	1997	1998	1999	2000
Thousands of houses	137	149	160	171	172
MM 1994 US\$	2,547	2,753	2,976	3,223	3,416

Source: Ministry of Housing and Urban Works

exceeding US \$55,000), considering that there is an unsatisfied demand for these instruments on the part of the Institutional investors, particularly Insurance companies. Therefore, an important development for this kind of business is expected in the immediate future.

It is foreseen that a potential market for real estate lease contracts securitization will arise as a result of the housing leasing system development, considering the impact that it is expected to produce in the expansion of the low-income housing mortgages.

At present, the secondary mortgage market is based mainly on transactions of mortgage notes in the Stock Exchange.

OPPORTUNITIES FOR FOREIGN INVESTORS

The country is undergoing a period of significant change in the housing sector, including the creation of new instruments and economic agents. The economic outlook is favorable in the medium term, including real increases in per capita income, as well as a probable reduction in the cost of capital.

All these factors work together toward the expansion of the market. A larger number of new houses will be built, with greater surface areas and higher market values.

With respect to financing, there also will be an increase in the number of new originations,

greater than the growth in the number of new houses. This reflects increasing housing mobility in the middle-lower and lower sectors that will result in more than one mortgage loan or leasing operation per each subsidy that is granted. Similarly, the total value of mortgage loans will increase.

There are a number of new business opportunities that can be mentioned:

1. The potential development in securitization of low-income leasing contracts and mortgages.
2. The development of mortgage loan administrators (servicing companies).
3. Real estate companies focused on the housing leasing market.
4. Financing for real estate companies, necessary for the expected growth in the sector.

The future development of the mortgage market appears to be promising, not only due to the rapid growth of the Chilean economy and the progressive improvement in the population's per capita income, but also because of the need to overcome some existing deficiencies, such as:

1. The persistence of a significant housing deficit.
2. The ineffectiveness of the collection mechanisms during periods of economic

crisis or recession. The experience gathered during the 1982-83 recession period has led to the implementation of various courses of action to improve the performance of the sector:

- The transfer to the private sector of the servicing for the loans originated by the Ministry of Housing
 - The creation of a Stabilization Fund for Mortgage Installments, which triggers itself in periods of high unemployment, and
 - The insurance for unemployment.
3. The insufficient development of the market for second purchases of low-income dwellings.
 4. The low volume of securitization transactions.

These factors will make the Chilean mortgage market an interesting investment opportunity in the coming years.

NOTES

¹In 1981, Chile privatized its pension system. This reform led to a spectacular rise in its national savings rate, from 8.2% of GDP in 1981 to 27.6% in 1995. For more detail see the *Economist*, "Retirement Revolution," November 23, 1996.