

Promising Prospects for Real Estate Finance in Brazil

by Anésio Abdalla

FROM PAST TO PRESENT

Households and companies all over the world dedicate a good part of their efforts to occupy and maintain functional, well-planned and safe residential units. Adequate units are desired in modern societies as well as in the most advanced civilizations of history. The development cycles of cities and regions have mostly taken place accompanied by investments in real property, a sign of prosperity.

This aspiration continues to increase in industrial countries, as well as in emerging societies. However, due to the cost of real properties, it can only be fulfilled on a large scale when efficient finance systems and active investors and builders are in place, together with a favorable economic scenario, with moderate interest rates, long terms and stable prices.

Such statements may seem obvious, but it is not always possible to transform desires into reality. In Brazil, for example, the history of

housing finance has had its ups and downs (see Figure 1). Up to the early 1960s, housing finance was available to only a few privileged people.

Then came a very prolific period, after the creation of the Housing Finance System (Sistema Financeiro da Habitação-SFH) in 1964, which lasted one decade and a half but was followed by an equally long-lasting crisis. The conditions to fulfill the various purposes of an efficient real estate finance system have been re-established only recently. The dominant housing finance model—the SFH—had stopped meeting expectations.

The old system was extremely regulated. The government controlled both the sources of funds and the destination of loans. Deposit-taking institutions are required by law to invest at least 70% of their SFH deposits (basic passbook-type savings deposits) in real estate investments with a 12% real rate ceiling on the interest rate. At least 90% of these investments must be for purchase and construction of residential units—apartments and houses.

With ample new resources, coming from savings accounts, mortgage bonds and employer deposits into the Fundo de Garantia do Tempo de Serviço (FGTS), a workers' severance fund, the SFH experienced a very rapid expansion. About 3.1 million loans

were granted during the 1966 to 1980 period, giving access to real property ownership to low- and middle-class families. This lending also supported the building industry and enhanced the valuation of real property equity. Over two-thirds of the housing projects carried out during this period were financed with loans originated by the SFH.

Successful in the 1960s and 1970s, the SFH flourished on the razor's edge of an economic arrangement—monetary correction—designed to permit the system to live with inflation. As years went by, monetary correction lost its efficiency, hampering the operations of the system, as it was applied to both the funding sources and the loans. Due to monetary correction—and many other factors—housing finance had to be restructured in Brazil.

During the 1990s, other problems arose. Borrowers filed lawsuits against the financing institutions and began defaulting on their loans. Lenders experienced a reduction in the volume of operations and in the demand for loans. A double vulnerability gap between assets and liabilities showed up: first, the loan outstanding balances very often exceeded the value of the financed units; second, short-term funding was used to finance long-term operations, increasing the risk to financial institutions and limiting their leverage.

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Figure 1. Housing Finance in Brazil

	<i>Up to 1960</i>	<i>Sixties</i>	<i>Seventies</i>	<i>Eighties</i>	<i>Nineties</i>
Government	<ul style="list-style-type: none"> • Savings banks with increasing losses • No monetary correction 	<ul style="list-style-type: none"> • Creation of the housing finance system & National Housing Bank (BNH) • Introduction of monetary correction 	<ul style="list-style-type: none"> • Growth of savings and FGTS deposits 	<ul style="list-style-type: none"> • Phasing out of the BNH • Subsidies given to borrowers 	<ul style="list-style-type: none"> • Transfer of savings deposits to Banco Central • High interest rates
Origination	<ul style="list-style-type: none"> • Mortgage loans at fixed 12% interest rates P.A. • Savings banks & pension institutions 	<ul style="list-style-type: none"> • BNH • Savings banks • S & Ls • Pension institutes 	<ul style="list-style-type: none"> • COHABs • Financial institutions • Pension institutes 	<ul style="list-style-type: none"> • Savings banks • Multiple charter banks 	<ul style="list-style-type: none"> • Savings banks • Multiple charter banks
Funding		<ul style="list-style-type: none"> • FGTS • Mortgage bills • Budgetary funds 	<ul style="list-style-type: none"> • Savings deposits • FGTS 	<ul style="list-style-type: none"> • Savings deposits • FGTS 	<ul style="list-style-type: none"> • Savings deposits • FGTS • Own resources • Real estate investment funds
Servicing	<ul style="list-style-type: none"> • Savings banks • Pension institutes 	<ul style="list-style-type: none"> • BNH • Savings banks • S & Ls 	<ul style="list-style-type: none"> • BNH • Savings banks • COHABs • Financial institutions 	<ul style="list-style-type: none"> • Savings banks • Multiple charter banks • Independent S & Ls 	<ul style="list-style-type: none"> • Savings banks • Multiple charter banks • Independent S & Ls
Securitization	<ul style="list-style-type: none"> • Non-existent 	<ul style="list-style-type: none"> • Non-existent 	<ul style="list-style-type: none"> • Non-existent 	<ul style="list-style-type: none"> • Non-existent 	<ul style="list-style-type: none"> • Non-existent

The problems were aggravated by the unstable situation in the economy, but especially by the anti-inflation economic plans implemented in the 1986-1991 period, which produced very bad results for the system (see Figure 2).

Some of those problems—especially the gap-related ones—are not unique to Brazil. They were also present in the mortgage systems of industrial countries, such as the

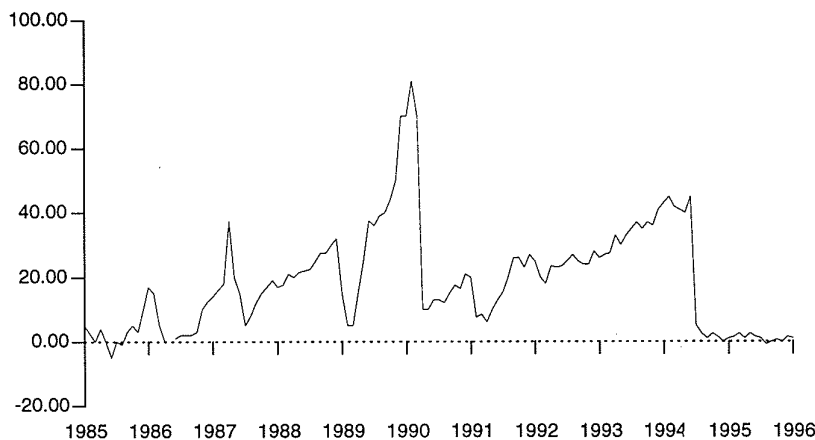
United States. However, in Brazil, incompetence and populism added to the difficulties inherent in a free market economy. Furthermore, without a strong personal savings structure, it was impossible to avoid problems, and they reached dangerous proportions.

The diagnosis of the crisis was made in the middle 1980s. However, a vigorous plan to combat the problems of housing finance

was defined only three years ago. In November 1997, Congress approved a law proposed by the Fernando Henrique Cardoso administration to modernize the housing finance system along the lines of that in industrial countries, commencing with the United States.

It is important to compare both systems, the old and the new, starting with the role played by the financial institutions of the SFH when

Figure 2. Inflation: Comparison With Previous Stabilization Plans



the system was set up to be used for housing finance loans. Originally, a specialization model based on that used in the United States was created.

The financial institutions which provided housing finance were the real estate credit companies, savings and loan associations and the National Housing Bank (NHB). The NHB worked through public and private ancillary companies (such as cooperatives), and builders and developers chosen to act in the name of the bank. Specialization was pursued, but success was relative. Specialization depended on know-how and market respect, but the Brazilian state had a tradition of intense regulation.

The first initiatives were carried out under market-oriented economic authorities, such as Roberto Campos, Otávio Bulhões and Mario Henrique Simonsen; but subsequently the influence of the state bureaucracy increased. Enormous risks ended up being transferred to the National Treasury as the years went by, and the public accounts were affected.

The model failed the moment populism started to prevail, granting huge and indiscriminate subsidies to all mortgagors by trying to solve the disequilibrium problems of the housing finance contracts in general. Large portions of the losses were transferred to private institutions and to the depositors.

The new model arose from the desire of the community and the conviction of the authorities to improve the housing finance system. The focus has been on deregulation. Even the rules of the SFH, which will continue to exist together with the new system, are being eased to prevent total paralysis of the old system.

Currently, the number of participants is much larger. Credit is supplied by private and state banks, housing companies and the Federal Savings Bank (Caixa Econômica Federal), which administers the FGTS funds. Loans can be granted not only to finance residential units but non-residential units as well.

New instruments have been created to allow

the securitization of real property loans, reducing the risk of the main parties to the loans—financial institutions and builders or developers. Nonetheless, this process is only being slowly put in place, as it depends on cultural changes and on the macroeconomic scenario.

THE LEGAL CHANGES

The new Real Estate Finance System (Sistema de Financiamento Imobiliário-SFI) was created by Law 9514, enacted on November 20, 1997 (see Figure 3). The new system amounts to a revolution in housing finance, as it involves the creation of new companies, new instruments and elimination of subsidies. It will facilitate the standardization of the whole mortgage loan process, reducing costs and making the system more efficient.

Figure 3. Legal Framework, Law 9514

Basic Principles

- Free market environment = deregulation
- Privatization of activities
- No burden to government coffers

Innovations

- Creates the certificates of real estate receivables (CRIs—Certificados de Recebíveis Imobiliários) and securitization companies, thereby introducing the secondary real estate receivables market in Brazil.
- Introduces the fiduciary regime.
- Introduces the "Trust Sale" (interest security) on real estate property as collateral of loans ("hire purchase" in U.K.), which is similar to that of Decree Law 911/69. Full property is only granted to borrower upon debt repayment.
- Permits the creation of arbitration chambers to settle claims and differences between the interested parties under law 9,307/96.

A new legal framework will make capital less expensive, as there will be a higher level of security. The main features of the new system include:

- **Fiduciary sale** (alienação fiduciária): To ensure the legal foreclosure of defaulting loans, a new device was created that is similar to the chattel mortgage applicable to vehicles, which has been successfully used for 30 years. Under this system the full ownership of the property will only be transferred to the borrower upon full settlement of the debt.
- **Trust** (fidúcia): To protect the equity of the financial institutions, the fiduciary regime was introduced.
- **Securitizing companies** (companhias de securitização): To create a secondary market, the law enabled the setting up of securitization companies for real estate receivables.
- **Certificates of Real Estate Receivables** (Certificados de Recebíveis Imobiliários—CRIs): Created to ensure uniformity, liquidity and safety to the securitization operations. The CRI will be negotiated upon the authorization of the Comissão de Valores Mobiliários (CVM), which is the Brazilian equivalent to the U.S. Securities Exchange Commission.

The CRI will have the following features:

1. Combines the guarantee of a real estate property with the liquidity of a security.
2. Fixed long-term interest rates, ensuring higher yields in a declining rate environment.
3. Allows a distribution of funds to secure short- and long-term yields.
4. Tailors the features of the securities to investors' needs regarding terms, rates and monetary adjustment, as long as borrowers accept the underlying loans.

5. Allows pension funds to invest in real properties or transfer real assets to securities without exceeding their operational limits.

- **Securitization Document:** To secure the CRIs, a Securitization Document will be issued under the Fiduciary Regime. The Document will be registered with a real estate registration office. The assets will be separated from those of the issuing company. The credits and receivables will serve as collateral, and the securities will benefit by being the issuer's obligation as well as from the collateral.

FAVORABLE MACROECONOMIC SCENARIO

Enormous steps have been made in the last few years to build economic stability in Brazil, which overcame the 1997 Asian crisis and the 1998 Russian crisis with the help of the international community.

- Inflation, as measured by the National Consumer Price Index, was reduced from 2,489% in 1993 to 22% in 1995, 4.3% in 1997 and 2.5% in 1998.
- Brazil was the emerging country that best managed to deal with a devaluation, which occurred in January, as 1999 inflation is being forecast at 8% to 10%; and recession is less severe than expected, with GDP growth being forecast at around zero in 1999 and 4% in the year 2000.
- Foreign exchange reserves remain around US\$40 billion since April, tending to grow as from July.
- The IMF accord is being complied with, an unheard event in the Brazilian history of letters of intent signed with that agency. The country registered a US\$12

billion public sector borrowing requirement surplus in the first half of the year and is reducing the balance of payment current account deficit.

- Foreign investments are high. The flow of risk and portfolio capital should exceed US\$20 billion this year, according to private sources, compared with net US\$24 billion in 1998.
- Interest rates are being reduced dramatically. They came down from 45% per year in March to 19.5% per year at the end of July, enabling the recovery of lending operations. This has been possible because Brazil adopted a flexible exchange rate and the inflation-targeting regime as inflation anchor.

The real estate market is beginning to show signs of recovery.

GETTING OUT OF THE CRISIS

The economy and the real estate market go hand in hand (see Figure 4). With economic stabilization since 1994, the real estate equities were reappraised. Brazilians learned that real estate cannot be the main store of value in times of high inflation, when economic plans destroyed financial savings and drew people to invest their savings into real assets.

The real estate market is becoming more professional and integrated into the international markets. Large international corporations are setting up offices in Brazil, as investors (Soros, Hines, Tishman Spyers) or as servicers (Turner, Dumez, Cushman & Wakefield, Compass, Jones Lang La Salle, Collier, CB Richard Ellis). The time of low market professionalism has come to an end. In the new cycle, which is just starting, the number of participants and of properties that may be financed has grown substantially.

Figure 4. Economic Impact on the Real Estate Market

- Construction business = 14% of 1998 GDP of US\$ 756 billion
- Housing deficit of around 6 million units
- Home equity loans not available. Demand is probably higher than that for housing facilities.
- Sharply increasing demand for offices, shopping centers, and hotels due to lower interest rates and growth of services.

Lower Office Space in São Paulo / Rio than in New York

	<i>Rio de Janeiro</i>	<i>São Paulo</i>	<i>New York</i>
million sq. meters	3.8	6.7	42.0
million people	5.5	9.8	7.8

Source: Bolsa de Imóveis SP

- Shopping centers increasing, but still far from meeting potential demand—32% annual sales growth; US\$ 4 billion investments forecast for next 4 years.

	#	<i>Shop Area million sq. meters</i>	<i>Sales US\$ billion</i>	<i>% of Retail Sales (excl. cars)</i>	<i># Employees thousand</i>
Brazil	147	3.6	14	18%	276
USA	41,235	462	914	58%	10,853

Source: ABRASCE

In addition to houses and apartments, offices, shopping centers, hotels, industries and warehouses may be financed. The financing agents are multiple charter banks, commercial and investment banks, real estate credit companies, mortgage companies and securitization companies. The funding instruments, such as the CRIs and debentures, may be placed in the domestic market or abroad, or funding may come from the repayment of the loans granted by the system.

As interest rates decline, the value of real properties with good characteristics tends to increase. Investors are attracted by the possibility of obtaining, by renting a real property, an income which is comparable to that achieved in the financial market—with the advantage that they may provide a capital gain in the future.

Companies are now leasing real properties which they once owned outright in order to increase their working capital and pave the road toward expansion. Brazil has many experts capable of providing services to meet the needs of sophisticated investors. Brazil can serve multinational companies, which require buildings that meet international standards; local companies, which must have a high degree of flexibility to adapt their investment decisions to the macroeconomic environment; or individuals, who are seeking higher profitability in their real property portfolios.

THE ROLE OF CIBRASEC

The Companhia Brasileira de Securitização (CIBRASEC) was created in 1997 to become the catalyst agent of the mortgage

market in Brazil. The CIBRASEC concept is based on the successful model of the securitization companies in the U.S., such as Fannie Mae. CIBRASEC, a private company will be the main agent of the secondary market for real estate receivables in Brazil.

It is a capitalized company, whose controlling partners are: the largest private and public banks in Brazil; international groups such as ABN/Amro, Citibank, Santander, Caixa Geral de Depósitos and Sudameris; and most likely, agencies such as the International Finance Corporation (IFC), a subsidiary of the World Bank (see Figure 5). CIBRASEC was created to manage, standardize and be an arbiter in the secondary market. Its role will be decisive for the development of the market, providing the degree of security and trustworthiness of the operations demanded by investors.

Figure 5. CIBRASEC Shareholders

- | | |
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| <ul style="list-style-type: none"> • Bradesco • Unibanco • Itaú • Citibank • Caixa Geral de Depósitos • Santander • BMB • Poupex • BESC • BRB • Banestes • CEF | <ul style="list-style-type: none"> • Banco do Brasil • BBV • ABN/Amro • Sudameris • Santos • Banestado • Banrisul • BEG • BMC • plus 14 other financial institutions |
|--|--|

The security is ensured by the company's focus on loan documentation, appraisal and servicing, and credit risk management. Underwriting operations will be carried out by the company. CIBRASEC will issue book-entry securities that will be negotiable in the market (the CRIs), and will provide liquidity for those securities.

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The company will permit the reduction of risks to the main parties in this market, the originators and the builders. The latter will have more resources to develop their specialized activities without being encumbered with long-term assets tying up their working capital. The leverage of the capital invested in real property operations of the originating banks will, of course, be much larger.

The securitization process will facilitate a maturation of the Brazilian real estate industry, allowing it to participate in a new real estate investment cycle. Local and foreign in-

vestors are stimulated by the need to have a base in the main developing regions of the world, and Brazil is the land that attracts the most investments, except for China.

Domestically, the institutional investors have increased the amount of funds available for investment. The equity of pension funds, insurance companies and mutual funds total approximately US\$200 billion, part of which will be channeled to real properties or real estate receivables.

The government authorized, by Resolution

2623 of July 30, 1999, that 10% of the resources of savings deposits, which total some R\$90 billion, be invested in real estate receivables.

The prospects for the real estate market and for real estate finance will improve as rapidly as economic growth is resumed. Favorable signs already started to appear early this year and are getting stronger. It is hoped that the economy will start growing in the third and fourth quarter of 1999, and particularly in the next year. The real estate finance engines are ready to meet the demand.