

Mortgage Lending in Brazil

The Existing Housing Finance System and the New Financing System for the Real Estate Industry

by Luiz Pinto Lima

Housing finance in Brazil has had a very interesting history. If the study were to comprise the 1964 to early 1980s period, it would be viewed as a success story. The 1983 to 1990 period can be viewed as a lesson of what has to be avoided to prevent the system from nearly collapsing. The recent past tells us about how a secondary mortgage market can be introduced by the private sector to promote medium- to long-term financing to the real estate industry.

THE HOUSING FINANCE SYSTEM

In 1964 the Housing Finance System was introduced to provide medium- to long-term financing for the construction or purchase of residential units for the low- and middle-income families. Loans obtained by individuals had to be used for the building or purchase of a housing unit for their own use and were subject to a number of restrictions, such as limits on the financed amount, the property value and the loan-to-value ratio. The bor-

rowers were not allowed to own another house or flat in the same town or city where the financed residential unit was located. Interest rates charged on a large part of such loans were also subject to ceilings.

Housing finance loans were made possible in Brazil through the use of monetary correction (a form of indexation), which was also introduced in 1964 to prevent the capital base of such loans and of government-issued securities from being eroded by inflation.

The System used two basic funding sources: (1) savings deposits held by the public with financial institutions authorized by the Central Bank of Brazil to make housing finance loans available with such funds; and (2) mandatory deposits made by employers in accounts held in the names of their employees in the Fundo de Garantia do Tempo de Serviço—FGTS, a workers' compensation fund administered by the Federal Savings Bank. Both deposits accrued interest of 0.5% and 0.25% per month respectively, plus monetary adjustment.

The Housing Finance System worked very well until the early '80s. In 1982, the System financed 600,000 residential units, of which about 250,000 were made with savings deposit funds.

Damage From Inflation

However, the upsurge in inflation together with strict wage policies increased payment delinquencies and resulted in the government extending a series of subsidies to all borrowers of the system in the 1983 to 1985 period. Subsequently, borrowers were further favored by several economic stabilization plans carried out during the 1986 to 1991 period, imposing mortgage installment freezes which increased the gap between the scheduled monthly or quarterly adjustment of the loan balances and the actual loan adjustment, with many loans still being adjusted on a yearly basis.

The result of such policies was a dramatic fall in the repayment flow of housing finance loans, reducing the lending capacity of financial institutions (see Table 1).

The Savings and Loan System, which was the part of the Housing Finance System that funded their loans with savings deposits, was further hurt by the dramatic decline in those deposits following the Economic Stabilization Plan of March 1990. At the time, a considerable part of their US\$30 billion in saving deposits was transferred to the Central Bank of Brazil. Today, housing loans

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Table 1. Housing Finance System Loans (thousands of finance units)

Year	FGTS Funded Loans	Savings Deposit Funded Loans	Total Loans	Yearly Average
1965 to 1979	1,561	913	2,474	165
1980 to 1982	848	786	1,634	545
1982 to 1989	375	566	941	118
1990 to 1993	573	235	808	202
1994 to 1997	102	183	285	71
Total	3,459	2,683	6,142	192

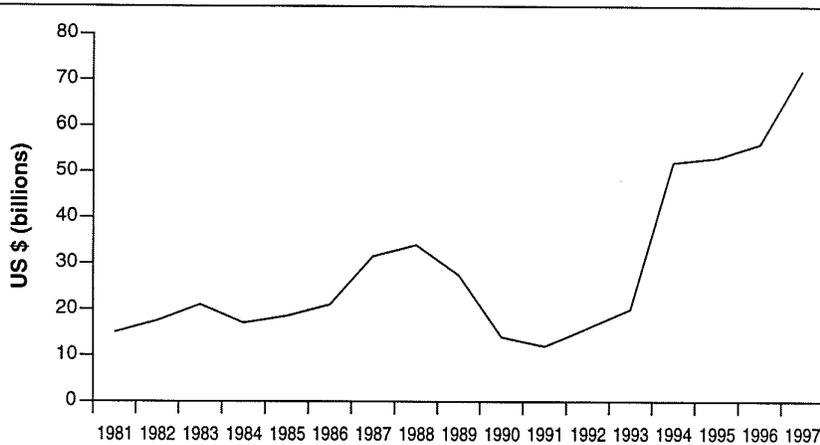
Source: ABECIP / National Housing Bank and Central Bank of Brazil.

Table 2. Savings & Loan System

Year	Thousands of Finance Residential Units			Loan Volume in US\$ Million		
	Building	Purchase	Total	Building	Purchase	Total
1994	40	21	61	1,253	678	1,931
1995	22	25	47	850	1,081	1,931
1996	21	17	38	673	735	1,408
1997	20	16	36	750	850	1,600
1994-1997	103	79	182	3,526	3,344	6,870

Source: Central Bank of Brazil

Figure 1. Savings Deposits



Source: Central Bank of Brazil

financed with savings deposits account for approximately 36,000 units per year totaling US\$1.6 billion (see Table 2).

Several factors, such as growing unemployment and underemployment and high delinquency rates of borrowers also reduced the availability of FGTS resources for housing finance loans. Loans with FGTS resources financed about 52,200 residential units last year. These loans were destined to lower income families, that is, families with a monthly income of up to twelve minimum wages or R\$1,440.00.

Savings deposits at the end of 1997 totaled approximately US\$80 billion and FGTS deposits some US\$50 billion (see Figure 1).

There are currently about 68 million savings accounts held by 50 public and private financial institutions authorized by the Central Bank to make housing loans available with savings deposit funds. The National Monetary Council establishes the rules for the use of these deposits. These rules recently were made more flexible to enable housing finance loans to be granted to a larger number of families.

Housing finance loans also are made available by state or local government-run housing companies and by private and public housing cooperatives. These loans are funded mainly with the FGTS resources mentioned previously.

NEW FUNDING SOURCES

Since the early 1990s, new funding sources for real estate financing have been introduced in Brazil, but most became operative only after the 1994 economic stabilization process started producing positive results.

One of the funding sources comprises the Real Estate Investment Funds. The law introducing such funds in Brazil was passed

in 1993. The funds are supervised by the Comissão de Valores Mobiliários, the Brazilian Securities Exchange Commission. Today there are about 60 real estate investment funds, most of which finance nonresidential projects. The scope of each fund, though, is limited to the project for which it was set up. The fund is divided into quotas, which are sold to investors, mainly pension funds and other large institutional investors.

Construction Capital Innovations

In view of the lack of financing for the middle class and the restrictions imposed on borrowers by the Housing Finance System, real estate developers and builders came up with their own finance schemes to raise capital for their projects. They started selling flats or offices well before construction was started. Construction began when the flow of installments was sufficient to pay for the building costs.

By the time the purchaser received the keys to his home or office, normally after 48 months, most of the costs had already been paid. The purchaser, however, continued paying installments for another 12 to 52 months, depending on the project. It is estimated that about 100,000 units have been financed and built this way.

This resulted in a large volume of real-estate-backed receivables held by the building companies or real estate developers. Some companies resorted to discounting such receivables with banks to obtain working capital. A few have placed real-estate-back debentures in the domestic capital market and abroad, in the last two years, giving rise to the first securitization operations in the Brazilian market.

In 1995 mortgage companies were authorized in Brazil. Their funding sources are mortgage bills (letras hipotecárias), debentures, foreign loans, and other loans. How-

ever, they may freely use their funds in any type of real estate financing. Three mortgage companies have already been set up so far and others are on the "assembly line." Financing from these institutions has been slow to develop.

THE SECONDARY MORTGAGE MARKET IN BRAZIL

About three years ago, ABECIP—the existing trade association of the savings and loan institutions—started a new system aimed at providing a larger volume of financing for the real estate sector. The result of these studies was the implementation of a secondary mortgage market in Brazil with the creation of a securitization company, named Cia Brasileira de Securitização—CIBRASEC.

The basic guidelines of the new financing system were set forth as follows:

- Socially oriented operations are to be treated separately from the market-oriented loans.
- The major risks of a loan are to be borne among the various players of the new market.
- Mortgage loans will be market-oriented and financed from multiple funding sources.
- Contracts will have to be respected by all parties; loans shall be fully honored by the borrowers and guarantees must ensure a speedy recovery of the loan in case of default.

The secondary mortgage market was introduced by Law 9514 on November 20, 1997. The law also provides for the creation of securitization companies and for a special security which will be issued solely by these companies, the certificates of real estate receivables. These securities will be backed

by receivables such as rents from commercial real estate projects or renters in residential projects.¹

CIBRASEC's Role

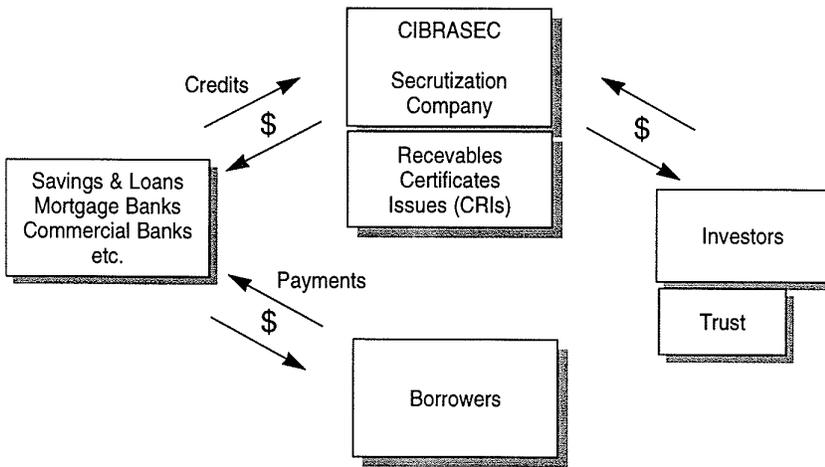
CIBRASEC, which was created on July 31, 1997, will be playing the role of Fannie Mae / Freddie Mac in Brazil. It will be purchasing real estate credits and receivables from mortgage companies, banks, real estate credit companies, saving banks and savings and loan associations and issuing securities guaranteed by such credits and receivables. These securities will be placed primarily with pension funds, insurance companies, investment funds and foreign investors.

The main purposes of CIBRASEC are:

1. to implement and centralize operations of the secondary mortgage market in Brazil;
2. to raise medium- and long-term funding with institutional investors (i.e., pension funds, investment funds and insurance companies) domestically and abroad, at terms which are compatible with those of real estate loans granted to individuals;
3. to divide the risks of a real estate financing operation between the originator, the securitization company and the investor;
4. to insure liquidity to the originating companies;
5. to provide standard procedures and guidelines for the market and
6. to create a data bank of all real estate financing products and operations throughout the country.

The shareholders of CIBRASEC are public and private financial institutions, most of which have a long experience in housing finance loans in Brazil. It is expected that they will also be selling their credits and

Figure 2. Functions of CIBRASEC



receivables to the company. No shareholder, however, is allowed to acquire more than 10% of the capital of CIBRASEC.

Figure 2 illustrates the functions of CIBRASEC

CIBRASEC, as the first Brazilian securitization company, will define the standards for the real estate loans and receivables, select lenders and servicers, structure the receivable contracts and issue receivable certificates.

There are three basic types of receivables that CIBRASEC will purchase when it starts its operations in 1998. They include commercial rent receivables and house financing receivables for both home improvement and purchase transactions. In the future CIBRASEC will purchase traditional mortgage loans and leasing receivables.

The asset pool will be structured to support security issues that will be electronically regis-

tered and controlled by CETIP (the Brazilian Bonds Market Clearing House). The asset pool will be ranked by the rating process of specialized international rating agencies such as Standard & Poors, and Moodys.

Sources of Loans

The first set of the loans will be generated by CIBRASEC's shareholders—subject to meeting the standards and requirements and also the servicing duties. Initially, sellers of loans and receivables will retain the risk of default on the contracts; but it is planned that CIBRASEC will purchase loans without recourse to the seller, in the same manner as Fannie Mae and Freddie Mac do in the United States.

The Regulatory Law No.9514 has implemented the Fiduciary system for the Brazilian Real Estate Market, improving the liquidity of the real estate assets and allowing delinquency to be transformed in faster foreclosures and asset recovery.

Initially, the sellers will have the choice of credit enhancement techniques, including: (1) over-collateralizing the receivables or loans purchased; (2) providing a credit replacement agreement for the first 24 months of the contracts; or (3) obtaining third-party default insurance. Mortgage insurance does not yet exist in Brazil but a large insurance company is considering offering it.

For the investors, CIBRASEC will guarantee its obligations backed by strict credit risk management, including oversight by lenders to insure tight collections control and foreclosure management.

Who Are the Shareholders?

CIBRASEC's shareholders are the major private and public institutions in the Brazilian financial market focused in the savings and mortgages market. The Brazilian private institutions include BRADESCO, ITAU, REAL, UNIBANCO.

The international shareholders include CITIBANK (USA), ABN AMRO (Holland), BILBAO & VIZCAYA e SANTANDER (Spain), SUDAMERIS (French/Italian) and CAIXA GERAL DE DEPOSITOS (Portugal). Several others will be invited to join later this year.

Public sector shareholders include the CAIXA ECONOMICA FEDERAL BANCO DO BRASIL (committed) and a number of state banks. Other shareholders are small regional mortgage companies which specialize in savings and housing finance.

The shares are distributed as public (40%) and private (60%) and CIBRASEC, as implemented by Regulatory Law No. 9516/97 (that structured the Fiduciary system for Brazilian real estate) will not receive any kind of government subsidies or tax advantages.

CIBRASEC has a total capitalization of R\$60 million and is programmed by its business plan to start its regular operations in July 1998. The operations will begin with asset acquisitions, with bond issuance planned by the end of the year. The business plan envisages R\$1.5 billion in 1998 and a R\$60 billion (almost US \$60 billion) asset portfolio at the end of the 10 years.

CONCLUSION

The new financing system will be operating in a free market environment as opposed to

the highly regulated Housing Finance System. However, the systems will be complementary, for in the long term the Housing Finance System will be financing mostly builders and developers, whereas the Real Estate Financing System will be financing the purchase of ready-to-use residential and nonresidential units.

The secondary mortgage market will be an important player in the future development of real estate financing in Brazil, providing a new and increasing source of building and the purchase of non-residential units. It is

expected to finance in the next 10 years the same number of units as have been financed by the Housing Finance System during the 30 years of its existence.

NOTES

¹ Under the new law, a purchaser of a home does not get title to the property until the loan is fully paid. Thus the flow of mortgage payments is the collateral for the security instead of the loan asset. This arrangement allows for more speedy foreclosure in the event of default.