The Mortgage Business in Colombia

by Guillermo Gomez

TYPES OF PLAYERS

Origination

Colombian financial legislation allows both commercial banks and savings and mortgage corporations to issue mortgages. However, the commercial banks, which were only authorized to perform these transactions in 1990 when the country underwent a thorough reform of the financial system, have a minor share (1%) of the outstanding mortgages. This means that the savings and mortgage corporations are the main mortgage lenders in Colombia. As a result, this assessment of the mortgage market is limited to a study of the development of these institutions.

The savings and mortgage corporations, also known as CAVs, were created in 1972, when they were charged by the government to be the sole administrators of the Upac (indexing) system (see Figure 1). This system, which was implemented the same year, is the basis for all the funding and credit operations conducted in constant purchasing power units, Upacs.

The goal assigned to the Upac system was the generation of the financial resources required to undertake a massive housing construction program. This was the main component of the economic development strategy of the government in power during that period.

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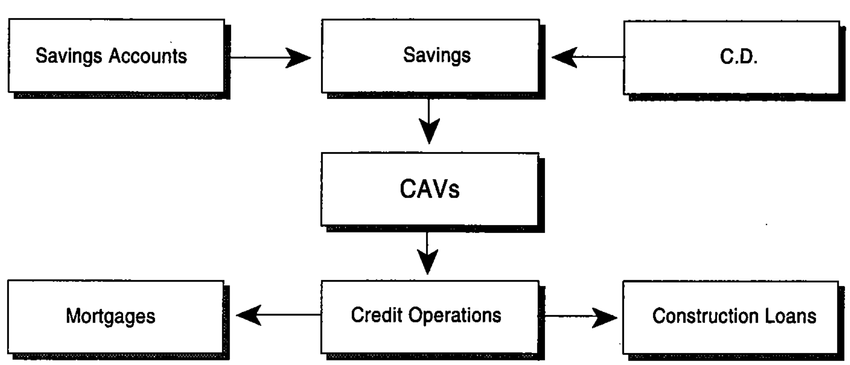
The legal obligation to use Upac savings solely for the issuance of loans either for construction projects or for real estate transactions brought about, as a result, the specialization of the CAVs in the mortgage business. However, the government, based on the 1990 financial reform, has progressively allowed CAVs to fund other credit operations. This diversification in services has allowed them to serve the financial requirements of people in a more comprehensive way. Recently, a government decision opened the way for CAVs to become mortgage banks, which is the likely direction to be followed by most of these institutions.

Figure 1. UPAC System

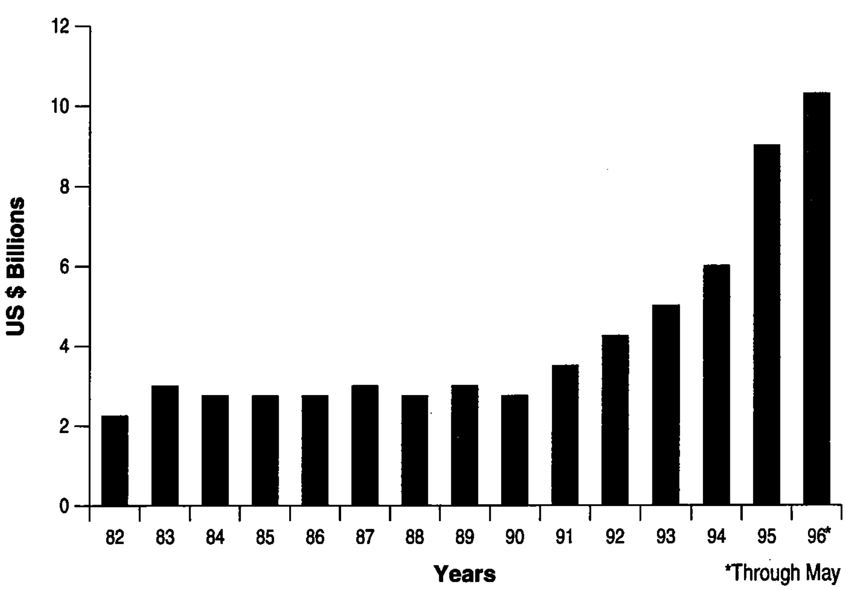


The 10 CAVs that were created in 1972 are still in operation, with one of them having been absorbed by its principal owner, the only mortgage bank which has operated in Colombia as such during the last 60 years. In Colombia, funding, mortgage issuance and servicing operations are conducted by the same organizations (i.e., CAVs), unlike what occurs in many other countries.

Funding

Funding for the CAVs comes mainly from the financial market, although in the last year the secondary market has become an additional source of monetary resources.

Figure 2. Savings Deposits

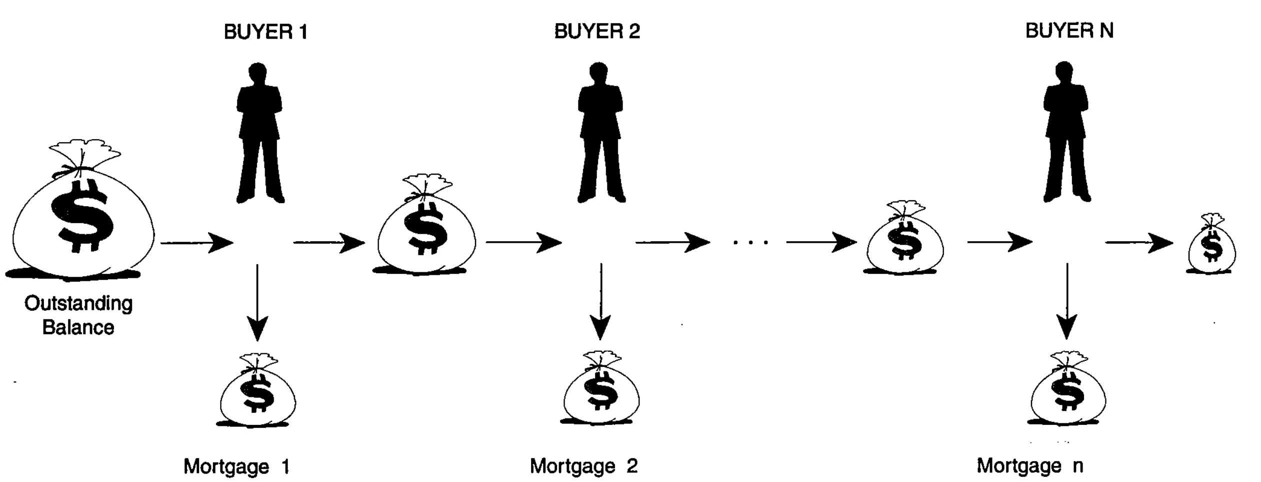


Total deposits for CAVs are equivalent to approximately US$10 billion (see Figure 2). This amount gives CAVs a 35% share of the total national financial resources. This share has not changed significantly in the last five years, despite two facts: the market's increasing competitiveness and the removal, in 1990, of the protective provisions that the CAVs had enjoyed since their inception.

Servicing

Each CAV services all the mortgages it has issued. The debtor makes monthly payments, either at branches or at ATMs throughout the country. Currently, CAVs have in operation 1,300 branches and 1,350 ATMs. This amounts to an average of 130 branches and 135 teller machines per CAV.

Figure 3. Construction Loans—Payment Characteristic



SIZE OF THE MORTGAGE MARKET

Number of Originated and Outstanding Mortgages

CAVs have issued close to 1 million mortgages during their 25 years of existence. At present, there are 660,000 outstanding mortgages.

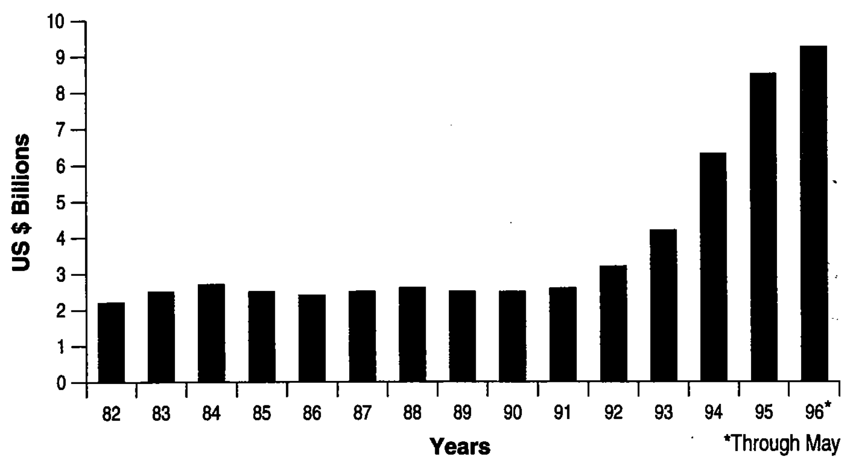
Real estate financing in Colombia includes two types of credit operations: construction loans, which are short-term credit tools to assist developers with the financing necessary to undertake their projects; and mortgages, which are long-term instruments that allow buyers to purchase both housing and commercial real estate.

Construction loans have a special feature which makes them very appealing. This characteristic derives from the option developers have of not paying back their debts in money, but rather by transferring loans to eligible buyers of individual properties. From a financial perspective, this particular payment arrangement implies that mortgages originate when the CAVs and the developers conclude the construction loan contracts, instead of when the CAVs lend money to assist buyers with the financial resources required to purchase the real estate assets (see Figure 3). Consequently, CAVs take advantage of the promotion and sales efforts conducted by the developers, because as soon as a buyer is identified and approved, a CAV automatically receives a customer for the mortgage.

Value in US$

The value of CAVs' outstanding mortgages exceed US$9 billion. The way such a value has varied during the last 15 years is shown in Figure 4. This exhibit illustrates that after having fluctuated between US$2 and US$4 billion, the value rose to the US$9.3 billion level, after undergoing an impressive growth in real terms. The highest rate was achieved between June of 1993 and the same month a year later, when it reached the 46.4% level.

Figure 4. Mortgage Assets



GENERAL CHARACTERISTICS OF THE COLOMBIAN MORTGAGE PORTFOLIO

Average Value

The average loan balance of the mortgage portfolio is approximately US$12,000 and that of the construction loans is close to US $500,000. However, the average value of the mortgages that are being issued at the present time reaches the US$20,000 level, making it higher than that of the portfolio. Mortgages are usually issued for an amount of money not higher, on average, than 70% of the asset price.

Average Term

Most often, mortgages in Colombia are issued for 15-year periods. Nevertheless, the average term fluctuates between seven and nine years. The reason for prepayment of loans is that the monthly cash outlays grow at a lower rate than does the income of the debtor (see Figure 5). So, as the purchasing power the debtor increases, it provides him with the possibility of changing the real estate asset for one that is larger or with higher quality, or both. Since the change is dependent on the sale of the old unit, the outstanding balance of the mortgage must be paid in full as soon as the sale is closed.

Types of Mortgages

There are two kinds of mortgages in Colombia: housing mortgages, which are for the purchase of residences, and commercial mortgages, which are issued to those acquiring commercial real estate (see Figure 6). Although the legal framework for both types of mortgage is similar, the financial terms are different.

In the case of housing mortgages, the average interest rate currently stands at monetary correction, MC, an index defined below, plus 15%, which in pesos is currently equivalent to 42.6% annual effective rate. Since the rate of

Figure 5. Personal Income/Mortgage Monthly Payments—Accumulated Growth Rates

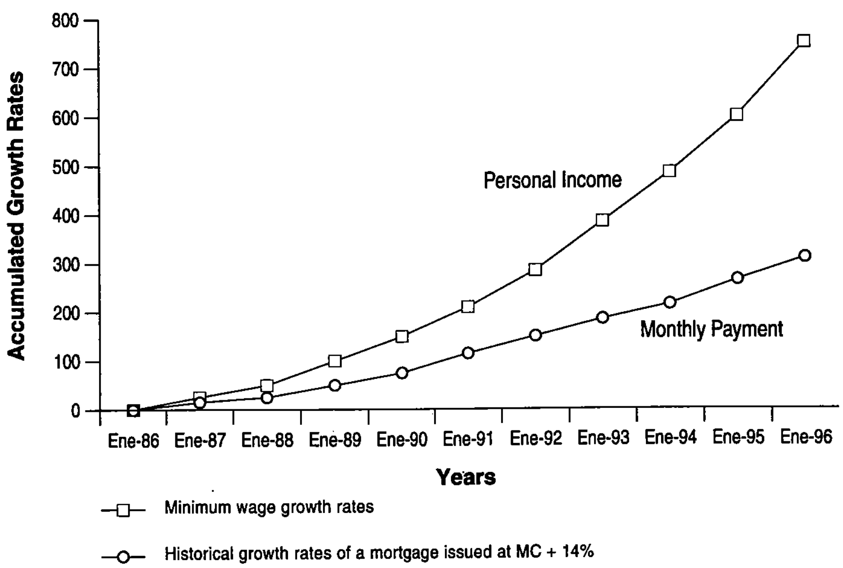


Figure 6. Types of Mortgages

Types	*Interest Rates*	
	Mortgages Issued in UPACs	*Mortgages Issued in $*
Housing Mortgage		
Lending Rate	M.C. + 15%	D.T.F. + 7.5%
Effective Rate $	42.6%	42.4%
Effective Rate US$	24%	23.8%
Commercial Mortgage		
Lending Rate	M.C. + 18.5%	D.T.F. + 11%
Effective Rate $	47%	47%
Effective Rate US$	27.8%	27.8%

M.C. = 24%
D.T.F. = 32.4%
Devaluation Rate = 15%

devaluation has been fluctuating around the 15% mark, this represents an interest rate of approximately 25.6% in US dollars.

Commercial mortgages have an average interest rate of MC plus 18.5%, which at the present time amounts to 47% in pesos and 29.5% in dollars. The term of these mortgages is usually eight years.

Currency or Unit of Mortgage Issue

Most mortgages are issued in Upacs. The Upac was created in 1972 as the core of the Upac System. By that time, the country's total savings were relatively small, due to low interest rates that made the return on saving deposits negative in real terms. As a result, any increase in the level of savings depended to a great extent on neutralizing the damaging effects of inflation. This was accomplished through the adoption of the Upac mechanism.

At its inception, the Upac, which had a starting price of $100 Colombian pesos, would adjust its daily price according to a specified index, (the monetary correction or MC), which depended on the variation of the consumer price index. Since then, a special charter of the Central Bank has provided the monthly MC values.

The basis for calculating the MC's value has been re-evaluated frequently. In the current formula, MC values do not depend on variations of the consumer price index. At present, changes in the value are pegged to the behavior of the CD market rate, known as DTF rate. By June 30, 1996, the Upac's value was $8,850.

CAVs are also legally authorized to issue loans in Colombian pesos. When this occurs, the interest rate is the result of increasing the DTF rate by 7.5%, which is closely equivalent to the rate of Upac mortgages.

Loan to Value

According to studies conducted by Fedelonjas, the Colombian Association of Realtors, the average value of real estate transactions in 1995 was approximately US$26,000. Therefore, if the average value of mortgages is US$12,000, the relationship between loan and value is 46%.

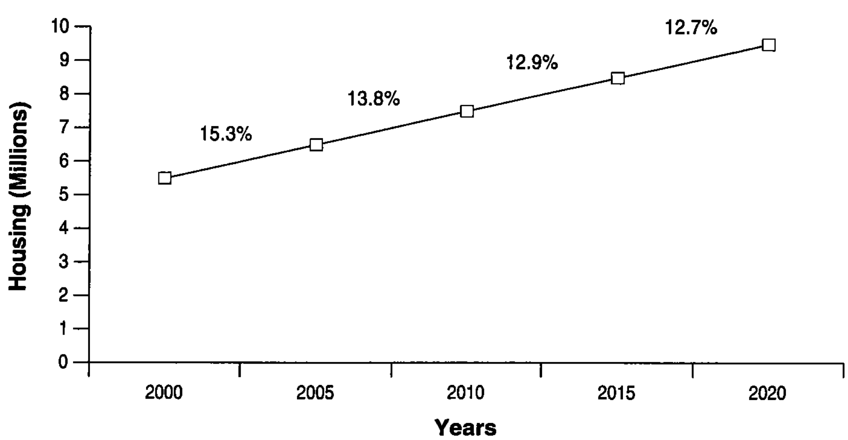
Rates of Delinquency

For June 1996, balance sheets showed that 0.2% of the outstanding mortgages had a delinquency between one and four monthly payments. Additionally, 3.5% of those mortgages had a delinquency of four or more monthly payments and are classified as being in default. These statistics are viewed as accurate, since the legislation mandates that for mortgages delinquent four or more monthly installments, the whole loan is classified as in default, both the outstanding capital and the unpaid interest, instead of only the amount of the late monthly payments, as in the case of delinquencies less than four months (see Figure 7).

Figure 7. Mortgage Portfolio—Deliquency

Number of Monthly Payments in Default	*Amount in Default*	*Deliquency Rates*
Less than 4	Total value of payments in default	0.20%
4 or more	Outstanding balance plus unpaid interests	3.5%

Figure 8. Total Housing Growth Rates



Source: National Department of Planning

MORTGAGE MARKET POTENTIAL GROWTH

Population Growth Rates

Between 1985 and 1995 the Colombian population grew by 21%, from 30 million inhabitants to over 36 million. Preliminary estimates provided by the National Department of Statistics, DANE, show a progressive decrease of the population growth rate from 9% in the period 1995–2000 to 5.2% by the years 2020–2025. At that time, the total population should reach 54 million inhabitants.

Demand for Housing

According to preliminary studies conducted by the National Planning Department, the number of homes will double by the year 2020, when the total number should reach 9.5 million units. Therefore, over the next 25 years, it will be necessary to build 4.6 million new residences, which in and of itself, represents an enormous challenge for the country, but mainly for the financial system, which will be responsible for providing the capital resources necessary to meet this goal (see Figure 8).

Market Trends

Existing data indicate the extent to which the mortgage market will have to reach in the near future to satisfy the demand. Potential growth increases even further when taking into account the fact that only 10% of the existing homes have an outstanding mortgage. This means that 4 million families may become customers for credit either to remodel or improve their current homes. Even if, hypothetically, 75% of those families were not eligible for a loan, due to substandard quality of the properties they own, at least 1 million homeowners could qualify for additional credit. This is not a negligible quantity.

SECONDARY MARKET

Securitization Developments

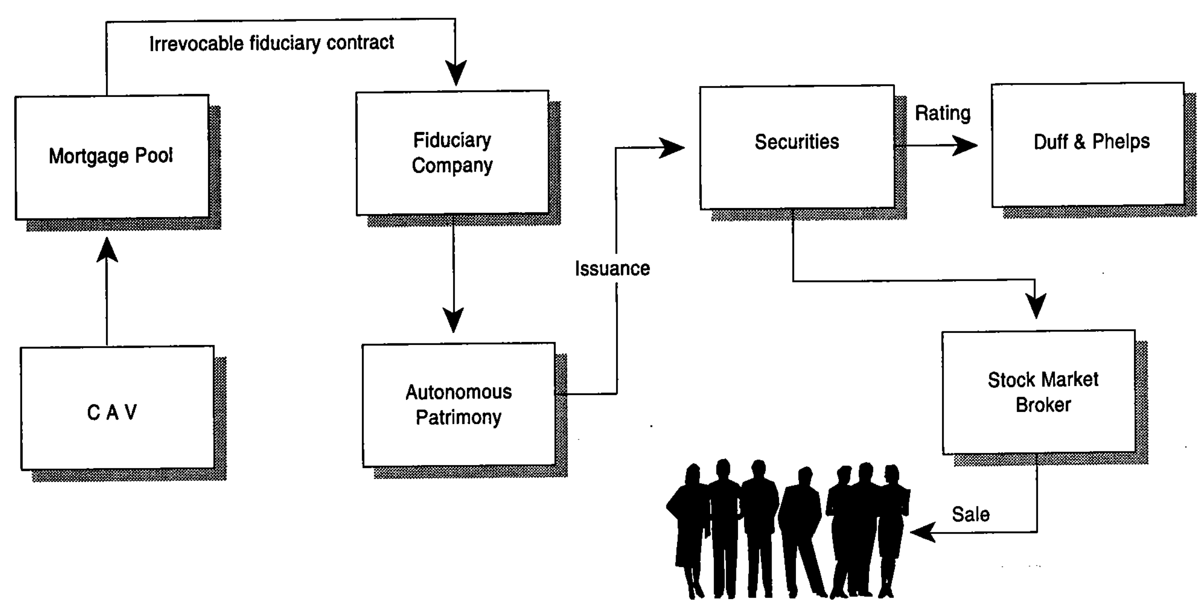
Development of securitization started in Colombia in early 1995. Since then, the CAVs have successfully carried out six offerings of mortgage-backed securities, for a total amount of US$250 million.

The steps of the securitization process are as follows (see Figure 9):

1. The CAV interested in the process chooses the set of mortgages that will back the securities.
2. The CAV transfers the set of mortgages to a fiduciary company, using not the common sales contract but a legal figure known as "irrevocable fiduciary contract." The irrevocable fiduciary contract rules establish that the fiduciary company must keep the set of mortgages out of its own assets. To do this, the company must create an "autonomous patrimony" in order to protect the set of mortgages against the risk of being damaged by any sort of business problem the fiduciary company could incur. On the other side, the CAV cannot, under any circumstances, retake the property of the mortgages, at least until the liquidation of the fiduciary contract. The legal figure of our autonomous patrimony is very similar to what is known in the United States as the special purpose vehicle.
3. The fiduciary company issues the securities, immediately after the autonomous patrimony is created.
4. The securities are then qualified by an authorized rating agency.
5. Subsequently, the securities are sold in the stock market and the total sales price is transferred to the CAV.
6. The CAV continues to do the collection of the mortgagors' monthly payment, which is then transferred to the fiduciary company.
7. The fiduciary company pays interest and capital to the investors, according to the terms of the specific security.

Duff & Phelps, the only rating agency established in Colombia so far, has rated all the securitization transactions thus far with a AAA grade.

Figure 9. Securitization Process



Future Trends for the Secondary Market

The future for the secondary mortgage market depends mainly on the existence of real investors, because the capacity of the CAVs to issue mortgage-backed securities is greater than the capacity of the stock market to find investors. In fact, CAVs have securitized only 2.24% of their total mortgage portfolios.

So far, the Colombian stock market is still considered to be relatively small. Pension funds, which have been the major investors in mortgage-backed securities, are the most important potential clients. However, their current investment capacity is still too low, as a result of their relative youth. There are other investors, but they do not have much capacity to absorb the core of a securitization process. Therefore, pension funds (with the possible addition of foreign investors) will determine the secondary market's path.

OPPORTUNITIES FOR FOREIGN INVESTORS

Before addressing this subject, a quick glance at the macro economic conditions of Colombia is necessary (see Figure 10).

The exhibit shows the major indicators of the Colombian economy, which is in a very healthy condition. The favorable statistics illustrated improve even further when taking into account the fact Colombia has been rated with a BBB- grade or better by both Standard and Poors and Moodys, the major rating agencies of the United States. As in any other open economy, foreign investment is welcomed and investors are allowed to export profits with no restriction. Additionally, the constitution provides foreigners with the same rights as nationals. All this makes Colombia a very appealing country to invest in.

For the purpose of facilitating foreign investment in stock market securities, the government has implemented a very efficient mechanism, known as "foreign investment funds" (see Figure 11). These funds, which can be organized either within the country or abroad, may take one of the following three forms depending on the structure of their resources: (1) Individual funds, when those resources belong to a single owner; (2) Institutional funds, when the resources come from a public issuance of shares abroad (i.e., mutual funds); (3) Omnibus funds, when the resources are a set of collective accounts, administrated by an international broker, in which each account is managed separately. At the present time, there are at least 150 foreign investment funds operating in Colombia.

In the specific field of real estate financing, there are several investment opportunities. First of all, the mortgage securitization process offers a very attractive alternative for foreign investors, mainly Americans, due to the fact that the securities can yield returns on capital of over 20% in US dollars. This is not easily achieved in other countries.

Second, soon there will be another highly attractive investment possibility. The government is very interested in encouraging securitization developments; as a result, it is developing a legal framework that will enable the participation of CAVs in the capital of conduit companies. This currently is not allowed. CAVs have a keen interest in receiving this authorization, because they see conduit companies as an excellent mechanism for improving the efficiency of securitization in Colombia. Therefore, finding foreign investors with experience in this specific business will be one of CAVs' priority goals in the near future.

Finally, investors interested in participating in the CAVs' capital or in a capacity to offer the latest technological improvements for the mortgage business, will find a very fertile ground for their efforts.

Figure 10. Macroeconomic Major Indicators—1991–1996

	1991	*1992*	*1993*	*1994*	*1995*	*1996 (Estimated)*
Inflation	26.8%	25.1%	22.6%	22.59%	19.5%	20%
Devaluation	11.2%	16.7%	8.8%	3.1%	18.8%	15%
GDP Growth	2.1%	3.5%	4.7%	5.2%	5.3%	3.5%

Figure 11. Types of Foreign Funds

Individual	Resources of one individual or entity
Institutional	Resources coming from issuances of shares in foreign countries, i.e., mutual funds.
Omnibus (Collective accounts)	Resources coming from different investors which are separately administered by an International Broker