<u>Challenges and Opportunities in the Mexican Mortgage Markets</u>
<u>In the Wake of the '95 Financial Crisis</u>

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Introduction

The peso devaluation and ensuing banking crisis of 1995 hit Mexico's housing finance markets hard, making evident certain structural limitations of the system. Though in some respects Mexican commercial banks and the housing finance markets are returning to where they were in the early '90s, the high default rates and temporary vacuum of conventional credit did provide space for new players to emerge and new practices to develop. These changes in the marketplace, along with regulatory shifts, have dramatically altered the mortgage markets in ways that most borrowers consider positive.

That said, questions linger as to whether reforms implemented after the devaluation afford adequate safeguards for a comparable economic shock were one to occur in the near future. And concerns remain as to how additional liquidity can be brought to the market and housing production (across a range of incomes and geographies) ramped up, particularly in the context of existing industrial and regulatory barriers. Focusing on the foreclosure process as a key example, this paper argues that dramatically increasing the flow of domestic and international capital supporting mortgage lending is a critical next step, but that public-sector driven reforms are needed to manage and overcome a set of distinctly Mexican regulatory and industrial hurdles.

Background: Financial Crisis of '95

The shape of the mortgage markets today reflects the tumultuous history of the industry over the last several decades. In the 1980s, the banking system was nationalized and federal requirements mandated only a relatively small volume of "social interest" or low-income loans to be originated each year. When the commercial banks were liberalized, in the early '90s, mortgage lending took off in response to the pent-up demand for credit – as a percentage of GDP, housing investment went from 1.3% in 1991 to 3.0% in 1992.[1]

However, as the markets were booming, the value of the peso plummeted in 1995 in response to a set of national macroeconomic problems. Though the effects of this devaluation were felt in all sectors, nowhere was the impact greatest than in the financial markets and mortgage markets, where the rate on adjustable rate mortgages (Mexico did not use fixed-rate mortgage products) jumped to extraordinary highs.

Though most Mexican home loans had been designed to track inflation, repayment could not keep pace. Mexican borrowers' incomes were rarely experiencing nominal inflation jumps comparable to that of their mortgage payments. And borrowers with DIMs (Dual Index Mortgages – where borrowers' interest rates tracks inflation, but the payment tracks a multiple of the state minimum wage) did not fare much better – the spread between what borrowers were paying and what was owed often became so high that the loans were negatively amortizing themselves to a point where ultimate repayment was essentially impossible. Even worse, these economic problems came on the tail end of a boom in real estate prices in Mexico (particularly in Mexico City) where real estate prices had already climbed to untenable heights. As home prices dropped and interest rates spiraled, unprecedented numbers of borrowers walked away from their mortgages. In all, over 30% of home loans went into in the mid- to late- 90s.[2]

[1] "The Mexico Mortgage Market Boom, Bust and Bail Out", by Nathalie Pickering, Joint Center for Housing Studies of Harvard University, April 2000
[2] Pickering, 2000

Some homeowners were spared from this financial earthquake. In the mid-90s, more than half of new construction was self-built, in the informal sector, where the mortgage market collapse far less impact on their lives. The share of informal housing is steadily decreasing but its presence has helped provide an outlet for intense housing demand in Mexico.

The Mexican government, with international assistance, ultimately spent more than $100 billion to pull the financial system out of its tailspin. Though a significant portion of the money went to borrowers helping them directly refinance their loans into better loan products, most was in the form of a bailout to Mexico's banks. As a result of all this, however, loan volume origination was relatively low in the years following 1995. Over the last few years, the large majority of loans have only been originated by the country's pension funds, INFONAVIT and FOVISSTE, as well as government trusts, FONHAPO and FOVI. These have generally targeted lower-income workers, particularly those with professional or governmental jobs. Many others, despite having a solid income and decent credit have been unable to obtain financing for several years. Softec, a Mexican consulting firm estimates that demand for housing will average 1.6 million units per year until 2010, but actual production may not surpass 800,000 with half that total being built in the informal market.

The Response to '95 – Changing Housing Finance Markets

The withdrawal of conventional mortgage lending following the mid-90s crisis produced two parallel responses. One was on the public side – the Mexican government came under intense political pressure to not only bail out impacted borrowers and lenders, but also to erect regulatory safeguards that would help reduce the chances of a several effect. The other response was on the profit-making side. Because population growth and, to a lesser extent, job growth, continued to rise, pent-up demand for mortgage products grew larger and larger. As a result, innovative non-bank players and international entities jumped into this underserved market with new, creative vehicles for delivering loans and making money. The Mexican market, though smaller than that of its neighbor to the north, has comparably strong demographic and economic drivers pushing demand for homeownership. [3] Over the last few years, a set of new players and new practices have been emerging – and continue to emerge – on the public and private sides.

New Players

One of the key new sets of players on the scene are the SOFOLes (Sociedads Financieros de Objeto Limitados), non-depository lending institutions similar to mortgage banks in the United States. Legislatively authorized in 1995, they quickly moved into the vacuum left by the collapse of the banks, and in the last eight years have originated over 160,000 loans and captured almost the entire low-income mortgage market of those earning under US$ 10,000 per year. Unlike U.S. mortgage companies who resell their loans into the secondary market, SOFOLes have traditionally kept their loans in portfolio, relying on below-market rate loans from Mexico's big pension funds and government trust to re-lend downmarket, capturing profits through spread and fees. Though SOFOLes had the market largely to themselves after the bank collapse, their

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Comparison of Mexico and U.S. Housing Markets

	Mexico	United States
Households	21.5 Million	72.5 Million
Persons per Hh	4.5	2.3
Average SF	700	1900
% of Housing Stock that is substandard	~50	-
% of Housing Stock that is self-built	>50%	<1%
Potential Market per year for new housing	1.6 Million	1.2 Million

From Mexican Housing Overview 2002, by Softec, S.C., 2001, Mexico City, the 2000 U.S. Census, and "The State of the Nation's Housing 2003", 2002, by the Joint Center for Housing Studies of Harvard University success is also due in large part to a set of innovate practices designed to overcome regulatory and industrial hurdles unique to the Mexican market. The two largest players, Hipotecaria Su Casita and Hipotecaria Nacional, hold 52 per cent of the mortgage market and boast delinquency rates of less than 1 per cent.[4]

The international financial community has become involved in Mexico's mortgage markets like never before. The financial collapse of the mid- 90s, and particularly the high volumes of accumulated bad debt, pushed many Mexican banks to seek out acquisition by capital-rich entities.[5] The shortage of liquidity in the Mexican market has made for lucrative investment opportunities. Almost 90% of Mexican banks are now under foreign control, which means that as of 2003, these banks are backed by relatively clean balance sheets. In the case of Pulte Mortgage, an American-based homebuilder and lender who desired to expand their construction presence south of the border, acquiring a 20% share of a SOFOL, Su Casita, was the most effective way to ensure adequate financing for their products. Citicorp and Ford Motor Co., likewise, have acquired major stakes in new SOFOLes.

<u>New Practices</u>

Since 1995, Mexico has worked to develop and institutionalize new mortgages to mitigate against the effects of inflation. One example is a widely used price-level-adjusting "UDI" (Unidad de Inversion) denominated loan type. Lenders issue loans based on the value of an UDI to generate an interest rate that is lower than a typical peso loan because it neither needs to add a component for expected inflation nor a premium for unexpected inflation. Similarly, a couple of the larger

[4] "US-style mortgages to ease Mexican housing" by John Authers, Dec 4, 2002, *Financial Times.*

SOFOLes have recently employed derivatives in creative fashions to allow a limited number of fixed-rate mortgages to be sold – a first for Mexican homebuyers. These newer products not only make it easier for borrowers (though inflation-tracking loans are not entirely new, as they date back several decades), but they also make the lending market more accessible for investors, particularly international investors who are very wary of seeing the value of their investments erode through interest-rate risk.[6]

Over the last several years, lenders have moved towards securitization or bond issuances to attract new sources of capital off of loans held in portfolio. Unlike the system of the U.S., where lenders resell their loans to a secondary market player, like Fannie Mae, increasingly SOFOLes are taking their products directly to the market.[7] This reflects the nimbleness of the SOFOLes and the role they've already established in intermediating between international capital markets and borrowers. It also reflects a concern from SOFOLes that the pension funds and government trusts (the traditional sources of capital) are too bureaucratic and inefficient (or would be perceived as such by investors) to effectively manage public offerings of products. So though a SOFOL manages the process, an MBS offering is generally guaranteed by Sociedad Hipotecaria Federal or SHF (formerly known as FOVI, a pension fund recently structured as federal mortgage bank), one of the few Mexican entities that may be, politically, "too big to fail". This past year, a number of sizable of MBS issuances have been launched or are in process,

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[5] Mexico's commercial banks also responded to the financial crisis through a wave of consolidations. Of the 18 banks that existed in the early '90s, only four still exist. These larger entities offer greater economies of scale in the mortgage business, and may reduce the costs for the end borrower.

[6] The value of the peso declined 99.01 percent from 1983 to 2001. (from an unpublished paper titled "Exchange-Rate Risk Mitigation with Price-Level-Adjusting-Mortgages: The Case of the Mexican UDI" by Libscomb, Joseph et al, Dec 11, 2002)

[7] SOFOLes are prohibited by law to collect deposits. Traditionally all their financing has come from pension funds, banks, or the government. Moving to the secondary markets is critical. According to Carlos Obregon, president of the Mexican Association of Sofoles, the organization's "…first priority is to diversity []sources of funding." ("Need a Loan? Here's Where to Find One" by Elisabeth Malkin, April 30, 2001 *Business Week*)

undertaken through the support of Deutsche Bank, and directed for sale primarily on the Mexican market. And though the issuances rely heavily on credit insurance, and UDI/dollar lease swaps as a hedge against inflation, buyers are increasingly moving into the market. The expectation is that once these recent issuances are proved in the domestic market, the next generation will increasingly target foreign capital.

Case Study – the Foreclosure Process

To understand the Mexican housing markets and the creative responses of certain players it's worth examining the foreclosure process. Though Mexico prides itself on a high level of protection for borrowers, few support the system as it stands now. It's frequently cited by domestic and international banks and investors as a key barrier to a liquid, efficient market. Banks must jump through significant regulatory hoops to repossess defaulted collateral. But though a foreclosure system like the one in Mexico would have disastrous consequences on housing finance if it were north of the border, Mexican lenders have developed creative workarounds to make the market work.

Historically, foreclosure required a lawsuit against the borrower in a Mexican state court. In the mid-1990s, these courts were overwhelmed with cases as defaults soared. In many states, the backlog has not yet cleared, and obtaining a court date can take three to five years with a lengthy process that allowed borrowers to make a series of time consuming, but generally groundless, claims. In the last year, new federal legislation has been passed to induce states to reform their processes, offering incentives for states who create specialized foreclosure courts, limit the nature of borrowers' defense claims, and enable a third party deed of trust system that holds the disputed asset. These reforms are only slowly and sporadically being implemented.

Though no study has been done to quantify the "foreclosure premium" that banks must attach to loans to account for the possibility of high costs at the time of default, it is not an insignificant component of the mortgage interest rate offered. During the course of foreclosure and asset sale, Hipotecaria Su Casita, one of the larger SOFOLes reports recapturing only 70% on average of the outstanding balance of the loan. Su Casita pays high recording fees, legal costs and the like. And over the course of the average foreclosure – two years from default to foreclosure completion – borrowers live rent-free, the buildings typically deteriorate, and no revenue is brought in. And up until recently, borrowers' credit history have not suffered as a result, creating a moral hazard problem, with borrowers intentionally defaulting. Poor reporting systems have prevented banks from exchanging information on high-credit risk activities. As of 2002, this is slowly changing, as TRW, a U.S. credit reporting firm has begun working with Mexican banks to create a credit database similar to that which exists in the U.S.

To bypass these barriers, Su Casita, as with many of its SOFOL peers have taken creative steps to avoid a formal foreclosure process. According to Michael Marez, Senior Vice President at Su Casita's parent company Pulte Mortgage, defaults can often be reconciled without using the courts, "It's often not their fault. They've lost a job or fallen ill. We make sure to offer them an amicable solution that keeps the situation from getting messy. We work to preserve their honor, even if not their house."[8] Even when workouts or repayment programs won't work, Su Casita reports being very successful in helping borrowers move to a smaller house or assisting

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8 From personal interview with Michael Marez, May 13, 2003.
A Financial Times article from Dec 27, 2000 "Room to Live the Mexican Dream" by John Authers, described Su Casita's efforts to deal with delinquent customers: "Borrowers only need to be a month behind before [the collections] process starts. Statements from Su Casita are delivered by hand, usually by a casually dressed employee. The bearer of a late notice however, is formal, dressed in a dark suit and black tie. All the neighbours know exactly

borrowers in selling the defaulted property themselves. Additionally, Su Casita will often wave origination fees and provide streamlined underwriting to induce a new buyer to acquire the property for the sake of expediting the process and bypassing formal foreclosure proceedings.

Challenges Ahead

Mexican finance markets have rebounded spectacularly from where they were in the mid-90s after the financial crisis, particularly given the structural problems that have hindered the markets. As international capital moves in to aid a cash-strapped, but booming, housing market, new demands and opportunities are developing. The transfer of foreign expertise, as well as cash, has helped move Mexico towards the liquidity and efficiency of U.S. markets. And the ingenuity of local players, particularly in the banking and SOFOL community, have enabled creative responses to distinctly Mexican regulatory problems. A set of challenges and questions remain, however, as the market moves forward.

What are the lessons learned from the peso devaluation experience? Could the market today weather a shock similar to that of 1995? Does the far greater presence of (and prospects for) international capital help or hinder? The increasing segmentation of the financial industry and the cross-fertilization of international expertise have helped industries to be more accountable and more realistic in their risk forecasts. That said, several problems remain. The overwhelming control of foreign capital may help stabilize the markets by linking products to the international capital markets. But they may also mean that capital can more easily flee and move a situation from bad to worse. Additionally, though banks now carry larger reserves, some of the loan products and guarantees have made only incremental changes in the marketplace. The switch from peso-denominated DIMs to UDI-

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who he is. 'For lack of a better word, their clients are more subject to social coercion than most,' says Phil Cuarco, denominated DIMs, though billed as a hedge against inflation, may serve more as a hedge against inflation for international investors. Research suggests that UDIs would have moderated the impact of the 90s crisis, but not substantially corrected for it.[9] Additionally, one of the legacies of the peso devaluation was an unhealthy lesson learned – that when all else fails, the Mexican government and international community will come to the rescue. An interview with one banking professional intimately familiar with this market suggested that banks see the possibility of future collapse as a governmental issue – one which needs to be addressed and anticipated by the Mexican government and not by banks and mortgage companies themselves. According to Michael Marez, "The financial collapse brought greater transparency and economic accountability to the national government. It pushed up national reserves. And today, it provides banks with a confidence – they've been burnt once, so they know they can handle it again if they have to".[10] The next few years, with banks now having largely resolved the bad debt issues of the 90s and now harnessing the vast resources of the international finance markets will be the true testing ground. According to a 2001 World Bank report, bank credit to the private sector accounted for less than 20% of GDP in Mexico; the world average is 136%. There's plenty of opportunity for growth.[11]

Can Mexicans continue to leverage international capital, despite existing regulatory difficulties? And can they do it without ceding control of housing policy to Washington, DC and New York City?

International capital has been consistently moving to Mexican mortgage products over the last decade. Though structural changes are still needed and foreign investors need a better

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who covers the Mexican banking sector for Moody's Investors Service."

[9] Libscomb, Joseph, 2002

[10] From Interview with Michael Marez of Pulte Mortgage, Co., May 13th, 2003

[11] "Mexican banks open their pockets: Lending sees its biggest increase since the Tequila Crisis" by John Authers, April 8, 2003 *The Financial Times*

understanding of the mortgage markets, this capital (and associated expertise) has helped lower the costs and increase the availability of mortgage products. And Mexico has learned not only from its own mistakes but from that of its neighbors. For example, Argentina pioneered mortgage-backed securitizations in Latin America five years ago, but suffered a financial meltdown when the Argentine government converted cashflows on MBS from dollars to pesos. In response to concerns like these, Mexico is first targeting its MBS offerings to Mexican pension funds and mutual funds, before it seeks out financial capital.

That said, though no doubt the mortgage markets are short on capital, questions will linger for some time as to whether foreign investors reap disproportionate benefits relative to the Mexican homebuyers who need their cash. As one recent article in the Financial Times described, "Figures from Mexico's Banking and Securities Commission show fee income rising more than 50 per cent since 1998. Fees now account for 31 per cent of profits, up from 24.9 per cent two years ago. Politicians are left to speculate whether the main contribution of the foreign banks that now control 90 per cent of Mexico's banking assets bas been to teach the nation's bankers how to gouge their customers, rather than how to lend…"[12] Though it's too soon to know how accurate these fears are, Mexico must work to mandate transparency and accountability among all players.

To what extent do national regulators and policymakers need to intervene to enable housing production and the housing finance markets? How can the public sector role best catalyze or leverage existing resources going forward?

The mortgage market today is best able to serve borrowers at the top end and at the bottom end. Investment capital today generally flows to support mortgages originated to the poorest – who

[12] Authers, John, 2003.

qualify for "social interest" subsidized mortgages by the pension funds and SOFOLes – and to the richest – who pose little credit risk and have demonstrable income, histories, and purchasing power. Serving the vast middle of the Mexican mortgage is harder – access to additional capital, alone, will not adequately lower the high costs associated with serving this population. For these individuals, a set of long-term infrastructural problems most likely must be overcome:

- *Lack of Credit Reporting* – Traditionally, lenders have had to engage in what's called a "socioeconomic investigation" to ensure the creditworthiness of potential borrowers – lenders contract with investigators who visit a prospective lender's home and workplace to verify self-reported data. This high-cost and inefficient system is slowly being replaced, but more is needed to regularize and systematize the process. In 1996, a Mexican company began compiling credit card data for the minority of Mexicans who own credit cards. Over the last year, TRW, a U.S. company has been collaborating with banks to create a more comprehensive credit history database.
- *Few Checking Accounts and Unreliable Mail System* – Mexican borrowers generally pay their monthly payments in cash directly to the bank or to a local collection office. This reflects the paucity of Mexicans with checking accounts and the country's erratic national postal service. This is compounded by a legal system that places a burden of prove on borrowers to show that a payment has been received.
- *Foreclosure Laws* – As described earlier, overly-stringent borrower protection laws and the need to work through back-up local courts make it difficult for collateral to be collected.
- *Weak Recording System* – Deed recording systems are generally inaccurate – and *notarios publicos* (the local recording agencies) generally do not provide guaranties on their findings.
- *Prevalence of Informal Economy* – Many Mexicans work independently or receive a cash salary, earning enough for a small mortgage but not enough to trigger a tax liability. These types of

income are difficult for banks to prove and many Mexicans end up unable to borrow as a result. Additionally, the large amount of housing built in the informal sector causes problems in the long-run. Better urban planning or site-and-services designations may help on that front.

- *Overregulated Public Pension Funds* – The public pension funds have moved slowly to deploy their resources strategically. As a major source of capital, their resources are critical. Over the last few years, they have embarked on efforts to enter into co-financing arrangements with banks, create voluntary savings accounts for workers, use accumulated pension accounts as a guarantee on a mortgage, and the like, but more is needed.

The banking community, homebuilders, and the Mexican public are strongly united in a push to increase home production and home ownership. Together with Vicente Fox's recent pledge to see a new housing program that would construct 750,000 homes a year, Mexico is likely poised to move forward rapidly a high growth, high construction phase. The fundamentals are largely there and international capital is at the gates waiting for a way in. The challenges – overcoming antiquated public regulations, ensuring accountability among international players, hedging against Mexico's turbulent past – are large but not insurmountable. Given the ingenuity of private parties to date, and the continued public will to see new housing created, Mexico's housing finance markets hold a potential today for generating levels of production like never before.