The Home Mortgage Industry in Colombia

by Efrain Forero Fonseca

The purpose of this article is to provide a vision of the characteristics, evolution and current status of the mortgage system in Colombia. Given the importance of this subject in any economy, it is necessary to provide a general macroeconomic framework to carry out the analysis.

BRIEF DESCRIPTION OF THE COLOMBIAN ECONOMY

Colombia is a developing country with a population of nearly 38 million people, as shown in Figure 1.

Figure 1. Population and Housing in Colombia

Population	
Urban	25,849,387
Rural	11,815,324
Total	37,664,771
Number of Homes	
Urban	5,384,656
Rural	1,775,186
Total	7,159,842

Source: DANE

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Colombia traditionally has been one of the most stable economies in Latin America, characterized by its commitment to conservative economic management. During the '80s, when most of the economies of the region collapsed, Colombia kept its ordinary stability. It is worth mentioning that Colombia has a well-earned reputation for accurate payment of its external debt, having not defaulted or renegotiated its financial commitments during that period, as was the case with many other Latin American countries.

Despite this record, in recent years a combination of adverse political and economic factors, together with the effects of the Russian and Asian financial crises, have engendered a serious recession that has impacted almost all of the economic sectors.

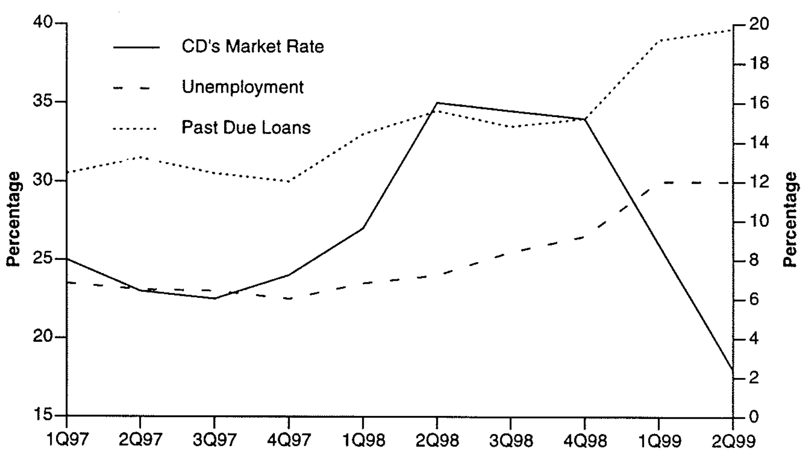
The unemployment index increased from 14% in 1995 to nearly 20%. There was virtually no GDP growth in 1998. From a fiscal surplus of 2.5% in 1994, the country is facing a fiscal deficit of 2.4% in 1999. In seeking for resources to finance its deficit, the former government launched a series of internal debt issues for more than US1.4 billion at very high yields. This pushed the market interest rates to nearly 50% a year, a level never seen in the history of the country. These factors combined with a decreasing inflation rate (it dropped from an average of 30% at the beginning of the decade to roughly 9% in 1999) generate a very heavy burden for borrowers and has resulted in a deterioration in credit quality, as shown in Figure 2.

The impact of the recession on the financial sector, and specifically on the mortgage market, was critical and has created important changes in the way of doing business in the country.

Despite this difficult scenario, the current government has put in place adequate policies to overcome the situation, including a devaluation of the peso, creation of credit lines for the capitalization of financial institutions and the launching of refinancing schemes partially supported with public funds. These measures have begun to produce results. As a matter of fact, the market interest rate has fallen to approximately 20%. This percentage, although still high, demonstrates a very favorable tendency. In addition, the measures taken towards the improvement of credit quality have also shown results.

As a consequence of these favorable actions, the International Rating Agencies have maintained the investment grade rating given to Colombia (BBB for D&P and the equivalent for Moodys[1] and S&P). It is also worth mentioning that the Colombian government, as well as the private sector, have received great support from Inter American Development Bank and the World Bank through the approval of loans for an approximate amount of $2.2 billion in the last year; and the direct investment by International Finance Corporation in various companies of the financial sector.

Figure 2. Factors Impacting Credit Markets



THE FINANCIAL SYSTEM AND THE MORTGAGE INDUSTRY

The recent recession has struck the financial sector, which in general has been one of the most sound and stable in the region. Nevertheless, with few exceptions, the deterioration is concentrated in the financial intermediaries owned by the government rather than in the private institutions.

The financial sector in Colombia has several different types of intermediaries: banks, mortgage intermediaries and other types of intermediaries with different degrees of specialization in specific businesses, such as financing companies and leasing companies. Commercial banks and mortgage intermediaries are the largest financial institutions, holding more than 80% of the private retail and commercial deposits. The financial institutions specializing in mortgages hold 40% of the total (see Figure 3).

The performance of the financial institutions is closely supervised by the Banking Superintendency, an entity linked to the Ministry of Finance.

Figure 3. Colombian Financial System as of June 1999

	COL$ MM.	*US$ BLL*
Assets	78,194,131	45.1
Equity	8,202,925	4.7
Liabilities	69,991,206	40.4
Profits	(996,241)	(0.6)

Exchange Rate
COL$/US$ (June 30 1999) 1,732.1

Source: Superintendencia Bancaria de Colombia

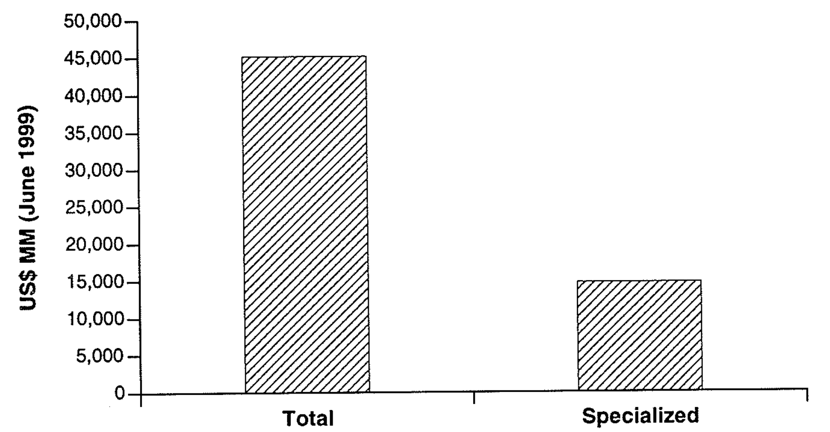
Among the regulatory mechanisms that Colombia has adopted are the General Rules of Capital Adequacy under BIS guidelines, Risk Weighted Asset evaluation standards, mark-to-market investment appraisal methods, and regulations regarding treasury and capital investments. The credit portfolio is subject to a rating system that determines not only past due loans but also the accounting effects of suspension of interest accrual as well as the constitution of reserves. This regulation is in general more demanding than the international standards.

The traditional legal scheme that was in force until 1990 in Colombia established a clear separation between the activities performed by banks and by other intermediaries, specifically those concentrated in the mortgage business. Banks were focused in corporate business and in short-term financing. Their primary funding sources were checking accounts and CDs. On the other hand, the mortgage lenders, known in the country as savings and housing corporations, were protected against the competition of the commercial banks. The savings and housing corporations had a privileged regulation that gave them the exclusive right to remunerate savings accounts by recognizing, on a daily basis, the effects of the inflation of the Colombian peso, plus a fixed real interest rate.

As will be further explained, this environment of protection permitted the creation of a stable base of savings that was successfully channeled to funding mortgage activity. In this way, the industry grew and became one of the most sound and stable housing systems in Latin America, managing more than $14.5 billion in assets, which represent 32% of the total Colombian financial system's assets (see Figure 4).

The 1990 financial sector reform introduced a radical change. In seeking to benefit both depositors and borrowers, the regulators opened up the competition among the different financial institutions. This created a new and very difficult scenario for the mortgage market, but the expected benefits for the borrowers unfortunately did not materialize.

Figure 4. Colombian Financial System Assets



THE UPAC SYSTEM

The Initial Stages

The Colombian home mortgage industry was created in 1972 and is called the UPAC System, due to the fact that it operates based on a unit named UPAC, which in Spanish stands for "Unit Of Constant Purchasing Power." The savings and housing corporations were also created at that time, with the exclusive purpose of acquiring savings from the public and originating mortgages in UPAC instead of in pesos.

The activity of the savings and housing corporations consists in transforming short-term deposits taken through savings accounts and CD's affected by changes in the market rate into long-term assets. The main goal of the UPAC was to protect these intermediaries against the mismatch of assets and liabilities derived from the market changes in the interest rates.

There are several important characteristics of the system as it was created in 1972. First, it was exclusively for the savings and housing corporations; other institutions were not allowed to use the UPAC indexation system, nor to originate mortgages.

The determination of the formula for the calculation of the UPAC variation has been, since the creation of the system, a responsibility of the Central Bank. In the initial stages of the system, the UPAC was linked to the inflation index.

Finally, the system was surrounded by several protections such as a special liquidity mechanism by which the companies could access special credit lines in the Central Bank to overcome shortages of liquidity.

The Achievements of the Industry

The Colombian mortgage system has been the only one in Latin America that has survived for more than 25 years. It has managed to expand and adequately cover the demand for housing finance, thus contributing to a reduction in the housing deficit that affects most countries in the region. It also has been a key factor in the building industry expansion and thus has supported the economic development of the country.

Real estate finance in Colombia includes not only long-term mortgages but also special loans specifically designed for the builders, known as construction loans. These are short-term credit lines that the S&Ls and the specialized financial institutions grant to the builders to provide them with the liquidity required to finance their projects.

The construction loans are given for the term necessary to complete the construction plus the sales period. These developer loans are not normally paid back in cash but through the substitution of the long-term mortgages granted to the eligible buyers of the individual properties.

This system offers appreciable advantages for all the parties involved in the business. The financial institution facilitates the mortgage application process and gives preferential treatment to the purchasers of projects financed by it. This turns into an aggregate value for the builder that enhances its sales process. The builder's marketing efforts benefit the lender, who does not need to promote directly new housing mortgage products.

The Colombian UPAC system has originated more than 1 million mortgages in the last 27 years and currently holds more than 800,000 seasoned mortgages with a value greater than US$9 billion.

One of the fundamental characteristics of this system is that it permits the design of convenient amortization methods with small monthly payments. This aspect is absolutely key in a developing economy where the average family income is very small in comparison with the capital required to purchase a home.

The UPAC system allows the mortgagor not to pay the whole yield (including expected inflation) of the loan in the first years, because the portion corresponding to the UPAC variation goes directly to the balance. The basic idea is to maintain the value of the unpaid balance of the mortgage in terms of constant purchasing power. Thus, balance increases just reflect the variation of the value of the currency (UPAC) in which the mortgage is originated.

Social Housing Finance

Perhaps due to the amortization system just described, Colombia is one of the few countries that has successfully combined private and public efforts in dealing with social housing finance.

The Colombian social housing system is composed of dwellings valued up to 2,300 UPACS, which is equivalent to approximately US$20,250. The purchasers of these dwellings receive special support from the government by means of a cash subsidy of around $2,000. In order to promote social housing, mortgage originators are obliged to allocate 20% of their total disbursements to this sector.

In the beginning, the system faced strong resistance from originators, mainly due to the fact that purchasers were not compelled to make a downpayment. This requirement resulted in very high default rates and significant losses. As a consequence, the regulation was changed; the current system requires a minimum 20% downpayment from the buyer.

It is important to note that as the mortgage originators are compelled to make loans in this sector, they have worked to improve the quality of the housing projects, by setting high standards for aspects such as the location of the projects, public facilities and in the design and construction specifications.

These requirements have forced the developers to be more creative and efficient in creating projects that, despite the economic limitations, are acceptable as collateral and qualify as worthy real estate investments. From the lender's point of view, these mortgages have generally shown good credit quality. Moreover, the price appreciation of social housing dwellings has tended to increase more than that of higher valued houses.

Currently, the Colombian social housing mortgage portfolio equals US$1.8 billion. The average value of a social housing loan is US$6,000, and the monthly payment is close to US$93.

Other Services

The savings and housing corporations are also leaders in retail banking. They have created a revolution in financial services through the introduction of ATMs, credit and debit cards, home banking, collection services and related products (see Figure 5).

The Evolution of the System

This structure, which promoted the stability of the system and allowed it to grow, was completely changed in 1990 with the legal reform. The basic idea of the legal change was to eliminate the specialization and the privileges given to some intermediaries such as the savings and housing corporations. These measures aimed to increase competition among financial intermediaries in order to promote efficiency and reduce costs.

As a result, the banks were allowed to use the UPAC system, and the savings and housing corporations were authorized to originate mortgages in pesos, as well as other type of loans. Consequently, the privileges given to the savings and housing corporations to remunerate the savings disappeared, and they had to face the competition for funding sources. It is important to mention that this new regulatory framework induced many savings and housing corporations to merge with bank holding companies or to convert into commercial banks. As a consequence, today the mortgage players are not only savings and housing corporations but also commercial banks with a total or partial specialization.

Until 1990, the formula to calculate the UPAC had been changed several times by the Central Bank. Nevertheless, it had always been related to inflation and in a smaller proportion to the variations of the interest rates in the market.

Figure 5. Specialized Mortgage Intermediaries vs. Other Institutions, June 1999

	Specialized in Mortgages	*Other Financial Institutions*	*% Specialized*
Deposits (US$ MM)	12,035	17,895	40.2%
Debit cards (#)	6,381,000	2,482,000	72.0%
Branches (#)	1,794	3,670	32.8%
ATMs (#)	2,646	2,931	47.4%
Credit cards (#)	617,000	1,794,000	25.6%
Profits (US$ MM)	(246)	(329)	42.8%
Equity (US$ MM)	1,070	3,666	22.6%

When the legal reform opened up the competition with the banks, the formula had to be changed, in order to enhance the mortgage industry capacity to compete for the savings deposits. The UPAC was linked to the market rate by defining it as 74% of the DTF (name given to the CD market rate). In this way, the increases in the market rate would be reflected both in the asset and liability yields. This was an indispensable measure in this new context of competition, and it worked properly for a significant period of time.

However, the exaggerated increases in the market interest rate mentioned above were reflected in the mortgage balances and monthly installments. These increases exceeded in many cases the diminished capacity of borrowers affected by unemployment and the economic crisis. This produced a deterioration of the credit quality and increased the number of foreclosures and repossessions.

In making an objective analysis of the Colombian home mortgage industry, it is important to identify that the cause for such a difficult period was not an intrinsic defect in the instrument but a macroeconomic problem. With real interest growing at rates that surpass the increment of the borrowers' income, no mortgage system can succeed.

As has been previously mentioned, the commitment of the government to lower the market interest rate has produced positive results. Consequently, the mortgage market was eventually returning to its traditional path. Nevertheless, mainly due to political pressure, the Constitutional Court in a heavily criticized decision ordered the Central Bank to change the UPAC formula and to link it again to inflation without reference to the level of the market interest rate.

Besides the inconvenience of having the judicial authority interfering in topics of economic policy, it is an accepted conclusion that in the new environment of competition, the mortgage industry has been left in a position that can affect it severely in stages of interest rate increases. In fact, a mortgage system can only be successful if it works under market conditions—in other words, if the mortgages render a yield sufficient to attract investors.

As a consequence, the mortgage industry in Colombia is facing today the challenge of defining new rules of operation that permit its preservation and expansion. The government has already received full power from the Congress to introduce the necessary adjustments to guarantee the stability of the mortgage market. The solutions currently under analysis include the expansion of the secondary mortgage market, support of the government in the credit enhancement activity, particularly with regard to the management of interest rate risk, and the introduction of new long-term funding instruments such as mortgage bonds (letras hipotecarias).

In addition, some important changes have been recently adopted, such as the establishment of private arbitrator courts that will be empowered to perform the foreclosure procedures in a non-judicial way. This will undoubtedly contribute to the efficiency of the repossession procedures, not only for the lenders' benefit but also for the borrowers'.

Finally, it is worth mention that the legal framework already contemplates the existence of securitization companies authorized to purchase mortgages from the originators on a regular basis so as to convert them into securities.

MORTGAGE SECURITIZATION

To complete this review it is necessary to make some reference to the secondary mortgage market status.

The Colombian government and the private sector, led by DAVIVIENDA, the main mortgage originator of the country, started exploring the topic of securitization in 1992, when the Congress was studying the reform that would give birth to the pension funds. Until that moment, there were no long-term options to invest in the country, and it was obviously necessary to design some type of mechanism that could satisfy this need for future pension funds.

In these circumstances DAVIVIENDA, with very important support from the IFC, decided to explore the possibility of converting the mortgages on its balance sheets into negotiable instruments. This involved in the first instance an analysis of the changes necessary to improve the legal framework to make securitization viable in the country. Although no major changes were required, some refinements were implemented; in addition, economic studies were carried out to determine the feasibility and the conditions required for the creation of a secondary market.

In 1994 DAVIVIENDA created the first mortgage securitization transaction. That deal, which was the first securitization in Latin America, obtained a AAA rating by Duff & Phelps of Colombia. The placement of the securities for the equivalent amount, in pesos, of US$16 million was completed in less than one week, inside the country, among institutional investors such as pension funds, banks, insurance companies, mutual funds and fiduciary companies.

Subsequently, DAVIVIENDA has launched four more deals. The basic information regarding all the DAVIVIENDA's MBS issues, is contained in Figures 6 and 7, indicating in millions of US dollars the initial balance or total amount of the issue and the remaining balance to date, as well as the credit enhancement mechanisms. Most of the balance in the first two transactions has been amortized.

Figure 6. DAVIVIENDA's MBS

Issue	*Initial Balance (US$ MM)*	*Balance (May 99) (US$ MM)*	*Maximum Initial Term (Years)*	*Maximum Remaining Term (May 99)*	*Rating (D&P-Col)*
Dec. 94	16	3	5.5	1	AAA
Jul. 95	22	9	6.5	2.5	AAA
Oct. 96	33	29	10	7.5	AAA
Dec. 96	26	22	10	7.5	AAA
Jan. 99	68	70	10	9.5	AAA
TOTAL	165	133			

Figure 7. MBS Main Features and Performance

Issue	Index	Credit Enhancement	Enhancement %	Issue Value / Mortgage Pool Initial	May 99
Dec. 94	DTF	Subordination CCA	21%	77%	29%
Jul. 95	DTF	Subordination Overcolat.	16%	87%	61%
Oct. 96	UPAC	Excess Cash Flow	10%	83%	89%
Dec. 96	UPAC	Excess Cash Flow CCA	11%	84%	90%
Jan. 99	UPAC	Overcolat.	9%	95%	95%

DTF: CD'S Market Rate
UPAC: Unit of Constant Purchasing Power

After DAVIVIENDA's first placement, other Colombian savings and housing corporations entered the secondary mortgage market, also with great success. In Figure 8 the information regarding these deals is shown, indicating the name of the originator and the value of the deal.

The total MBS currently in the market equals 308 million dollars. Although these balances might seem very small compared with the U.S. market, in Latin American economies they represent a very important advance. Nevertheless, the development of the Colombian secondary mortgage market is just commencing. Securitized mortgages only represent 7% of the total existing mortgage portfolio, not to mention the growth potential of the mortgage industry.

The pension funds have been the main purchasers of Colombian MBS. As previously mentioned, the private pension fund system was created in Colombia in 1994. At this moment there are eight pension funds owned by the main economic groups, with participation in some cases of foreign capital. They manage a $3.5 billion portfolio and have a great growth potential.

Figure 8. Total Mortgage Titularization Deals in Colombia

Originator	*Issues (US$ MM)*	*Participation %*
Conavi	22	6%
Granahorrar	56	14%
Colmena	70	18%
Colpatria	85	21%
Davivienda	165	41%
TOTAL	398	100%

With the evolution of securitization and the reduction of the inflation index in the economy, the investors are focusing on a more long-term scenario. This is absolutely key for the further development of the mortgage industry, which, in the new regulatory environment, will tend to rely more on long-term funding.

In our opinion, the stabilization of the economy, together with the expansion of long-term investors and the adequate implementation of the regulatory measures mentioned above, will certainly allow the Colombian mortgage industry to continue being one of the most prosperous in the region.

NOTES

[1] Moody's is currently in the process of reviewing their rating.