The Current Situation and Future Outlook for Housing Finance in Latin America

by Dr. Vicente Lozano

INTRODUCTION

This article provides the point of view of the Interamerican Union for Housing (UNIAPRAVI) on the current situation and the future of housing finance in Latin America.

The article will have two parts: The first will outline our views on the housing policies and instruments of housing finance that are necessary to build solid primary mortgage markets and that serve as a basis for appropriate development of secondary markets. Many of the basic principles needed are already part of the practice in many countries of the region.

The second part will stress some current tendencies that surely will be accentuated in the future environment of our countries and that will significantly condition the future development of housing finance in Latin America.

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PAST POLICIES

The housing policies that prevailed on a widespread basis in the past in Latin America were characterized by:

- State building and direct backing of housing construction;
- Strong regulation by the state;
- Interest rate subsidies;
- Sale prices below market costs; and
- Practical assistance in helping the poorest people.

The counterproductive results of these policies are reflected mainly in the enormous housing deficit accumulated in the countries of the region. The conditions were established statistically in a study published several years ago by the ECLAC, which found that one of every four households lacked housing, and half of the existing homes were in unsatisfactory condition.

Other adverse results included:

- Limited formal private investment in the housing sector;
- Inadequate credit in relation to the need; in only a few countries are there mortgage credits over 30%;
- Concentration on the higher income sectors;
- Limited access to credit by the low-income population due to lack of payment capacity, lack of satisfactory guarantees and impossibility of documenting permanent income; and
- Growing informality in the construction and financing of housing.

These policies have been based on two premises that, in our opinion, are erroneous:

- The first premise considers the housing sector primarily or almost exclusively a social sector; and

- The second premise holds that the housing problem can be solved through big and massive projects of housing construction.

Since those holding these views do not acknowledge that the housing sector involves a problem with special social development connotations and that technical aspects have a place in any sector initiative, the prevalence of these premises has led to the design of flawed instruments that prevent the housing sector from attracting resources within the economy in competition with other economic activities, drive away private investment, eliminate opportunities for long-term financing and reduce the sector to an activity level far smaller than the potential impact it could have on overall economic activity.

AN ALTERNATIVE POLICY MODEL

Given these limitations in traditional housing policies, UNIAPRAVI has backed the use of an alternative policy model whose characteristics can be summarized as follows:[1]

- A model of sectoral development based on the market;
- Consideration of housing as a productive sector and not only as an element of social policy;
- Adoption of policies of an integral character that embrace instruments and appropriate resources for all strata of income;
- Recognition that the state alone cannot solve the housing deficit and, therefore, that it requires private sector participation;
- Understanding that the state role should be as a facilitator for the creation of conditions of profitability and stability for private investment;
- Enabling the private sector to assume a primary role in the construction and financing of housing; and
- Using the state to facilitate access to opportunities offered by the market to lower income families.

Recent experience in Latin America confirms that some countries, with residential policies based on this model, have achieved annual housing production that exceeds the new demand generated every year by population growth and formation of new households. This means that these countries have begun to reverse the accumulated housing deficit.

A crucial aspect of viable housing policies is the mobilization of savings for the sector. In order to obtain funds, housing must be able to compete for resources in the financial capital market through instruments that offer attractive rates, maintain the possibility of borrowers' access and provide security to the savers.

This implies the existence of mechanisms that protect the savings for housing from inflation, the existence of appropriate instruments for mobilization of long-term resources and the readiness of sources of funds that can be invested long term in order to achieve a balance between assets and liabilities.

Inflation has contributed to the failure of traditional methods of housing finance and has caused distortions in the financial markets serving housing. One effect is the establishment of negative interest rates in real terms, which leads to the disappearance of long-term credit and the decrease of investment in the sector.

HOW LATIN AMERICA HAS COPED

To counteract these effects, several countries in the region have created at one time or another indexation systems with diverse mechanisms which will be commented on below.

The mobilization of savings for housing not only involves questions of relative magnitude of instruments but also variations in terms. Another of the problems that face Latin American housing finance systems is the liquidity risk that exists when long-term mortgage credits for housing are financed with retail savings. It is necessary, therefore, to work toward a balance of terms between assets and liabilities, using instruments that allow a capture of long-term resources.

In Chile, for example, the introduction in the '80s of letters of mortgage credit activated an old savings instrument that substantially improved loan terms for housing. The securitization of mortgages, an instrument that deserves growing attention in the sector, also serves this purpose.

It is not only necessary to use financial instruments that allow long-term financing, but also that there exist sources of funds that, by their nature and conditions, are capable of being tapped by such instruments. In several countries in the region institutional investors are appearing—for example, private pension funds and life insurance companies—that administer long-term funds.

In particular, the Chilean experience can be mentioned, where letters of mortgage credit, the instrument used to finance market-cost housing, are one of the most important alternatives to placement with the private pension funds. This helps to create enormous resources for housing finance.

Challenge in Capturing Savings

Given the necessity to capture long-term funds and the potential that these sources of resources offer, it can be affirmed that in the future housing sector policies will be guided fundamentally by the need to capture the general savings of the economy and channel it somehow to housing finance.

This saving can be in the form of public deposits in the universal banks, the saving coming from the pension funds or the savings of the rest of the world. Tapping these savings sources may be through a change in the instruments of the financial sector, such as through the securitization of mortgages. The relevance of mandatory savings dedicated to finance housing will be reduced because this segmentation limits the volume of the mobilized resources and reflects inefficiencies in its use.

A basic characteristic of a solid primary mortgage market is the origination of mortgage credits whose repayments are sufficient to recover the real value of the loan and in this way allow the financing of new housing. Regrettably, inflation has prevented full loan recovery, and in many cases this shortfall ends up affecting the main source of housing finance funds, thereby decapitalizing the financial lenders. In the face of this situation, different countries at different moments in time have adopted indexation systems to adapt the conditions of repayment of mortgage loans for housing to an inflationary situation.

In Latin America diverse mechanisms have been applied: some that base the monetary correction on the inflation rate; others that base the correction on the prevalent interest rates in the market; others that use a measure of wages; and still others that use double indexation, in which the balance of the credit is adjusted according to the interest rate and the payment is adjusted by a measure of wages; and finally, mortgages in which the dollar operates as an index of readjustment when loans are denominated in this currency.

Certainly, none of these mechanisms is exempt from problems. The main lesson learned, however, is that a universal recipe doesn't exist for the design of an indexation system. It must be adapted to circumstances peculiar to each country, staying in harmony with other aspects of macroeconomic policy.

THREE CATEGORIES OF MORTGAGE CREDIT

However, it is clear that in Latin America there have been three large groupings of mortgage credit, two of which will stay in use and one of which will disappear. The first group is composed of mortgages originated in dollars and the second group is mortgages originated with some index of readjustment.

The group that is likely to disappear is made up of mortgages in national currency and in nominal terms. These are unprotected from the risks of eventual devaluations and inflations. This class of instruments no longer works and, therefore, will be very difficult to intermediate. For effective housing finance, the mortgage credit will have to be indexed to some domestic indicator or "dollarized."

Looking ahead to securitization, it will probably be easier to internationalize those mortgages denominated in dollars than those originated with some index of domestic readjustment. In addition, there may have to be some mechanism–for example, a swap–that compensates for any inability to make payments due to inflation or devaluation if these indexation systems are to be viable.

In fact, the FOVI of Mexico has recently designed mortgages denominated in units of constant value that are readjusted to inflation and which have a cover to absorb temporary shortfalls of payment capacity. These mortgages were designed to stimulate access to credit for housing, offer a better recovery of the credits and to create a more suitable product for future securitization.

By way of summary of this first part, it can be affirmed that in order to develop a solid primary market of mortgages, there must be a housing policy and instrumentation that:

- Reorients the role of the state toward being facilitator but subsidiary;
- Focuses on private sector investment in the real estate sector, including housing finance;
- Mobilizes the general savings of the economy, putting emphasis on the capture of long-term resources to finance housing by means of appropriate instruments; and
- Originates mortgages able to maintain their profitability over time, with due attention to the capacity of the borrowers' payments.

THE FUTURE OF HOUSING FINANCE IN LATIN AMERICA

The second topic of this article is a group of prevailing tendencies that will surely be accentuated and will have a significant effect on the future of housing finance in Latin America.

A first tendency is that Latin America is undergoing remarkable changes, many of which are associated with economic globalization. These changes have two important effects on housing finance. On one hand, the real estate sector, typically considered as a sector of non-traded goods with very low liquidity, will become a sector increasingly integrated into the global economy, attracting a larger share of capital that flows through national frontiers. In this way, housing markets will become less local by nature and more dependent on global tendencies.

On the other hand, and closely associated with the above, housing finance systems are more and more exposed to the evolution of the international financial markets, as has been verified in recent years.

Around 1996 the net flows of resources toward Latin America coming from commercial banks and other private creditors rose to about US$55 billion or 3.5% of the GDP of the region. This year flows will decline dramatically to less than US$20 billion, representing barely 1% of the regional GDP. Since these external resources are intermediated through the domestic financial markets, an external shock of significant proportions will reduce the liquidity and the terms of the transactions, restricting the readiness of long-term financing required for housing.

In order to reduce the exposure to this type of turbulence and in order to give stability and sustainability to housing finance in the long term, it will be necessary to create the sources and the mechanisms that permit greater savings to be generated internally. This takes us to a second important tendency: the relationship between structural reforms and institutional development.

In many of our countries, the reforms in the financial systems have been directed at eliminating controls and subsidies to interest rates, to demolishing the programs of directed credit, to reducing legal frictions, to privatizing or liquidating banks and other state-owned financial entities, to stimulating competition among lenders, and to adopting prudential norms of regulation and bank supervision.

Also, capital market regulations have been adopted to regulate the operation of new agents and instruments. But these strongly highlight the previous reforms of the systems in several countries—Argentina, Bolivia, Chile, Colombia, El Salvador, Mexico, Peru and Uruguay—which are encouraging the growth of internal savings and the appearance of important institutional investors, such as the administrators of private pension funds that press for the creation of long-term investment instruments.

Changing the Institutional Model

A third important tendency is the transformation process or adaptation of institutional approaches to housing finance. The old way of mobilizing the public's savings, in relatively short terms, to be transformed into long-term mortgage credits that are maintained as active and relatively unadjusted during the lifetime of the credit, is being displaced by an intermediation formula that will not only mobilize resources of the financial market through traditional mechanisms, such as the public's savings, but will also create bonds for the capital market to mobilize the long-term savings that the institutional investors administer.

The result will be changes in the nature of the mortgage business. Expansion of capital market finance will result in a greater specialization among lending agents with increased economies of scale. In this new model the originators of the credit will not necessarily do the administration and will be able to achieve quicker rotation of the resources involved in the long-term credits. This will result in a better handling of the risks involved in managing mortgage credit, among them credit risk and liquidity risk, diffusing them among the participants in the capital market.

Public Sector Role Changes

The role of the public sector will continue to be subject to revision but, contrary to conventional wisdom, it will have to be very active. This constitutes a fourth tendency. The traditional state role as a subsidizer of interest rates, in competition with private lenders, will diminish. What will be increased is the state's catalyst role.

The institutional models of second-floor banking, already existing in many countries of the region, will have greater validity as instruments for a more efficient accumulation of resources for the origination of credit and for stimulating the formation and consolidation of a housing finance system under market conditions. The model of second floor banking with state support will be useful to foster the development of a secondary market for the securitization of mortgages.

Alternatively, this model can improve management of debt, where resources can be channeled through the private financial system (for example, through an auction mechanism for developers provided by FOVI in Mexico) or to support the liquidity of private lenders by rediscounting mortgages, as is the case in Costa Rica, Paraguay and Uruguay, or through lines of external credit coming from multilateral organizations or private creditors, to be channeled through private lenders.

This state catalyst role should be reinforced by the use of programs of direct housing subsidies, a mechanism of state support that allows the transformation of potential demand for housing into an effective demand. In this way, among other benefits, the state will stimulate growth from the potential market of mortgage borrowers by reducing the indebtedness required to buy the housing. The direct housing subsidy also contributes to the portion of the housing market that lacks adequate purchasing capacity and requires a state contribution. Improvements in payment capacity will allow these households into the market served by private lenders.

Innovation in Housing Finance

Finally, the fifth tendency we will observe is innovation in the operating models for housing finance. The housing finance system will look for stability, profitability and sustainability. To attain long-term resources, these systems will generate mortgages that maintain their real value in the long term, will reduce the risks associated with the granting and the administration of long-term mortgage credits and will assist appropriately in meeting the demand for housing finance. In this perspective, as the performance of the housing finance system improves, growing attention will be focused on the mechanism of securitization of mortgages and, in a wider sense, the formation of secondary markets for mortgages.

It is important to emphasize that the securitization of mortgages alters the operation of the primary mortgage market by separating the functions that are usually integrated in the same lender, that is, originating credit, capturing the resources to finance it, administering the credit and assuming the risk.

New functional and operative techniques will be developed by agents already in the market, and also for new agents that can enter the mortgage financing market once there are structural reforms in the financial systems. The development of securitizing mortgages in Latin American countries will result in growing opportunities to accommodate long-term financial investments, which are a product, to a great extent, of the development of capital markets, of the globalization of financial markets, and of favorable legal regimes created to stimulate the foreign investments that have created important flows of resources through bank systems and domestic stock exchanges.

Success in the securitization of mortgages requires a group of fundamental prerequisites, highlighted among them a positive experience in the primary mortgage market. It is required that the mortgages have good payment records; a reasonably predictable future cash flow; preferably homogeneity regarding their origination and administration; and long-term profitability. The perception of profitability and security that the mortgages demonstrated in the primary market will be essential for the successful placement of funds in the capital markets. In other words, the securitization of mortgages will expose the quality of the mortgage portfolio to the public and specialized actors in the market.

Several Latin American countries have taken concrete steps in the formation of secondary mortgage markets. From this experience we can highlight the following:

1. The securitization of mortgages in Latin America is still in an incipient state:
   - Few countries have completely established the necessary legal and institutional framework;
   - The operative procedures are still being implemented; and
   - There are few operations that have already been completed; only in Colombia, Argentina and Chile have securities been issued, for an amount of about US$850 million.
2. The advance of securitization of mortgages has been hindered by a series of factors, among them:
   - The lack of standardization in the housing finance system, where the approaches to and the documentation for the origination of mortgages usually are not uniform, which makes the creation of a package of mortgages an expensive and time-consuming process;
   - The presence of very limited information on the historical experience of the mortgage loans;
   - The recent financial crises that have not only weakened the performance of many mortgage portfolios but have created uncertainty in many economies about the possibilities of continuing to offer conditions of reasonable stability for long-term financial investments;
   - The lack of experience of participants who are involved in a process of learning-by-doing, in that securitization is a novel process; and
   - The lack of critical volumes of mortgages in countries of smaller economic size.
3. In spite of these obstacles, the prospects for the securitization of mortgages can be considered encouraging for several reasons:
   - The existing enormous housing deficit will provide a significant continuing demand for new mortgage originations;
   - The penetration of the mortgage market–that is to say, the number of mortgages as a proportion of the number of housing units—is very low, even in the countries that have mortgage portfolios of significant volume;
   - Several countries already have mortgage portfolios whose sizes are significant;
   - Capital markets are developing and deepening; and
   - In several countries the conditions exist to welcome foreign investments in mortgage-related securities.

We have tried to point out the key factors that will impact the future of housing finance in the Latin American region. We face great changes, dominated by globalization and structural reforms. We will have by necessity new regulation and institutions. We will need to create innovative operating procedures and new agents.

Finally, we will have to restructure the roles of the public and private sectors, making them complementary so as to stimulate the sectoral development over the long term, providing pre-eminence to the market mechanisms but assuring an appropriate access to financing opportunities for all population segments.

NOTES

[1] For more detail see the article by Gerardo M. Gonzales Arrieta, "Access to Housing and Direct Subsidies: Lessons from Latin American Experiences," in the September 1998 issue of *Housing Finance International*.