Broadening Access for More Affordable Housing: Challenges and Opportunities in Mexico

by Manuel Teodoro Campos Spoor

In Mexico, new organizations known as SOFOLs (Sociedad Financiera de Objeto Limitado or "Limited Scope Financial Society") are taking a lead role in providing affordable housing. Su Casita is a 30-month-old company, basically a start up, and is owned by six of Mexico's largest home developers and company management.

Last year, our partners bought and sold over 26,000 houses throughout Mexico. In our short life we have originated over 7,000 loans, an average of 500 a month during the last 10 months. We have 90 people working in 10 cities, and our current mortgage portfolio is $100 million.

The SOFOLs are new in the market, and we have gone from having no market share in 1994 to having over 50% market share. There are 10 SOFOLs in addition to Su Casita in the market.

Su Casita has been reaching markets not traditionally served by the private financial sector; half our loans are made to families with an income of less than $340 a month. We are a for-profit organization and our return on equity over the last three years has been 40% in dollar terms, so our partners are happy. Our delinquent portfolio is one-fifth that of the commercial banks, notwithstanding the Mexican financial crisis.

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LOCALIZING GLOBAL TRENDS

The major themes of today are the international trends of globalization, information and securitization. In Mexico and Latin America, these trends are evident, too, particularly in the area of securitization. Colombia has already securitized over $250 million in mortgage loans; Argentina is working on its third deal; and Brazil is starting its first securities company, a venture in which the private sector is very interested. In Chile, 85% of the homes are financed through the securities market; and in Mexico, we hope to have a first deal next year.

Securitization is important not because it can produce a profit but because it can help us to provide access to all the consumers in the market. The challenge our housing sectors face is to leverage the international trends in our countries so that mortgages are as common as Coca-Cola.

Mexico has a huge demand for housing and therefore for mortgages. Each year 720,000 new households are formed. The housing sector in Mexico generates only 220,000 new houses; the rest of the demand (more than 500,000 units) is covered through the informal sector. Houses are being built, with or without the government and the private sector. The informal sector leads to squatting and overcrowding. Squatting (Invasiones) is a mechanism where people squat (normally organized by a leader) and build substandard houses without the basic services. Demand is also covered by having several families live in one house, which results in overcrowding (Hacinaniento).

CHALLENGE FACED BY THE FORMAL SECTOR

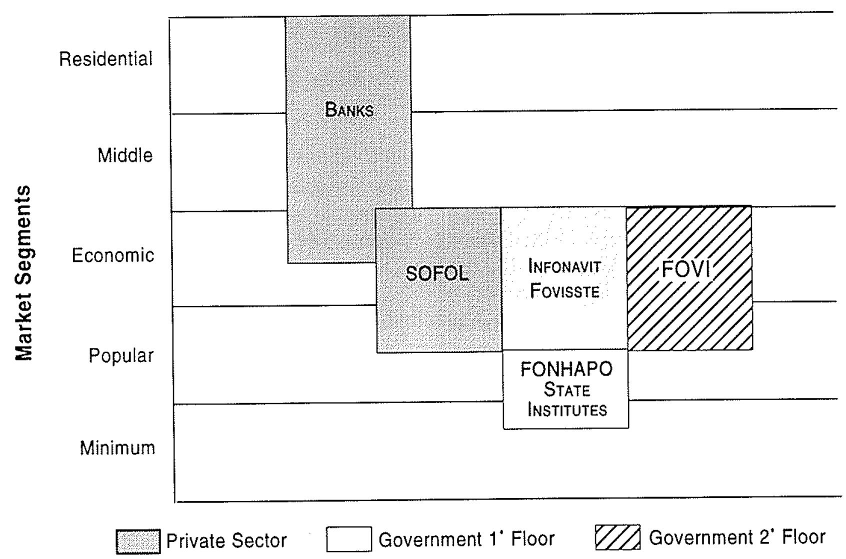
The challenge we face in Mexico is to incorporate the formal housing finance and construction sectors into the ongoing process of providing affordable houses to Mexican families.

The housing finance sector needs to provide between 800,000 and 1 million mortgages a year to finance the existing demand. In 1996 the housing financial sector covered 26% of that need. Even in our best year, 1994, the sector just covered 47%. The national mortgage portfolio is around 10% of GNP. Why this huge deficiency? To answer that question we need to understand the market (see Figure 1).

Figure 1. Segmentation of Families in México and Value of the House Purchased

Market Segment	*Percent*	*Number of Families*	*Average Value of House*
Residential	1.5%	270,000	$120,000
Middle	3.5	635,000	45,000
Economic	8.0	1,450,000	22,000
Popular	22.0	4,000,000	14,000
Minimum	65.0	11,006,000	6,200

Figure 2. Institutions Serving the Different Market Segments



Source: SOFTEC-DIME

The mortgage market in Mexico can be divided into five market segments. The "residential" market segment contains those who earn over $100,000 a year, and they constitute 1.5% of the people. Normally, they are well served. The "middle," which is 3.5% of the population, can be understood as middle class. The "economic" segment is people who can buy a $22,000 house; they amount to 8.0% of all families. The fourth segment is the "popular" housing market segment, 22% of the total. The fifth and largest segment is the "minimum." This market segment is made up of people earning minimum wages or less; some 65% of Mexico's population belong to this segment. Throughout Latin America you will find a similar distribution of income.

In Figure 2, we can see who serves each segment. Obviously, commercial banks serve the top segments. (Bankers lend money not to those who need it but to those who already have it.)

The economic and popular market segments are served by SOFOLs and banks using development bank funds. Su Casita is in these two market segments. Funding to this market is provided by government agencies like INFONAVIT and FOVISSTE, and second-tier banks like FOVI.[1] The minimum market segment is being served by government institutions and state housing agencies.

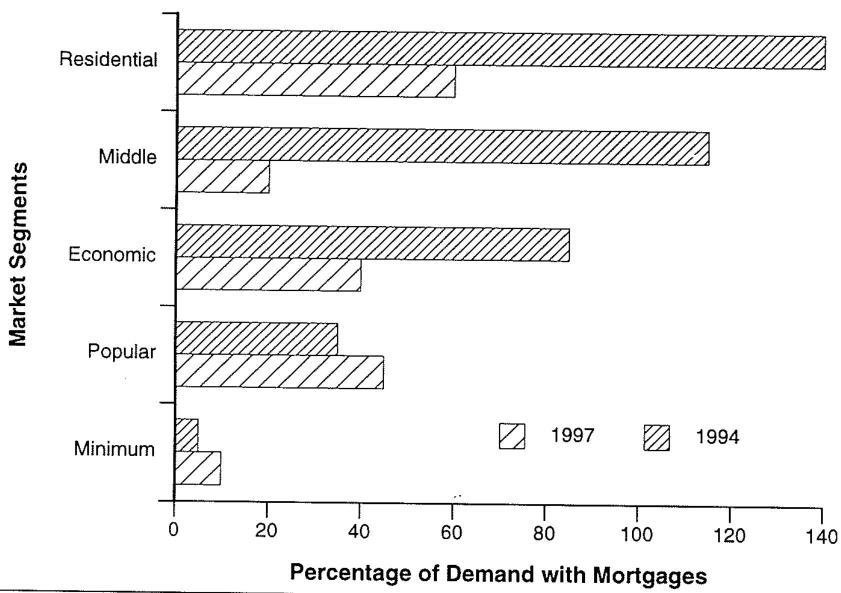
How well are the different market segments being served? To measure this we have developed an indicator called "market satisfaction" (see Figure 3). It measures the number of mortgages provided against household formation. A 100% market satisfaction indicates that all new families have access to a loan; there is no housing deficit. A <100% market satisfaction indicates there is a need for more mortgages, so the housing deficit increases. The deficit will decrease when market satisfaction is higher than 100%. In Latin America, only Chile and Costa Rica have reached a 100% market satisfaction. Market satisfaction in the United States is almost 200% which is explained by the strength of the used housing market.

In Mexico, market satisfaction reached 47% in 1994; but as a result of the crisis, this number is now down to 27%. The upper end of the market has been well served, reaching a 140% market satisfaction. But the minimum market segment is underserved, and in 1994 the supply of houses provided through the formal sector represented less than 5% of demand.

THE MARKET TRENDS

The 1994 economic crisis has helped to redefine the Mexican housing market. New financial intermediaries have appeared and

Figure 3. Market Satisfaction (Supply/Demand)



consolidated, namely, the SOFOLs. Because the banks withdrew from lending in the housing market, Su Casita and the rest of the SOFOLs have been able to grow with less competition. Banks have announced they will re-enter the market next year with programs for the middle and residential markets.

During 1995 and 1996 the government's main focus was the development of borrowers' support programs in order to solve the huge delinquent portfolio (30%) problem. When you have 10 people having problems, that's their problem; but when you have more than a million people having problems with their mortgage payment, it becomes society's problem. The delinquent portfolio resulted from the 1994 crisis, when interest rates increased up to 400%, unemployment doubled and the purchasing power of salaries decreased in real terms. Mexico will invest 12% of GNP in borrower support programs.

In 1997, the government has increased its support and focus to the lower end of the market. An example of this is the PROSAVI program geared to families with incomes equivalent to two-to-three minimum wages; they cannot make the payment in the traditional social interest housing programs. To bring the monthly payment down and reduce the risk, the loan balance is brought down with a onetime, up-front subsidy which complements the borrower's downpayment. Similar programs have been successfully implemented in Chile, Costa Rica, Colombia, and Ecuador.

Another interesting development in Mexico is the restructuring of the pension fund system. Up to 13% of the national payroll now gets deposited in a private pension fund system. In the first year the contributions will be about $4 billion; in the next 35 years it is going to manage over $150 billion dollars which can only be invested in long-term, Mexican securities. The challenge for the housing finance system is to create investment-grade mortgage-backed securities so that the resources in the pension system can be invested in housing.

The market has started to recuperate, particularly at the lower and upper ends; but market activity will not reach the '94 levels until the year 2000. We are emphasizing a savings program, and mortgages for existing houses are very important. Interest rates in Mexico are going to be higher than the rates in the United States; they should be, as we are more of a risk.

There is an opportunity to grow by providing mortgages for the popular and minimum market segments. The mortgages generated should be ready to be sold in the secondary mortgage market.

SU CASITA'S MISSION

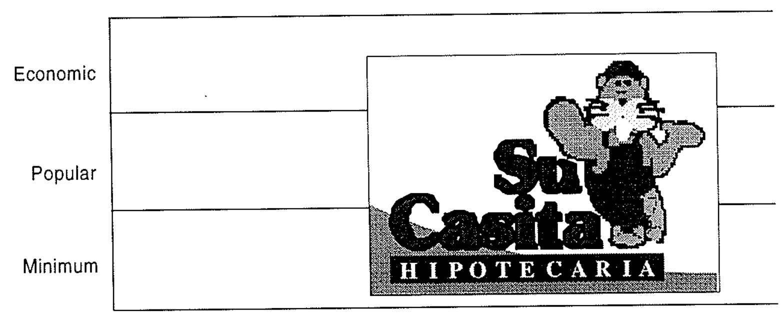
We want to be the financial agent of the Mexican family. Although we have been talking about low income, in Mexico even someone who earns three minimum wages is the middle class. So, our target market is middle class (see Figure 4).

Our second mission is to provide investment-grade mortgage-backed securities to pension funds and institutional investors. We are the link between two markets: borrowers and investors. We have to learn how to talk to both of them, because they are afraid. We have to be the bridge; that's our main function. We also want to make money.

CHALLENGES FACING THE MEXICAN HOUSING FINANCE SYSTEM

The challenges to the housing system are similar in all countries. First, how do you provide affordable houses? In Mexico, population growth has created a market opportunity which is limited because there are no

Figure 4. Su Casita's Target Market, the Mexican Middle Class



qualified borrowers. To take advantage of this market opportunity, we have to be able to build houses to match the borrower's purchasing power. Su Casita's business is to provide affordable loans.

Second, to provide affordable housing, a system which will provide enough affordable loans to meet the market demand has to be created. The loans have to be originated at market rates. They have to be serviced in a profitable way, and they have to be saleable in the secondary market.

In order to increase affordability, rates have to be reduced. To achieve this, the lending risk, both real and perceived, has to be reduced. We have to develop credit rating procedures applicable to lower income segments. This is something we can share with better developed countries.

The system must emphasize contact with the borrowers. The loan is not a one-time transaction; it is a 30-year relationship between the borrower and the financial intermediary.

Third, we must standardize forms and procedures. This is something that sounds simple, but it is not. Normally, vanity has ruled—"my form is nicer than yours." The only reason we want standard forms is because it reduces risk. With standardization it is easier to sell and to transfer.

Fourth, we must improve foreclosure procedures. Sometimes people will not be able to pay, and if we don't have a good foreclosure process, then the good borrowers who are paying will pay for the bad who are not.

Fifth, we have to develop mortgage insurance. Until now lending risk has been managed in a simplistic way. Banks are required to put up capital, and the regulators hope that there is enough capital to cover losses. The cost of capital increases the rate and reduces affordability. Mortgage insurance provides a better mechanism to measure and price credit risk.

Better information has to be provided to investors; hard data has to be used to change investors' perceptions. For example, there is a perception that "poor" people represent a higher credit risk. It is sometimes difficult when making investment decisions to understand how somebody who earns an income equivalent to what the investor will spend on a dinner can live on that money. The investor, therefore, perceives a high-risk borrower. Our experience in Mexico is that people with less income can pay, and they want to pay. Why? To get a house.

What is the government's role in the housing system? Our point of view is that it shouldn't be a competitor. We haven't been able to deal with all the market segments because it is very difficult to be competitive with someone who is giving money away. The government should be a promoter; it should help us grow; it should be a guarantor, thereby reducing perceived risk.

BUILDING HOUSES

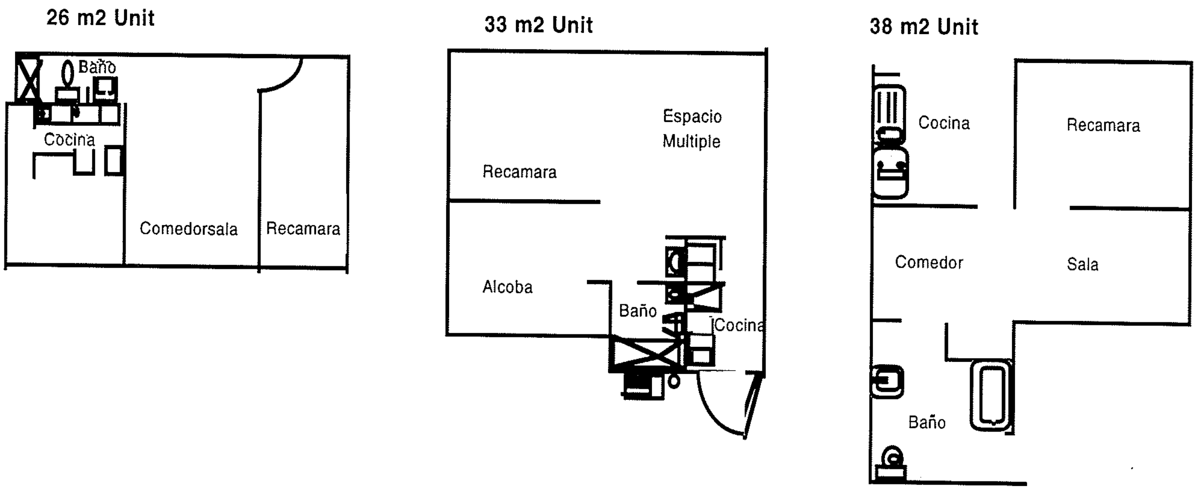
One of the good things that changed in Mexico because of the crisis is that traditionally developers had only been working with residential, middle and lower parts of the market. When they built in the lower end of the market, they were basically building as contractors for the government. The government programs were defined to meet "social" rather than economic criteria. Larger houses than consumers could afford were built.

But in 1994 the crisis overwhelmed the middle and upper income residential markets in Mexico. We stopped building. The developers, then, had a very good incentive to go to the lower end of the market. It was the only game in town. They either built cheap houses or they went on vacation.

As a result, the price of the entry level house in Mexico has gone down 30% in the last two years from 130 minimum wages, which is roughly $17,000, to 100 minimum wages ($13,000). Not only that, but due to competition, the house products we're financing today for low-income households, are much better than those we had a few years ago. It is not a result of government regulation; it's just a result of competition among the developers.

Su Casita is currently financing houses whose prices vary from $7,300 to $17,500

Figure 5. Examples of Houses Financed by Su Casita

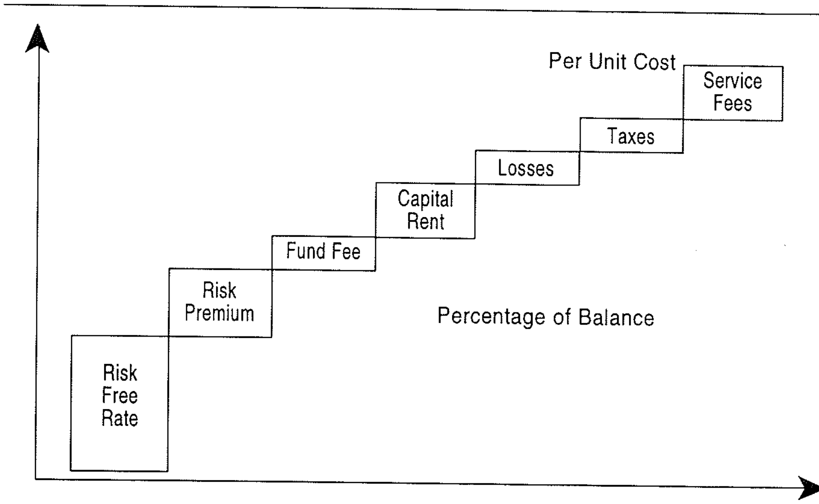


and whose sizes range from 22 to 65 square meters (see Figure 5). For a 26-square-meter house the borrower has to make a monthly payment of $22. The 33-square-meter house has a monthly payment of $48 a month. Most of the houses we finance can be enlarged to twice their initial size.

PROVIDING LOANS

Developers in Mexico are building affordable houses. The next question is, Can a small loan be both profitable and affordable? Lenders don't set the rates; they are just middlemen. Where do the rates come from? They are based on the market interest rate, Su Casita's funding premium, capital rent, losses, taxes and the servicing fee (see Figure 6).

Figure 6. Components of Mortgage Interest Rate



The servicing fee is a per unit cost. The other costs are a percentage of the balance. It costs the same to service a small- or large-balance loan, so if the rate paid by consumers is the same regardless of the balance, larger loans are more profitable. That is why lenders go to the middle and residential part of the market. Higher profitability in middle-income housing loans means that we can make more loans without losing money. Also, in middle and residential segments commercial banks can do cross selling.

As can be seen in Figure 7, the rate on a B1 house, which is roughly a $15 thousand loan, should be 12%.[2] The rate for a PEC-1 unit, with a loan of $5,200, should be 14% in order to be as profitable. Affordable housing

Figure 7. Spread Per Loan Type

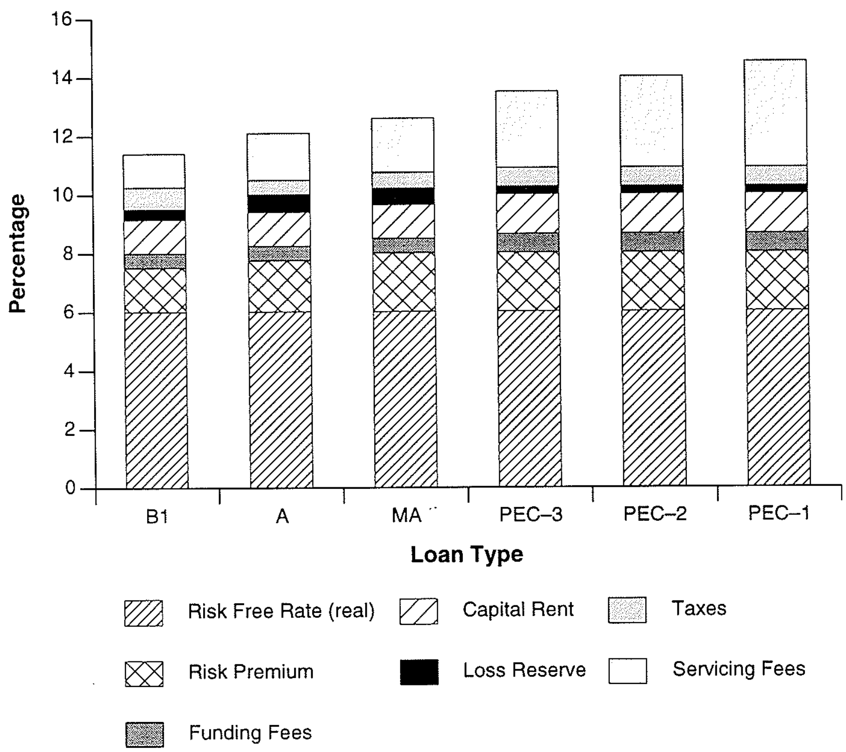


Figure 8. Actions Taken to Reduce Serving Cost and Credit Risk

Action	*Servicing*	*Risk*
High Volume (loans and concentration)	x	
On-site Collection	x	x
Shared Technology (forms and procedures)	x	x
Usage of Existing Infrastructure	x	
Government Guarantees (*) and other		x
Self-regulation		x
Complementary Services	x	

loans should be more expensive than middle-income loans, but politically this is a difficult argument to defend; "You have to pay more because you're poor" doesn't sell well.

In order to serve the lower-income market profitably, Su Casita has tried to reduce costs. One of the reasons Pulte invested in Su Casita is that we were looking for a United States partner who would help in the transfer of technology to Mexico.

To be able to serve the low-income market, high efficiency is needed. The servicing fees in the U.S. are probably 1/4 of a point, but the average loan is $100 thousand dollars. That means you get $250 per loan. In Mexico's FOVI's program we get around $180 per loan. In Figure 8, some of the actions instrumental to reduce the costs of Su Casita are listed.

A high volume of loans reduces servicing costs because economies of scale can be exploited. Concentration also reduces cost: rather than have 100 loans throughout the city, have 100 loans in one place. It is easier to service them and collect the money. On-site collection reduces both the servicing costs and risks, as does shared technology between industry participants. Usage of existing infrastructure and complementary services helps lower servicing costs, while government guarantees and self-regulation lower risk.

There are big economies of scale in the business. An MBA study just published shows that the servicing cost per loan goes down from $200 if the portfolio is less than $2 billion to $80 if the portfolio is over $20 billion. Also, if there is geographical concentration—for example, if I have 400 loans in one place—for the price of postage stamps a person can be on-site full time. The concentration makes it easier to service and more efficient.

We also want to become a significant provider of mortgages for large developers because that is part of the alliance we're developing–a business alliance with our developers.

ON-SITE COLLECTION PRACTICES

On-site collection means we want to be close to the borrower; we want him to be friendly. Most of them are very afraid of financial institutions. The only thing we know is that in the course of 30 years they will have problems, so the better they communicate with us, the better we can work together and reduce the risk.

On-site collection will facilitate payment collection. At Su Casita we receive payments on Saturdays and Sundays up to 8 P.M. The benefits of this approach are illustrated in Colombia, where the savings and loan organizations have put a branch next to a discotheque; they get a huge proportion of their deposits on Friday nights, because people will go out with the money from the office to go dancing, and on the way, deposit the money.

We practice what I call "mass customization." Rather than telling people this is the only way they can pay, we have to provide them with a menu and say, "How do you want to pay? Payroll deduction or having someone come to the house and pick the money up?" In all countries there is garbage collection; if money can be made collecting garbage, then it can be made collecting money.

Figure 9. Development and Usage of Shared Technology

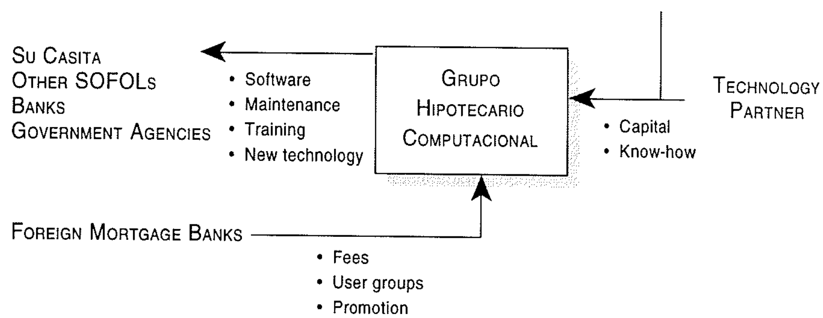
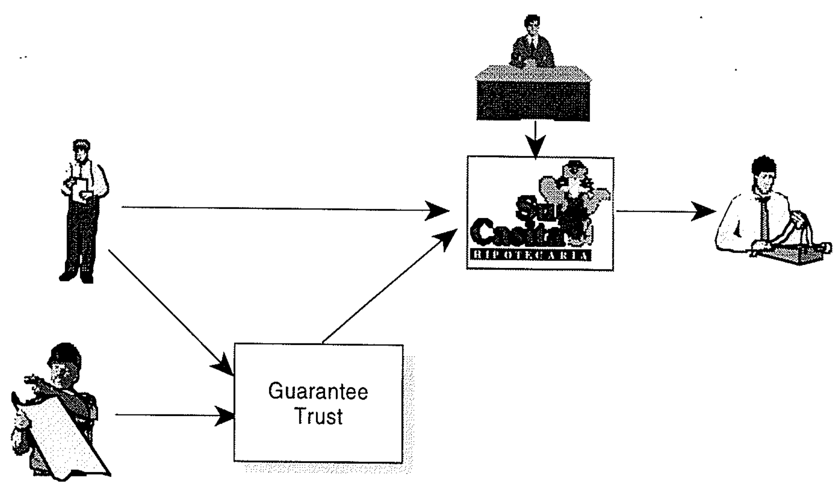


Figure 10. Reduction of Risk Through Self-Insurance Guarantee Funds



SHARING TECHNOLOGY

Another important part of the business is shared technology. When we started, because we were new, all of the SOFOLs decided that rather than each one of us having our own computer system, we were going to work on having one computer system. This seems like a very commonsense idea, but it has been revolutionary in Mexico.

There are banks in Mexico where they have four different computer systems within the same bank. The 10 SOFOLs, two banks, government agencies, and now lenders in Ecuador and El Salvador share the same computer system, and we are all investing in the computer company (see Figure 9). We formed a company where we have a technology partner, who puts in know-how, and we pay fees and put in the capital. We are working on software development, maintenance, training and technology. This also has helped us standardize because we have the same computer. It facilitates exploitation of economies of scale in a similar fashion as EDS, which has developed economies of scale and transfers some of their economies to the rest of the industry. Here we work together and get that transfer.

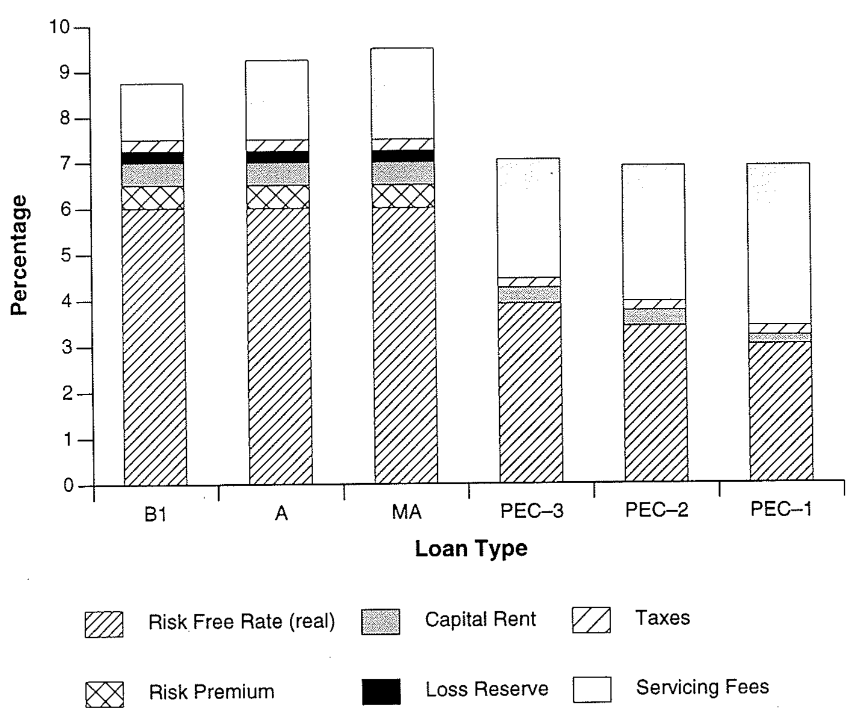
A common servicing system is important because it facilitates the syndication of loans. Everybody has been talking about the secondary mortgage market, which involves selling mortgages to investors. But in Mexico we haven't developed the primary secondary market, which is the transfer of portfolios within the mortgage business.

CONTROL OF RISK

Risk is a very important issue. What is the risk and how can we reduce it? First, there are government guarantees that reduce the cost of funds. If we can get cheaper money, we will be able to create more affordable mortgages. Also, there are foreclosure costs. One thing we have created is an enhancement mechanism wherein two or three advance payments can be made to a trust. If the borrower cannot make the payment in some month, the money is taken from the trust and the payment is made. It is a self-insurance mechanism that reduces the uncertainty of the payments (see Figure 10).

Another very important part of the business has been regulation. Our operations are being audited by different agencies, such as the National Banking and Securities Commission, FOVI, rating agencies, Price Waterhouse and internal operational audits done by Pulte Home, Co. Supervision reduces the credit risk but also increases costs, so coordination among the different auditors is important to reduce costs.

Figure 11. Spread Per Loan Type with Lower Cost and Government Guarantees



CONCLUSION

To take advantage of the market opportunities existing in the Mexican housing financing sector, Su Casita has to be able to provide affordable loans in a very efficient way. To reduce the servicing cost and the funding rate, the way loans are serviced has to change, and government guarantees have to be provided to lower the spreads for the low-income market mortgages.

In the lowest end of the market a government subsidy pays for part of the servicing costs and up to a 100% guarantee of principal, thus increasing the loan's affordability. The actual rates charged on different types of loans is shown in Figure 11. In contrast to Figure 7, the funding cost and loss reserves for the PEC 1-3 loans is less, reflecting the involvement of the government.

When sufficient loans are provided, developers can build houses targeted to the lower end of the market. This is the goal of Su Casita and other SOFOLs.

NOTES

[1] INFONAVIT and FOVISSTE are housing "pension" funds that obtain funds through payroll deduction and make housing loans to their "members." FOVI is a trust fund of the central bank that on-lends government and donor funds to banks and SOFOLs.

[2] In Mexico, the standard mortgage instrument has a balance indexed to inflation. Thus, this is a real rate of interest. For more detail on Mexican mortgage instruments, see Lea, M., "Restarting Housing Finance in Mexico," *Housing Finance International,* XI, 2, December 1996.