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A Report Based on the Proceedings of

The Brazil-U.S. Aspen Global Forum

April 8 - 11, 1999

Convened by:

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Brazil-U.S. Aspen Global Forum-Expanding Primary and Secondary Mortgage Markets and Housing Opportunity in Brazil

April 8 - 11, 1999

On April 8 to April 11, 1999, over eighty respected Brazilian and U.S. business, government, non profit, and academic leaders participated in the second Brazil-U.S. Aspen Global Forum on Expanding Primary and Secondary Mortgage Markets and Housing Opportunity, in Sao Roque, Brazil. They included investors, rating agencies, mortgage bankers, originators and servicers, government, quasi government and private sector secondary market participants, and housing policy analysts. Their discussions were vigorous and intense. They cared deeply about finding a way to respond to Brazil's housing priorities in an economically sound and socially conscious manner. While they did not always agree on particulars, they did reach consensus on a broad framework to reform Brazil's housing markets. They also concurred on many immediate strategies and next steps to further Brazil's current efforts to establish effective primary and secondary mortgage markets.

This report summarizes the proceedings and describes the participants' discussions and proposals. However, because it relies on written words, the report cannot adequately convey the intellectual and professional commitment of the participants to converting agreed upon policies and programs to reality. "We must take some important initial steps without waiting for complete certainty. Indeed, we will never have complete certainty. The Brazil-U.S. Aspen Global Forums on Housing have helped link what we know concerning housing problems and the effectiveness of present policies and programs to workable alternatives. We have reduced the risks and expanded the possibilities. We, now, must begin to move, we owe it to the citizens of Brazil" (Klumb).

The report is divided into several sections paralleling the discussions at the Forum. They include:

Section One: Problems and Opportunities; Section Two: Creation of a New System of Housing Finance; Section Three: Other Critical Issues; Section Four: Meeting the Housing Need of the Poor; Section Five: Consensus and Optimism; Section Six: Next Steps: Getting Started

Problems and Opportunities

Securing Macro Economic Stability

Brazil must overcome several complex economic problems as it moves to develop primary and secondary mortgage markets. While Brazil's economy appears to have turned the corner and did not suffer the predicted dire consequences resulting from the collapse of the Asian markets and Russia's serious economic problems, the country's economic situation is still fragile.

Present economic indicators are mixed. Inflation rates have increased but the rate of growth is not as high as anticipated during the winter crisis. General inflation indices appear at the present time to be declining relatively rapidly. Although interest rates have gone up, they seem to have peaked and stabilized in recent weeks. "Brazil's financial institutions have faced relatively high levels of loan delinquencies and defaults. But banks, given recent positive economic news and financial indices, appear ready to extend credit and respond to central bank interest rate reductions" (Mein). Devaluation has not aborted investor interest in Brazil. Indeed, devaluation may have helped investors look at Brazil more realistically. It appears to have reduced the perceived investment risks resulting from an overvalued Real. The Real seems to have stabilized. Most middle and large size firms in Brazil have been able to withstand devaluation pressures.

Both Brazil’s President and Congress have initiated policies to reduce federal expenditures and to bring the federal budget back in line. While the country’s account balance is still worrisome, estimates are that it, too, will illustrate reasonable levels soon.

The support of the IMF and the United States has been critical in calming the fears of international investors. Indeed, Brazil has begun to issue securities in the international market. "But we are not out of the woods yet. Brazil’s macro economic policies must be directed at assuring long term economic stability" (Mein). "We must continue to take those steps which assure Brazil a healthy economy at relatively low inflation rates. We must come close to zeroing out our account and trade deficits. We must develop and carry out important structural and political changes. Privatization, social security, pension fund, taxes and budget reforms must be combined with administrative improvements. They all must receive the commitment of the President and Congress" (Kapaz).

The country’s economic and political changes must be strategic. Clearly, "Our fiscal and monetary policies must be predictable. They must indicate both to international and domestic capital markets that we are serious about putting our house in order. However, our efforts to strengthen the economy must be balanced by our efforts to address our visible social and environmental needs. Our tasks will be difficult but they are necessary (Kapaz).

Housing Need and Recent Initiatives

Brazil has an immense need for new housing units. Estimates range from five million to ten million units, depending on definitions used by different analysts related to housing adequacy as well as housing need, and, whether the estimates of need accommodate both population growth and vacancy rates.

Meeting Brazil’s housing needs will be difficult. First, much of the population requiring improved housing has very low incomes. They will not be able to enter the market place or find adequate housing without government support. More than 90% of need is attributable to households earning five times less than the Brazilian minimum wage. Second, even for the portion of the population with higher incomes, purchasing a home is often difficult due to the lack of a comprehensive housing finance system. Third, while Brazil has recently initiated major legal, administrative and regulatory reforms to facilitate development of capital markets for housing, further changes are necessary to assure reasonable access to domestic funds and increased access to international funds.

Confidence in Brazils ability to stabilize its economy and "grow" again in a measured reasonable manner led Forum participants to reiterate what was agreed to at the first Brazil-U.S. Aspen Global Forum on Housing in April. "It is now time to develop the policies, plans and programs to respond to the country's significant housing needs" (Goldstein).

"We need to develop and put in place more effective housing policies, plans and programs. We need to continue to refine and reform regulations to assure predictability with respect to financing and development. Our laws and regulations need to facilitate development of both primary and secondary mortgage markets" (Klumb).

Legal and regulatory changes as well as complementary policies, plans and programs will take time to implement. The roles of government and business will vary over time. "But we cannot wait any longer. We should take advantage of the economic difficulties facing the country to define a comprehensive set of meaningful policy initiatives" (Lafemina). Their implementation can begin strategically. They can play a purposeful role in fostering a healthier more stable Brazilian economy. "We can fine tune, add or amend our efforts in an efficient and equitable manner as the economy continues to improve and as we evaluate housing needs and the success of existing initiatives" (Barbosa).

"Brazil has moved forward since the last Brazil-U.S. Aspen Global Forum on Creating a Secondary Mortgage Market. We have begun to implement the new law 95l4 enacted by the Brazilian legislature in November of 1997. It established the SFI or Sistema de Financiamento Imobiliario. The law changed the legal framework regarding residential property ownership. It permits deeds of trust and appears to allow property to be held in the name of an independent trustee. It makes it easier to foreclose on property. It provides increased protections to originators and potential lenders" (Filho). "We think that the law is a major step forward. But, we have no certainty yet that the courts, administrative systems, or the regulatory environment will be responsive. We also do not know if the political system will support efficient implementation of the new law. We want a balance between the interests of the financial community and the interests of the housing consumer. We need a good test of the law in the courts, particularly the foreclosure provisions" (Crestana).

The law, as discussed in the first Brazil-U.S. Aspen Global Forum on Housing, authorizes the creation of securitization companies. Their purpose is to assemble portfolios of mortgage credits and issue new financial products called CRIs based on real estate receivables in a secondary mortgage market. Their portfolios will be based primarily, but not exclusively, on residential real estate. CRI's will be able to be sold and traded to investors.

According to Forum participants, Law 9514 reflects progress toward creation of a mortgage backed

secondary mortgage market system. While the law envisions multiple companies, only one - CIBRASEC - has formed thus far. The company is privately chartered. It includes among its stockholders the federal government, several state governments, and a number of the large banks including the major players in the SFH system. According to its executive vice president, Luis Pinto Lima, "CIBRASEC is beginning to develop its administrative structure and its guidelines as well as its relationships with other institutions. CIBRASEC has also begun to think through how it can help standardize mortgage instruments and underwriting criteria. We are working with relevant administrative and judicial bodies to assure fair and efficient implementation of 9514 provisions, particularly concerning securitization and foreclosure. We are trying to define strategies to improve access to good information. Economic and market conditions have prevented marketing of the first" CRI's.

Participants were generally positive about CIBRASEC's initial work program. But they were not sure it went far enough. "If Brazil's leaders really mean what we say about significantly expanding housing choices, we must do much more. We must look hard at our current institutions. We must ask difficult questions. We must push the new law as far as it can go. We must assure development of a comprehensive integrated legal, administrative, financial and regulatory approach" (Mein).

Limits of Old Housing Finance System

No major experienced secondary market institutions exist in Brazil. No fully developed primary mortgage market has evolved in the country. Financing for residential real estate has traditionally come from FGTS (Fundo de Barantia do Tempo de Servico), a compulsory savings system absorbing 8% of wages, and from voluntary savings accounts in savings and loan institutions. A number of problems have been identified with the existing system:

<u>The Housing System has performed in an uneven manner:</u> *The system's ability to provide funding for housing has been negatively affected by recent economic cycles and by related government policies and regulations. FGTS and Savings Deposit Loans have varied considerably over the years (Table 1).*

Table 1. Housing Finance system Loans

(Thousands of financed units)

YEAR	FGTS funded loans	Savings dep. Funded loans	Total loans	Yearly average
from 1965 to 1979	1,561	913	2,474	165
from 1980 to 1982	848	786	1,634	545
from 1983 to 1989	375	566	941	118
from 1990 to 1993	573	235	808	202
from 1994 to 1997	102	183	285	71
TOTAL	3,459	2,683	6,142	192

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

The System has not provided builders with predictability nor the country and its citizens with sufficient housing capital.

Fear of economic instability and unanticipated shifts in government policy have resulted in unwillingness by financial institutions to make increased commitments to the housing sector. FGTS related institutions were hurt in the early eighties. Rapid inflation combined with tough policies concerning wage increases led to many delinquencies. This fact, combined with mortgage payment ceilings on borrowers, generated negative amortization during the late eighties and early nineties. Financial institutions suffered. Their cash flow was reduced significantly. FGTS funds have been and remain subject to swings, given employment changes and periodic increases in unemployment.

Similarly, savings deposits have been and remain extremely sensitive to general economic conditions and government policies. Housing loans typically have relatively short terms and relatively high interest rates due, in large part, to frequent inflation cycles in Brazil and the shortage of investment capital. Rates and terms have also been negatively impacted by the mismatch between the source of capital and the needs of housing purchasers. Savings accounts in Brazil for the most part reflect very short term liabilities while housing loans, despite their relatively short terms, are for longer periods. At times, disintermediation resulting from general interest rate increases place deposit based financial institutions at risk.

Government rules require financial institutions in the existing housing finance system to grant priority to housing loans. But priority does not translate into exclusivity. For example, the FGTS system does respond to infrastructure needs, like sanitation. Deposit based institutions may allocate up to 15% of their deposit funds for non-housing projects. Importantly, government regulations have limited the ability of institutions to compete in the market place for capital or to vary their portfolios and leverage interest rates based on changed or evolving market conditions.

No significant secondary mortgage market exists in Brazil. *Failure to develop a secondary mortgage market limits Brazil's ability to easily increase lender liquidity as well as the overall supply of funds for housing production and rehabilitation. Absence of a secondary market denies Brazil the capacity to readily access capital for housing. Very few secondary market institutions exist to efficiently link lenders to domestic and international investors.*

Lack of a secondary market impedes Brazil's efforts to reduce the capital disparities between its diverse regions; disparities that result from economic as well as social differences. Lack of a secondary market also frustrates Brazil's ability to lower the cost and improve the terms of housing credit. It mutes Brazil's ability to reduce and fairly allocate the risks associated with providing housing credit and it impedes development of diverse mortgage or loan products responsive to the needs of consumers, lenders and investors.

Almost all of the mortgage loans that are made in Brazil remain on the balance sheet of the originating institution. Caixa Economica Federale (CEF) has had limited experience with mortgage bonds based on their portfolio. Bad loans in the past combined with Brazil's economic problems have made it difficult to securitize Caixa's current portfolio and secure easy market acceptance of Caixa's bonds.

Builder/developers have attempted to issue debentures based on real estate receivables or the cash flow from their projects. Their experience to date has not been extensive and, according to Forum participants, has been very expensive. Builders/ developers have been required to accept relatively high interest rates and relatively short terms. Most of the securitizations do not reflect true sales or transfer of the property.

Real Estate Investment Funds have been created in Brazil, but they have focused most of their initiatives with respect to securitization on commercial properties. In l995, Mortgage Companies were authorized in Brazil. Only a handful have been established. Efforts to use debentures, based on pooled housing loans, have not been visibly successful. As noted earlier, CIBRASEC, a new secondary market institution, was established after passage of Law 95l4 in l997. While it offers great promise, it has not yet entered the secondary market.

***Brazil has not yet developed a strong primary mortgage market**. Absence of a secondary mortgage market has muted the willingness and or desires of potential primary market lenders to enter the housing market. Absence of a primary mortgage market has impeded development of a secondary mortgage market. Which comes first? Both must be developed in light of Brazil's housing needs.*

Mortgages are long term investments. Lenders or potential lenders in Brazil have no reasonably priced way to share their risks with capital market investors. They cannot lay off debt easily. Loans remain on lender’s balance sheets. Lenders, of necessity, have to assume and retain all the key functions- origination, servicing, risk management, finance, etc. "We have not developed the infrastructure necessary to establish a primary mortgage market "(Klumb). To decide to participate as a lender, except for very expensive loans in very safe niche markets, was and remains difficult. It required and still requires tremendous resources and faith.

Several additional factors have limited the evolution of an effective primary mortgage market in Brazil. As noted earlier, the cyclical nature of the Brazilian economy, combined with government stabilization policies, have muted investor interest in housing. There has been too much uncertainty in the economy. Interest and inflation rates have remained volatile. Other competitive investments, both in the public and private sector, offered investors what appeared to be safer alternatives to housing.

The existing Housing Finance System may have contributed to difficulties associated with development of a primary mortgage system. In some respects, the FTGS part of the system competes with the private sector. It provides implicit and explicit subsidies to participants in the system. It may have narrowed the market for private sector housing loans and impeded the establishment of fully developed primary mortgage markets.

As noted earlier, until recently, Brazil lacked a legal or regulatory framework to encourage lenders and investors. "We could easily not transfer assets. There was no assurance that lenders could foreclose on property in a timely, cost efficient manner" (Abud). Brazil still lacks a standardized mortgage instrument and standardized underwriting criteria. "It also still lacks good accessible information systems concerning housing values, housing markets, credit, liens, portfolio history, etc" (Kheirallah).

Developer Financing: necessary but not sufficient to meet housing needs. *Developers have partially filled the housing finance void. They have pre-sold units before construction and they have provided installment loans to buyers. Developer loans generally are not secured by the property. Construction of pre sold units often is delayed until the payments from buyers equal costs. "Precise estimates are not available, but data from Secovi suggest that in the city of São Paulo, developers financed approximately 68% of all units in 1998. Last year, the developer’s share was higher - 80% or more (Klumb)."*

While some developers have attempted to secure funding for pre-sold units and future projects by securing debt based on receivables, the going hasn't been easy, given the cost of money and the lack of a certain and predictable legal and administrative framework. Banks and/or other investors have not been forthcoming in part because of the perceived weakness of the portfolio of receivables. Some of the banking representatives at the Forum suggested that construction firms are not always best suited to evaluate the credit risks of potential borrowers. They argued that fewer risks would be involved if there were a separation of construction finance and buyer finance functions. Developers tended to agree but noted that financial institutions generally will not provide credit directly to developer/ builders.

Discounting of installment loans to secure funds has become more common than securitization. But it is very costly for developers. They pay a real premium for risks assumed by financial institutions.

Developers have also tried to form partnerships with local governments to lessen their financial burdens and to join in joint ventures with willing investors.

According to many Forum participants, developer-financing of installment loans may inadvertently have made the task of creating a mortgage market more difficult. Buyer expectations have been changed. "Home buyers seem to like installment sales. They think it poses less risk than mortgage financing (Jafet)." Some don't like the idea of mortgage financing and foreclosure possibilities. "We will have to re-educate the public regarding mortgage loans, deeds of trust, legal obligations etc. To develop a primary mortgage market will require that the consumer understands laws related to foreclosure etc" (Bôas).

Developer based financing has been a necessary way to keep the industry going and to provide consumers with an option in light of the limitations associated with the existing finance system. But it is not sufficient to respond to Brazil's immense housing needs. The amount of funds that has been and can be provided by builders is limited and the criteria imposed by builders on their loans are restrictive. "If funds are tied up in loans related to construction and sale and if we do not have an easy and economically effective way to sell or lay off loans, we are limited as to how many units we can build or provide consumers. We cannot go too far out in front of individual units and individual homebuyers. It is a risky and often an expensive way of funding production" (Andrade).

Creation of a New System of Housing Finance

Aspen Forum participants concurred on the need for Brazil's government and private sector to grant priority attention to the development of a fully functioning primary and secondary mortgage market. Forum participants generated a discussion concerning the various functions that they believed must be performed by an effective housing finance system. They recognized that the some of the particular approaches used in the U.S. to develop and sustain a primary and secondary market may not fit Brazil because of its different economic, political and social characteristics. However, they agreed that the U.S. experience in developing strategic primary and secondary market functions offered many practical lessons for Brazil.

Participants discussed several major functions or activities related to the unbundling of once integrated mortgage activities or services in the United States.

Loan Origination

Historically, deposit based institutions in the U.S. initiated all the key functions associated with mortgages. They originated them; they funded them; they managed them in their portfolios; they serviced them.

Some institutions, in the U.S., continue to fulfill all the major mortgage market functions. But since the advent of a comprehensive secondary mortgage market, unbundling, or the use of several specialized institutions to fulfill key mortgage market activities, is increasingly the norm. "We have in the U.S. a myriad of related but independent public, quasi-public, and private sector institutions" (Anderson).

Loan origination, for example, is now carried on by brokers, correspondents and mortgage banks as well as deposit based institutions. "It's important to have a broad range of originators" (Weiner). CIBRASEC's Luiz Pinto Lima agreed. "It would be useful to have specialized institutions in Brazil. Regular banks have too many other issues to deal with. We need the competition. We need the geographical choices that come with diversity of originators. We need many different types of windows. We need different *products to fit consumer needs. We need to separate origination from funding, if we ever are to achieve specialization and an increase in liquidity as well as total housing funds."*

Because Brazil does not have a mature secondary market, existing private mortgage activity is often managed in single institutions. Lenders hold loans in their portfolio. They directly fund loans from their own resources, service their own loans, and basically accept the primary risks associated with housing loans. They are limited in terms of how many loans they can fund by the amount of their resources.

Unbundled U.S. originators have more flexibility. They can decide to keep mortgage loans in their portfolios or sell to a secondary market institution. If originators successfully transfer loans to varied secondary market institutions, they will be able to replenish their funds for additional housing loans. They are able to allocate much of the credit risks first to a secondary market facility (e.g., FNMA) and subsequently to diverse investors associated with mortgage lending.

Mortgage Insurance

Many Forum participants suggested that Brazil should address credit or default risk through the development of mortgage insurance. While laws similar to 9514 make it easy to fairly and efficiently foreclose on property in case of default, most times neither portfolio lenders nor investors in single or pooled mortgages want to take possession of and liquidate foreclosed properties. They much prefer liquid assets.

Mortgage insurance protects the creditor against default by the borrower. Since the advent of the Federal Housing Administration (FHA) in the l930s, it has been available in the U.S. While there is a debate going on in the U.S. about the need for FHA now, given the evolution of private mortgage insurance, the debate itself is a sign of the success of FHA insurance. "FHA began in the thirties when there was no private insurance....when there was no standardized mortgage instruments or underwriting criteria....when financial institutions were afraid to provide long term reasonably priced loans for housing. All this has changed now in part because of the government's willingness to initiate mortgage insurance through FHA." (Anderson) The price FHA sought and secured through its ability to insure mortgages was standardization of mortgage instruments and underwriting criteria.

FHA insurance generated a willingness on the part of private sector financial institutions to extend

the length of mortgages and lower interest rates. FHA's existence and early achievements helped foster a private insurance industry in the U.S. Through insurance, FHA helped create acceptable securitization approaches and a secondary mortgage market. FHA laid a foundation for public and private sector collaboration and partnerships concerning securitization. It made the private sector comfortable about participating in both the primary and the secondary mortgage market.

Mortgage insurance is not generally available in Brazil. There are hopes that private businesses will develop relevant insurance products. "The idea of a single government insurer is an idea for the sixties, not the nineties," observed Luis Pinto Lima of CIBRASEC. "We want private companies to provide mortgage insurance."

Most Forum participants, however, felt that Brazil should explore government insurance and other ways government can help develop a well functioning mortgage market. While private sector entities might be able to provide insurance and otherwise handle risks associated with mortgages for the upper income segment of the market in Brazil, it will likely require government insurance to broaden the reach of the financing system to low or moderate income people.

In addition to mortgage insurance, there are other insurance products that will help reduce risk. For example, CIBRASEC anticipates the use of death and permanent disability insurance and casualty insurance (i.e., storms, fire etc.). These insurance products exist in the Brazilian and the U.S. marketplace.

"Title insurance offers another form of protection in the U.S. marketplace," noted Weiner. This type of insurance is probably not needed in Brazil, due to the government's role in registering titles and in noting liens.

Loan Servicing

Before unbundling in the U.S., the originator of the loan generally serviced the account. With unbundling, a whole service industry evolved. Development of a secondary mortgage market has increased the range of roles undertaken by servicing firms.

Mortgage loans in an unbundled system must be serviced by a competent entity. Responsibility must be assigned to collect payments and track interest and principal balances. Responsibility must also be assigned to monitor loans for potential problems and to initiate foreclosure proceedings based on default. Service firms must remit payments and provide reports to investors. Some firms may help service portfolios and even issue securities.

Representatives of three U.S. secondary market institutions indicated that they all rely on multiple servicing entities. "Larger servicing firms have better technologies and it's easier for us to deal with them," noted Mary Cadigan of FNMA. George Anderson of GNMA indicated, "GNMA relies on some 400 different servicers. But the top ten do about 50% of the business. GNMA prefers to deal with a larger number of participants, even if it is less efficient. We prefer to insure our future flexibility by preventing the possibility of market domination" (Anderson).

"It's important to structure the relationship so servicers have an incentive to do quality work," suggested Robert Van Order of Freddie Mac. Freddie Mac contracts with servicing entities. It allows a 25 basis point service charge. This provides a substantial flow of funds to the servicing entity. Since U.S. securitization institutions offer sufficient payment to make servicing a lucrative business, they have leverage to ensure that service firms initiate proper servicing functions including remittance, accounting, reporting, and management of loans.

In Brazil, loans are now serviced, more often than not, by financial institutions that provide loans and bear direct risks in case of default. Separate servicing entities are not common in Brazil. CIBRASEC hopes to partner with several different new service entities. But like its U.S. counterparts, CIBRASEC probably will limit the number it works with to achieve efficiencies of scale. CIBRASEC is working on a training program to impart necessary skills and techniques.

Participants from both Brazil and the U.S. indicated that the development of a capable servicing industry in Brazil is critical. "Government and groups like CIBRASEC should develop and foster fair and effective reimbursement schedules. They should assure transparent regulations and ground-rules concerning servicing functions. They should stimulate relevant information systems. They should standardize mortgage and security *instruments as well as related underwriting criteria. Government should not initiate competitive services" (Filho).*

Secondary Mortgage Market System Institutions

Forum participants acknowledged the differences between mortgage banking systems, secondary mortgage market facilities, and a secondary mortgage market system. Most discounted the long-term ability of a mortgage banking systems and secondary mortgage market facilities to meet Brazil's long term needs for housing capital. Both systems involve institutions that principally rely on general obligation bonds to access capital markets. Both generally require lending institutions to retain mortgages as balance sheet investments.

Mortgage banks and or secondary mortgage market facilities are used extensively in a number of countries. "They generally have developed in situations where there is relatively minimal specialization" (Holton). Absence of asset backed securities limits capital market opportunity. While there are cost savings, they do not seem to match the savings in interest and transaction costs accorded secondary mortgage market systems.

Brazil has created the legal framework and is now developing the mechanism to put in place a comprehensive secondary mortgage market system. Its domestic capital market is potentially relatively large, and with effective strategies, it can begin to penetrate international capital markets. According to most individuals attending the Forum, the U.S. experience with a secondary mortgage market seems more relevant to Brazil at the present time than the experience of other nations with mortgage banking and secondary mortgage market facilities.

Government sponsored enterprises (GSE) in the U.S., like FNMA, Freddie Mac and GNMA, have served in part as conduits between originators and investors. They have permitted the separation

of origination and servicing from funding. FNMA and Freddie Mac have been able to acquire mortgages from originators and package them as collateral for their own bonds or as collateral for securities sold to capital market investors. The implicit backing of the U.S. government for their securities has helped reduce the perception of risk on the part of investors. GNMA, through its full faith and credit U.S. government guarantees, has *facilitated pooling and securitization of mortgages. All three GSEs have facilitated off balance sheet financing and the liquidity of primary market lenders. They "have really made a difference with respect to the availability of capital for housing" (Desler).*

GSEs experience and track record in the U.S. have encouraged the growth of private sector firms which also issue mortgage backed securities. Generally, most analysts agree that the conduit and secondary market roles of GSEs facilitated development of a diverse secondary mortgage market in the U.S. While there are questions whether the U.S. now needs one or more government or government related secondary market facilities, most analysts concur that they still serve a useful function with respect to assuring predictability in capital markets. They also have helped assure a response to housing needs from capital markets and a reasonable response to geographical needs for housing funds. "They continue to reflect lower transaction costs and at least marginally lower interest rates (Little)". They have helped make housing finance competitive.

CIBRASEC is the only institution in Brazil created to perform secondary mortgage market functions within the framework of law 9514. Much discussion focused on clarifying the present and future character of CIBRASEC. Participants asked several questions. Is CIBRASEC a private company or a GSE? Is it or will it become a monopoly and if so, what precautions are in place to prevent abuse? What is the present relationship of CIBRASEC to Government and what should it be in the future? How does CIBRASEC compare to the secondary market system institutions that have developed in the United States?

Many Brazilians at the table indicated that CIBRASEC is "mostly" a private sector entity. It is not a government sponsored enterprise even though government is one of its shareholders. Its financial products will not carry any explicit or implicit government guarantee. "We have government support as a shareholder. We don't believe there is any implicit guarantee of our debt" (Pinto Lima). The fact that government and major financial institutions are shareholders, however, should increase investor confidence in the CRIs that are issued in Brazil.

A number of Brazilians indicated a preference for a securitization entity independent from the government. "We are wary of government. It is better to let private entities set the rules rather than government. We want to operate in the market without too much government regulation (Pinto Lima). Brazil should be able to build on the understanding of market mechanisms and products that have been developed elsewhere. "Brazil may not need an FHA or any of the government supported secondary mortgage market *institutions that developed in the U.S. It is conceivable that if we are able to secure an even playing field concerning our legal framework as well as our tax and regulatory system, the private sector will respond without significant government enhancements (Fonseca)".*

Most American and several Brazilian participants acknowledged the virtues of marketplace discipline. However, they suggested the need, at least at the outset, for greater government involvement. Indeed, some challenged the assumption that CIBRASEC was independent of government. Government's role as a board member and stock holder may create at least an implicit government guarantee - a moral or practical obligation to back securities. CIBRASEC should think through its present mission and structure. Its ties to government could well be an asset as Brazil moves toward the development of a secondary mortgage market. CIBRASEC could become a GSE - Brazilian style - and help lead efforts to establish a vigorous security mortgage market. As a GSE, like FNMA and Freddie Mac, it could help make the market.

Some participants indicated that at a minimum, government must create effective oversight mechanisms for CIBRASEC, particularly if CIBRASEC remains a monopoly. "It is necessary to have proper risk management and independent oversight of capital" (Little).

"CIBRASEC is not currently regulated as a financial institution. It will operate responsibly, because of the active involvement of its board. Unlike many Brazilian companies, our council (which is equivalent to the Board of directors in U.S. firms) exercises substantial oversight over the managers. They have imposed an internal limitation: CIBRASEC will not issue debt in excess of 25 times net worth" (Pinto Lima).

Lima indicated, "While CIBRASEC is now the only securitization entity resulting from law 95l4, it likely will not be a permanent monopoly". He argued, however, that "there is some value in having CIBRASEC operate as the sole secondary mortgage market entity initially". He suggested that, "it will make it easier to achieve levels of standardization which are critical to market functioning. It will permit achievement of volume and scale. Those who wait will confront a paved road. They will be able to take advantage of the expenses we incurred in developing the market".

Van Order of Freddie Mac agreed. "The first entrant teaches and makes the market. They don't have high returns in the early period. They must take many risks".

Many participants from Brazil and the U.S. were somewhat uneasy about a single entity dominating the market - even if mostly private. They argued for a fair and effective monitoring and regulatory system. They indicated that competition will lead to lower costs, more varied products and more efficiency. They also feared that if CIBRASEC were able to secure a very large share of the market, it would begin to act like a monopoly and freeze out potential competitors.

Most participants urged Brazil to consider the benefits and costs of a GNMA model or a Brazilian variation on the theme. Government ownership of a secondary market facility and government enhancement, including guarantees of MBS, would likely help Brazil develop both a primary market for mortgages and a secondary market for securitized mortgage pools directed at expanding housing opportunities for low and moderate income groups. Properly designed and regulated, a government owned facility could make a difference. It would not be competitive, except at the margin, with private groups like CIBRASEC. Indeed, it may help foster the growth of relevant private entities by making a secondary mortgage market and by building investor confidence in securities.

Bundling to Unbundle

To bundle or unbundle functions provides "too simple a set of options." According to Wally Little, "Brazil's efforts to develop sound and stable depository and non-depository institutions for loan origination purposes, and Brazil's need to secure a critical mass of stable institutions engaged in the secondary mortgage market may require government involvement at least during the next few years". Initially, the capital markets- domestic or international- may not be responsive in a significant manner to housing sector debt and equity requirements.

According to Little, "Brazil's economy, while apparently recovering, is viewed by many investors as uncertain. The legal framework for housing while improving is still basically untested; particularly with respect to use of property as collateral for housing related mortgage pools and securitization. CIBRASEC is the only secondary market institution to date that has evolved from 9514. It is still getting its feet wet." Government bailouts and restructuring in the eighties resulting from high inflation and loan delinquencies/defaults led to a shrinking market for mortgage finance and resulted in the ultimate transfer of 30 billion in mortgage loans from savings and loan Institutions to the Central bank. Investors at the present time are not overwhelmed by the prospect of housing investment. Lack of government credit enhancement likely will mute their willingness to significantly invest in housing loans.

Little noted that Brazil may need and may be able to initiate something unique to jump start its primary and secondary mortgage market. "Why not build a new government mortgage entity or add to the functions of an existing experienced organization or system - perhaps FGTS? The new or restructured group would combine insurance of primary mortgage loans and a secondary mortgage market guarantee. As an option, it could be granted powers to restructure present non-performing mortgage loans. If the present lending function of FGTS, for example, were included, the new institution would have four separate unbundled departments within its bundled structure: insurance, guarantee, restructuring and lending."

George Anderson supported Little's construct. He indicated that "the ability of the new or restructured organization to provide mortgage insurance would help increase the size and the liquidity of the primary mortgage market. Similarly, the ability of the new organization to guarantee securities backed by insured loans will help ensure liquidity in the secondary mortgage markets. Finally, the ability of the new organization to provide a conduit for the restructuring of non-performing mortgage loans held by the Brazil Central Bank and by Savings and Loan Institutions would increase the overall soundness of the housing finance system and the related ability of savings and loan institutions to extend mortgage loans." Clearly, if the new organization is established along the lines suggested, it will be powerful enough to "force" the standardization of mortgages and underwriting.

The proposal was not endorsed by the Forum. However, it was met with interest by many participants. "At a minimum, the proposal helps us understand the relationship between unbundled activities and the market. It also suggests Brazil needs to take bolder steps. We must think through the gap between our objectives and what we have done so far. The proposal illustrates a comprehensive approach. So far what we have done is incremental and partial. We can do better. The proposal provides a good yardstick" (Nogueira).

Several participants were concerned that if Brazil included lending, insurance, guarantees, and restructuring under one roof in one government supported group, it would create a dominant market institution; one able to crowd out many of the country's fledgling primary and secondary market institutions. "It would initially limit or impede competition. Investors and originators as well as other mortgage market groups and individuals would move to secure the visible advantages of the government supported enterprise. Brazil might find it difficult to establish private insurers...private securitization firms, etc." (Fonseca).

The new or restructured institution would likely become a major, if not the major player, in the mortgage market. Given the proposed combination of functions, it would be more powerful than the U.S.'s GNMA, FNMA and Freddie Mac. According to some participants at the Forum, Brazil might well benefit initially from the new group. Its size and integrated agenda could help the nation quickly rationalize the housing market and secure investor interest. However, over time, the new or restructured entity's market place dominance could generate political problems and possible conflicts of interest. Further, its policy and program mistakes, if and when it makes them, could have negative ripple effects in the entire housing market.

Most of the participants concurred on the need for Brazil to keep the proposal on the table as the nation moves toward developing effective unbundling functions and securitization facilities.

Other Critical Issues

Building a Domestic Market

Participants suggested that the primary market for CIBRASEC Mortgage Backed Securities will be domestic rather than international investors. International investors are constrained by country-level risk and can only devote a certain proportion of their portfolios to emerging markets. Brazil's rating is still not investment grade. Most investors will have difficulty further increasing their exposure in emerging markets. "You can't easily multiply the amount of international credit available to Brazil by solving structural problems internal to the housing finance market," noted Ken Birbaum. The amount of international credit will be driven by assessments of sovereign risk based on broader economic and political considerations.

"Mortgage backed securities are more likely to be placed within domestic capital market," continued Birnbaum. Likely purchasers include pension funds and insurance companies. In the short term, when the portfolio of mortgages is likely to be quite heterogeneous, it will be easier to find buyers inside Brazil. They will be more familiar with the collateral and have a fuller understanding of the local situation. The key is to jump start the market -- get the first deals done. According to Pinto Lima, "CIBRASEC has been negotiating with several domestic entities and expect potential purchases to emerge from these discussions."

Brazil must take steps to increase the availability of domestic capital for housing. According to Forum participants, it should:

- *reduce government competition for capital. "Government capital needs appear to be crowding out other borrowers," concluded Birnbaum. "Brazil must continue its current efforts to bring public sector deficits in line."*

- *increase domestic savings through social security and pension fund reform and strategic deregulation. Fabio de Araijo Nogueira indicated that some of Brazil's neighbors, Chili for example, do not depend on external investment. They have created enough domestic savings to support investment required for housing and other purposes.*

- *strategically extend current privatization efforts with respect to inefficient public services.*

Even, assuming overall capital availability is increased, the housing sector still must compete with other investments for capital. Securing a favorable rating from an established rating agency is critical to international investors and important to domestic investors. Regina Nunes from Standard and Poor's noted that "S and P is developing a new rating scheme that allows greater differentiation of the quality of issues for domestic market purposes. The country risk rating forces all issues into the lower part of the international rating schema, allowing too little differentiation of the quality of issues in domestic markets." The new system, it is assumed, will aid investors in choosing among investment options.

The Forum devoted considerable time identifying and discussing the factors that rating agencies and investors look for in evaluating mortgage backed securities issued by secondary mortgage market facilities and corporate bonds issued by development companies. They provide a menu for change in Brazil. They included:

- *Developing and sustaining a fair legal framework*
- *Developing and sustaining mortgage standardization and underwriting criteria*
- *Developing and sustaining dependable information and information systems*
- *Developing and sustaining fair tax and regulatory treatment*
- *Developing and strategically using possible public and private sector enhancements*

Adequacy of Legal Framework: *As indicated throughout the Forum, Brazilian and U.S. participants agreed that investors need a legal framework that recognizes and respects the various contractual relationships required to create an effective housing market. The*

court system must act in a timely and predictable manner to enforce contractual relationships and the provisions in the law.
The law must provide the investor with an enforceable claim on the property which comprises the collateral for the loan in the event that the mortgagee defaults on payments. Law 9514 provides for a deed of trust. Creditors, based on the law, may take possession of a property using an administrative process that is outside of court. The security interest, ostensibly, will be fully transferrable and creditors' interests will be protected in the event of bankruptcy or insolvency of the originating institution.

"The legal framework embedded in 9514 looks good," concluded David Barbour. If there is an issue, it will be in implementation. The law needs to be tested. "Investors need to be assured that true sales will occur and that foreclosures based on defaults will be timely and done in a cost effective manner. The courts ultimately will have to satisfy investors concerning perfection of their interests if seller bankruptcy occurs (Barbour)."

As noted earlier, participants expressed concern that politics and political pressure will not permit the legal changes concerning foreclosure, for example, to be easily converted to reality. "It's important to both foreclose and actually take possession of a property, evicting the defaulting buyer, in a timely fair manner (Abud)." Isabel Pereira de Souza indicated that what has occurred thus far is very promising. Caixa Economica Federale is now getting properties back in 60 to 90 days in cases of default. "I believe the administrative and judicial system have accepted the idea."

An effort has been made to inform judges about the provisions of the new law. A seminar was held in March 1999, bringing together industry, finance and judicial personnel to develop a common understanding of the types of contracts and legal relationships that are necessary to create a new system of housing finance. Both industry and judicial participants described the seminar as extremely positive. "We believe this law is a step forward in comparison to the old mortgage system. The deed of trust system is good. It will allow contracts to be dealt with without going through the courts. It also establishes the possibility of arbitration which is important in Brazil (Lewandowski)."

Brazil will have to be sure that reasonable protections are in place for the consumer. The types of market transactions anticipated under the new law will be complex. Brazil needs to provide clear cut information to consumers concerning their obligations and the obligations of financial institutions involved in providing and servicing mortgages. "If poor people, particularly, are drawn into difficult financial arrangements that are not easily understood, and then are dispossessed, there will be increased pressure to provide increased consumer protection. There is a collective social interest in helping people retain their property. We must balance social and community interests with the interest of the investor, developer, etc., "(Nogueira).

Forum participants agreed. It is important for the housing market to proceed in a socially responsible fashion. George Anderson of GNMA noted, "that public education regarding home ownership and related responsibilities is an important function that must be performed by some entity." In the United States, many non-profit organizations perform *this activity, partly with funding from government. With appropriate public education and good underwriting standards, it is possible to minimize hardships.*

Luiz Pinto Lima suggested that, "sometimes well-intended actions designed to protect the poor from adverse effects of market transactions can have the opposite effect." He cited a past instance when protection against evictions were strengthened in the law. "While it may have made eviction difficult, it raised the cost of housing for all and reduced its availability for the poor." Laws and related regulations are required that acknowledge both the lenders' rights to periodic payments on housing loans and their rights to efficiently secure property used as collateral for loans. Consumer protections, while necessary, should not impede fair and efficient enforcement of the rights of lenders and investors. If they do, Brazil will not be able to develop needed capital markets for housing and everyone will suffer, including financial institutions and consumers.

"The interrelationship between the new real estate law and consumer defense code is an unknown," noted Judge Lewandowski. Questions were raised whether many of the information systems and credit checking procedures common in the United States were or would be legal in the Brazil.

Speaking at a more general level, Judge Lewandowski noted many virtues in the Brazilian judicial system. Brazil has a uniform law for real estate. Unlike the United States, where laws governing contract, foreclosure and eviction vary from state to state, Brazil laws generally are common to the entire country.

Standardization: *Lack of standardization has impeded Brazil's efforts to form an effective primary and secondary mortgage market. Every contract, every deal looks different. "If you want to have a liquid market and to securitize, instruments and underwriting criteria absolutely must be standardized (Cadagin)." A large number of mortgages, generally, provide collateral in MBS. It is important to provide for some level of uniformity as to the structure and content of mortgages to facilitate risk calculations.*

CIBRASEC recognizes the importance of standardization. It has devoted considerable resources to developing a set of standard instruments. It is attempting to develop consistent mortgage origination standards and standardized servicing guidelines. It is creating forms that incorporate needed basic information. It is specifying the documents that are required for different types of transactions. "We are making drafts available for comment. We envision preparing kits that we will disseminate. We hope that the standards will be adopted by financial institutions whether they deal with CIBRASEC or not. It's critical that if and when other securitization companies form, they don't attempt to reinvent the wheel. Hopefully, they will follow CIBRASEC's lead (Pinto Lima)."

Banks have a strong interest in standardization. A It will lower legal risks and help overcome the absence of comprehensive information," observed Pereira de Souza. Standardization is critical for rating agencies and investors to evaluate mortgage pools.

"A tremendous amount of work has and will go into developing forms that address the full range of risks," indicated Lima. Thus far the primary reviewer of proposed standards has been CIBRASEC's shareholders. There is a need for input by others. CIBRASEC would like to subject its standardization efforts to a coordinated review process involving relevant market participants.

While no one disagreed concerning the desirability of standardization, questions were raised regarding how far and how fast? "Standardization is fundamental. But to go from a market with no standards or standardization to what is ideal may be too big a step. We don't want to erect a wall that is too high for us to scale. We need to identify and standardized the most important pieces," suggested Pedro Klumb. Robert Van Order echoed similar sentiments, "It would be unwise to wait until everything is perfect before attempting to access the market."

There was some disagreement concerning whether standardization implies that lenders must always extend credit using the same criteria. "We must have agreed upon threshold standards for granting credit -for example, loan to value ratios, loan size relative to borrower income, etc. This type of standardization will help the public understand the system and increase its acceptability (Pereira de Souza)." It will also facilitate the creation of homogenous pools of assets from different originators. Financial institutions and investors need to feel comfortable that pooled mortgages reflect certain bottom line criteria.

CIBRASEC, while interested in establishing common forms underlying basic elements of the origination process, was wary of moving to comprehensive criteria for everyone. "We don't intend to develop fixed crystallized rules for all originators (Pinto Lima)." Rules or criteria should vary, at the margin, depending on the economic situation, the locale, the kind of collateral, the terms etc. While reluctant to require comprehensive "one size fits all" situations, CIBRASEC recognizes that core standards should be created and used in Brazil.

CIBRASEC will provide a set of threshold standards and identify minimal information needs. It will also provide an envelope or frame of reference with respect to issues and questions to help others who are making specific financial judgements. CIBRASEC, at a minimum, will provide "rule of thumb" criteria and common forms to record key information relevant to loan decisions.

Forum participants questioned whether CIBRASEC alone could really move the issue of standardization. Maybe. Maybe not. "CIBRASEC, according to its senior officials, is a private entity. It is still learning. It has no real market wide clout at this time (Weiner)."

Many individuals at the Forum indicated that standardization, if it is to occur, may require government involvement or a partnership between government, financial institutions, professional, and consumer organizations relevant to housing. "Basic information requirements-loan value, credit, etc., should be identified and recorded on similar forms for most housing related mortgages and converted into underwriting *criteria (Erb)." Chose the most important indices to help financial institutions understand and judge housing loans. Any hope to develop effective primary, and, indeed, secondary markets will require that standardization of mortgage instruments and underwriting criteria occur as soon as possible.*

<u>Information and Information Systems:</u> *Primary and secondary mortgage markets work better when basic economic and financial information is available to relevant participants at each of the major decision points concerning loans and securitization. Given the potential volume of information and the need for analysis by different institutions and people, computerized systems for managing important data are critical.*

Brazil must decide what data is important to various participants in the housing market and who should secure, maintain and distribute it. As time goes by and more data are available, sophisticated models can be built that predict behaviors and aid in decision making. But at the outset, Brazil should try to keep its data collection and information distribution systems strategic and doable.

Participants briefly reviewed basic information needs for key market activities.

Origination

Information, now often absent in Brazil, is required to assess the credit-worthiness of borrowers and the value of the properties serving as collateral for loans.

- *<u>Credit Information:</u> Brazil's challenge is to create a system for collecting and sharing credit information hile protecting consumer interests. Several Brazilians seemed surprised by Americans descriptions of the amount of information gathered by the three major credit reporting companies in the United States. In Brazil, there is nothing comparable.*

> *Brazil's financial institutions must have access to data concerning the income and credit worthiness of mortgagees. "We need to know past credit history including but not limited to housing related debt (Fonseca)." Information must also be collected relative to a potential borrower's income and ability to repay mortgages. We need to know the status of the property being considered as security for the loans. We should know its value based on reputable appraisals. We need to establish accurate loan value ratios (Crestana)."*
> *Banks in Brazil are beginning to build information systems. Isabel Pereira de Souza noted that CEF is developing an information system that includes household payment and credit histories. She added that, "The American Chamber, CEF, various companies and commercial associations are working to develop a common framework for information collection and a system for sharing the information."*

Forum participants suggested that information systems must balance consumer desires for privacy and the needs for strategic information by housing finance related organizations. "Without good information concerning credit of the borrower and the characteristics of the collateral, financial institutions will be in a real risk situation (Kheirallah)." The process associated with developing effective information systems will likely be a cut and paste or mix and match process. Initially, what is developed must be consistent with Brazilian law. If, however, what is consistent with the law does not provide reasonable information to facilitate development of an effective housing finance system, then the laws on the books must be reviewed and consideration given possible amendments.

- *Property Values: Solid data concerning loan to value ratios are critical to originators, servicers and investors. "We need to trust information concerning the value of the home. Good appraisals provide the data for information systems concerning property values. Appraisals need to be professionally managed. They need to include data concerning the characteristics of homes and the neighborhoods. They need to incorporate market and replacement analysis" (Lafemina). If possible, information systems need to incorporate trend data concerning housing values. Indeed, historical patterns concerning housing values may serve to reduce (or increase) perceptions of risks concerning mortgages and mortgage backed securities. Appraisals should be done relatively frequently and on a predictable basis.*

- *Public Registry Systems: "To protect the rights of purchasers and lenders, all transactions involving real property are registered in Brazil. Notaries are required and the process of recording transactions is often costly" (Justice Lewandowski). Each time a mortgage is transferred, it must be recorded. Brazil should consider recording transactions electronically. "Initial transaction costs are higher but subsequent transactions are cheaper (Anderson)." Pedro Klumb suggested, "the importance of mapping the whole chain of transactions and determining the cost at each step."*

- *Servicing and Investor Reporting Systems: Servicers in Brazil will be required to provide key information to secondary mortgage market institutions. Bottom line, their information systems must be able to monitor and provide relevant data concerning the receipt of principal and interest. Their reports and related information systems should indicate delinquencies and defaults as well as pre-payments. David Barbour recounted his experience putting together a deal in Argentina. It took 15 months to do the deal, ten of which were devoted to getting the investor accounting and servicing system in place.*

- *Information for Secondary Market Institutions:* *Secondary market institutions in the United States have developed a number of other systems to support their work. According to Mary Cadagan from FNMA, they include:*

- *Financial modeling systems that facilitate the design of securities that match investor needs.*
- *Portfolio management systems that support the placement of specific mortgages into portfolios.*
- *Credit loss management systems that provide an early warning system for identifying mortgages likely to go into default.*
- *Property management systems that facilitate quick disposition of defaulted properties.*

Forum participants from both nations agreed that Brazil needs to develop a vastly improved set of integrated information systems. The U.S. approach was developed over years and is still being fine tuned. The U.S. initiatives should be looked at and reviewed by Brazil. They should provide some benchmarks and ultimate objectives. Information systems for MBS and securitization facilities, however, should be guided by where Brazil is now and where progress can occur, relatively quickly. "Clearly, priority should be granted to development of information concerning consumer credit and income, housing values, ownership and liens on property and related housing units, payments on housing loans and consumer defaults on loans (Kheirallah)." Just as clearly, priority should be granted development of background data and analysis concerning national, regional and local economies, housing markets and capital flows. Information should be identified, collected, stored, and distributed to reduce risks to participants in both primary and secondary mortgage markets.

Tax Reform: *A comprehensive look at Brazilian tax laws and administrative regulations is a necessity noted several Forum participants. Early in the Forum, Congressman Kapaz noted the importance of comprehensive tax reform to the restructuring of the Brazilian economy. Brazil has many different taxes; several that are imposed at each stage in the production cycle and that are imposed on the full value of the product.*

Forum participants expressed concern over the relationship between taxes and Brazil's desire to build a functioning primary and secondary mortgage market. They warned that tax consequences must be considered by Brazil. "They will be considered by originators, servicers, investors, and rating agencies," suggested Brigitte Posch. They will limit the market and restrict the flow of capital into housing.

A secondary market inevitably involves transfers of assets. "If the movement of mortgages from the originator to a secondary mortgage market facility and from that facility to the *investor etc. are treated as independent transactions subject to taxes, Brazil will find it tough to respond to its secondary mortgage market needs," stated David Barbour. The cost will be tremendous.*

Participants applauded Brazil's commitment to tax reform. They asked that proposed tax reform initiatives acknowledge the negative impact of the present tax system on the housing sector and that they evaluate and anticipate the impact of future reforms on housing.

The tax system is used as a vehicle for stimulating investment in housing in other nations. The United States tax code favors home ownership. It makes interest paid on mortgage loans deductible from income in calculating income tax liability for individuals. There was no agreement on the wisdom of emulating U.S. policy in Brazil.

"The U.S. has put in a system of tax credits to encourage investment in low income housing," indicated Professor William Simbieda. Credits, primarily, increase investor willingness to provide equity investment. They have been effective in stimulating the production or rehabilitation of housing serving low-income households.

Participants urged Brazil to consider the pluses and minus associated with using the tax code to stimulate housing. Among the benefits: Using the tax code for housing purposes generally does not require a new bureaucracy. Further, the code can be used to provide benefits both to developers and consumers. Among the disadvantages: Tax subventions are difficult to monitor and evaluate in a transparent manner. Tax subventions can become expensive and frustrate a response to revenue needs. Tax subventions may create equity problems.

Forum participants urged the housing industry and consumers to sit at the tax reform table to "make sure that reforms, at a minimum, do not penalize the housing market." How much beyond a Ado no harm" to the housing market objective should be sought by housing leaders as they address tax reform depends on housing policy and program alternatives considered by government.

Regulatory Reform: *The need to streamline current regulations affecting the housing sector was a continuous and pervasive theme of the Forum. As noted earlier, rules governing contracts, foreclosure, information, financing, and government support must be examined critically in order to assure the development of a fair, efficient and effective regulatory system. If Brazil is to initiate strong primary and secondary mortgage market systems, Awe need to create a workable balanced regulatory framework (Andrade)." It must reflect the public interest and the interests of the consumer. But it also must reflect an understanding of the needs of the market place for quick, transparent and equitable decisions. Regulations need to acknowledge profits and cash flow as much as they need to respect social welfare objectives. One without the other will not produce what is necessary- expanded capital markets and housing choices.*

The participants suggested that Brazil, as part of its proposed housing policy deliberations, grant extensive time to the transparent development of fair and efficient regulations. Most wanted government to review the need for present rules that: direct and limit the allocation of deposits in the SFH system; discourage flexibility concerning the sale and or portfolio treatment of construction loans; and, limit the use of insurance, mutual funds and or pension funds for housing purposes. Forum participants urged the government to involve all relevant parties in the regulatory reform process including business , community and consumer groups.

Credit Enhancements: *Finding buyers for mortgage backed securities will be easier if there is some form of credit enhancement. "The market isn't interested in or able to analyze the individual mortgages underlying the issue," said Ken Birnbaum. The market will be most receptive if there is some kind of guarantee, government or private. George Anderson suggested that, A FGTS could offer guarantees of CIBRASECs offerings." He also indicated that, "initially government enhancements may be necessary to encourage or jump start a primary and secondary mortgage market in Brazil."*

"Credit enhancements could take other forms than insurance or guarantees," articulated David Barbour. "The same goal might be accomplished by appropriately structuring securities. One option is to over collateralize mortgage-backed securities. Another option is to strategically subordinate varied interests to the interests of different investors." Many participants argued that Brazil should evaluate and initiate varied strategies, including possible government insurance and guarantees to foster vigorous primary and secondary markets. At the outset, Brazil should not view options as either/ or, but to the extent that they are feasible, as complimentary to or part of an integrated set of needed credit enhancement strategies.

Developing Feasible Product Types

Secondary mortgage institutions offer a variety of mortgage based products to investors. The simplest is a pass-through security which in effect is debt secured by a package or pool of mortgages.

Given the maturity of the secondary market in the U.S, secondary market institutions are able to offer a varied number of different kinds of investments based on mortgage pooling. Each product allocates risks in different ways appealing to different types of investors. "Securitization permits restructuring of mortgage pools to develop varied MBS securities responding to different investor needs (Little)."

"CIBRASEC should initially offer simple products. It should function primarily as an intermediary between originators and investors (Van Order)." It will take time for the market in Brazil to accept complex securitizations. Over time, CIBRASEC and other secondary mortgage market facilities can develop new products. "Simple, however, is better at the outset (Van Order)."

Reaching International Investors

As noted earlier, while Brazilian domestic capital markets will likely be the principal source of housing funds, Brazil must expand over time the total volume of housing funds secured from international investors.

The primary obstacle Brazil faces in obtaining capital in international markets has more to do with the general economic and political situation than the specifics of Brazil's housing market. The resilience shown by the Brazilian economy following the recent financial crisis and the willingness of Brazil's government and financial institutions to continue stabilization policies and pursue further structural reforms will help interest international investors in the long term. "Once confidence has been shaken, it takes a long time to build it back," observed Ken Telljohann. "In the past, many investors lost money as a result of changes in government policy. They need to be assured that government will not place them at risk in the future."

A specific obstacle that should be addressed are restrictions on the entrance and outflow of foreign capital. Under current rules, repatriation of capital is often difficult. If principal cannot be remitted easily, investors will have heightened fears concerning exchange and convertibility risks. Depending on the terms of the loan, they may also worry about interest rate and prepayment risks.
Obstacles to the repatriation or outflow of capital are and will be a pervasive impediment to accessing international markets. Restrictions, unless simplified, eliminated or reduced, will require a large discount in investor cash flow analysis and varied enhancements to reduce perceived risks. "Compensating for restrictions will require issues to be priced very high (Little)."

Meeting the Housing Needs of the Poor

The Brazil-U.S. Aspen Forum's primary agenda related to creating a primary and secondary mortgage market. Success in establishing a primary and secondary mortgage market will increase Brazil's access to domestic and international markets. It will expand housing choices for an emerging and hopefully growing number of moderate and middle-income households. It will free up government obligations and funding for low-income households.

While there was strong support for and commitment to building a primary and secondary mortgage market, Forum participants recognized that the primary beneficiaries of both will not be the poor. Clearly, the private sector, acting alone, cannot respond to the housing needs of very low-income families and individuals. Government must play a more active role.

Forum participants discussed the range of programs now being initiated by varied governments in Brazil. Some appeared very innovative; some were producing visible results. But on balance their overall impact, given limited funding and related requirements, was relatively small in light of the large numbers of poor people in Brazil. Several programs were reviewed by participants. They included:

- City or municipal programs using city funds and or World Bank, IDB as well as funds to build apartments for low-income families.
- State programs that provide funding for the development of units. Many are administered by Asemi-public" companies. They are funded by state funds and or a temporary increase in value added taxes.

Additionally, participants discussed CEF initiatives. They noted that CEF uses FGTS funds and its own savings and loan deposits to administer Associativo and Prodecar, two programs aimed at low and moderate income households. Prodecar provides funding to buyers and not directly to developers. Monies are released monthly to developers through a relatively complicated formula based in part on units sold and down-payment requirements. Regulations governing both programs limit the ability of many low-income households to secure assistance. Down payment requirements are relatively high and loan limits as well as loan/value relationships appear geared more toward units priced for moderate than for very low-income households.

Given the cost of housing and the low incomes of the poor, Brazilian government support of both builders (loans, interest subsidies and grants etc) and potential homeowners will be critical. While Forum participants questioned why CEF has not provided developer loans or letters of credit, they commended CEF for considering new leasing programs that would provide direct construction funding to builders. Units funded in this manner would be purchased by CEF and rented to low income households. Renters who remained for at least l5 years would be granted full ownership; after five years, partial ownership.

Forum participants discussed the debate in the U.S. concerning whether it is more cost efficient and equitable to provide direct income supports through vouchers and or rent certificates to households or to provide support for construction and production. Because of supply constraints, they generally indicated that both will be needed in Brazil. Funds for capital construction will be needed to increase the supply of housing in a measured and strategic way; funds for direct and implicit income support housing initiatives will be needed in order to expand the mobility of the poor. Realizing Brazil's economy will initially seriously constrain the total funds available for housing, Forum participants strongly recommended the development of a multi-year strategy to respond to the housing needs of the poor.

Consensus and Optimism

Brazil-U.S. Aspen Forum participants reached a surprising degree of consensus during the two and one half days of intensive discussions. Agreements concerning both principles and strategies provide a framework within which Brazil can develop both an effective secondary and primary mortgage market as well as meaningful strategies to respond over time to the housing needs of many lower income households. Forum Participants agreed that:

1. Brazil <u>must</u> grant priority attention to efforts to stabilize and Agrow" the Brazilian economy again. To secure, macroeconomic stability will require the Brazilian government to coordinate its fiscal and monetary policies. The nation must continue efforts to close the gap between revenues and expenditures and to sustain initiatives to reduce current account and trade deficits. Reform of pension and social security programs is a necessity. Progress concerning both will send a signal to domestic and international capital markets that Brazil is serious about achieving renewed economic health. Continued strategic privatization of inefficient public services is essential to increase productivity and reduce government deficits. Similarly continued market liberalization is critical to the healthy expansion of the overall economy.

2. Brazil <u>has</u> room, even given its current economic problems, to develop a comprehensive set of housing policies and strategies to assure needed expanded housing choices for its citizens. A major initiative should be undertaken by the government, in concert with private sector and community leaders, to define long term housing objectives and short as well as intermediate term strategies and programs. Central to the effort should be the development of innovative housing finance and development partnerships among and between all levels of government, the private sector and community groups.

3. Brazil <u>should</u> make the establishment of effective secondary and primary mortgage markets a key element of its effort to develop a comprehensive set of housing policies, strategies and programs.

Current approaches to develop both secondary and primary mortgage market facilities are noteworthy and deserve commendation. But they are far too tentative and incremental. While they will generate increased access to capital over time, the aggregate amount will likely be minuscule in terms of need.

4. Brazil <u>should</u> reconsider and amend its current approach to creation of needed primary and secondary market institutions.

Government and private sector leaders should reach a firm agreement on what CIBRASEC is now and what it should become. While the new secondary market institution created by law 9514 has great potential, the absence of clarity, particularly concerning its objectives and its relationship to other potential secondary market facilities, will mute its ability to help Amake" a secondary market in Brazil.

Brazil should consider: The establishment of at least one government supported or assisted secondary market institution to help initiate and expand secondary market activities with respect to the securitization of middle income related mortgage pools. The new facility, if created, would have the ability to secure loans from the government. It would also have the ability to insure or guarantee mortgage pools and to develop differentiated securities.

Brazil should establish a wholly owned government institution to help foster secondary market activities with respect to the securitization of

lower and moderate income related mortgage pools. The new facility would receive funding support from the federal government. It would have the capacity to pledge the full faith and credit of the government to back approved mortgage pools and related securities.
Brazil <u>should</u> take steps immediately to establish a government owned facility to insure mortgages for low and moderate income households issued by originators in Brazil. A new government insurance agency will be essential to help foster a primary mortgage market for low and moderate income related mortgages. Without targeted government insurance, it is unlikely that private sector organizations and investors will respond to the needs of low and moderate income households.

5. Brazil <u>should</u> initiate strategic steps to standardize mortgage instruments and underwriting criteria.

Both standardized mortgage and standardized underwriting criteria are essential to the creation of primary and secondary mortgage markets. Both will be abetted by the establishment of strong secondary and primary market institutions and by a strategic government role with respect to insurance and guarantees (see recommendation 4). Government assistance and government absorption of risk should generate government requirements relative to standardization. However, with or without government involvement and assistance, a major effort should be initiated in Brazil simultaneous with and as part of the housing policy development process to standardize key or threshold elements of the mortgage instrument and related underwriting criteria. At a minimum, it should involve government, business (e.g., financial institutions, developers) and community as well as consumer leaders.

6. Brazil <u>should</u> immediately begin to develop more effective computerized information systems that are accessible to relevant financial institutions.

Brazil's effort should begin with a careful review of basic information needs that, if met, will permit financial institutions and investors to evaluate the risks associated with mortgage lending and mortgage backed securities. At the core will be information and criteria related to personal and household credit, housing values; loan/ income value relationships; property status etc.

The U.S. systems now in place should provide benchmarks but not necessarily short term models for Brazil. Information system objectives and content should generate from a collective effort involving relevant government, business, consumer and community *leaders. Brazil in developing information should balance consumer needs concerning privacy with financial institutions and investors to determine the feasibility of loans and securities.*

7. Brazil should initiate a sustained effort to, at a minimum, provide an even playing field for the entire housing sector (e.g., finance) with respect to taxes. Brazil should also initiate a sustained effort to develop a fair, effective and efficient regulatory system to govern the housing sector.

***(Taxes)** Brazil, as part of its long overdue tax reform agenda, should evaluate the precise impact of its present tax system on housing. It should assure that final reform initiatives create a more equitable and efficient environment for housing than is now apparent in the tax laws and regulations. It should create, at a minimum, a tax system that is neutral, if not favorable, with respect to housing investment and housing related capital flows.*

While there is no absolute wisdom concerning the use of tax subsidies or imputed subsidies to foster housing production and housing choice, there is absolute wisdom concerning the negative effect of the present tax system on housing opportunity. Generally, taxes should not treat one sector of the economy or one set of firms better or worse than others. There is evidence in this context that housing in general is not being treated fairly by Brazil's present tax system. Similarly, there is evidence that different kinds of firms within the housing sector are not being treated fairly by the tax system. Brazil's present tax system narrows the housing choices of many low and moderate income households.

***(Regulations)** 9514 creates a "once in a life time" strategic opportunity for Brazil to develop a comprehensive set of sound regulations concerning the housing sector. The law literally establishes the framework for a solid primary and secondary mortgage market. It should lead quickly to a participatory development process. The final result should be a set of integrated efficient and fair regulations that help frame administrative and judicial judgements concerning the law's new foreclosure, transfer of assets and securitization provisions. The final result should provide for efficient, effective oversight of the new financial institutions created by the law. The final result should incorporate targeted initiatives to remove current legally unnecessary restrictions on financial institutions-restrictions that unwisely discourage or reduce options concerning the provision of housing loans -construction and household loans- and that limit institutional access to capital markets. Brazil's housing related regulations, except when sanctioned by specific policies, should not promote advantages or disadvantages for different organizations, people or institutions in the primary or secondary mortgage market.*

Brazil has significant housing needs among low and moderate income households. While creation of a primary and secondary mortgage market will expand housing choices for Brazilian citizens, the primary direct beneficiaries will be middle and upper income groups. Development of effective broad primary and secondary markets will better permit government to target its limited resources on low and moderate income groups. Creation of a government owned secondary mortgage market facility will expand housing opportunities among low and moderate income Brazilians.

Brazil should initiate steps to develop strategic options that go beyond improved mortgage markets to help the needy secure better housing. Leaders from all appropriate sectors and the low-income community should discuss the wisdom of direct housing related income support programs vs. production support programs. The discussions, based on a review of the experiences of other nations and Brazil's current efforts, should result in a commitment to define and carry out coordinated policies and prioritized programs to assist low and moderate income households improve their housing situation.

The collaborative discussion in Brazil should be premised on a thorough evaluation of the disparate list of current programs now being funded and initiated by Brazil, including the programs related to required employee savings. Objectives, policy and program recommendations should be forthcoming within a specific limited time frame. Its success is essential, given Brazil's commitment to provide decent affordable housing to its citizens.

Next Steps: Getting Started

The participants in the Brazil-U.S Aspen Global Forum were optimistic that Brazil will move to expand housing choices for its citizens. Forum members from Brazil and the U.S. expressed a desire to continue working together to facilitate Brazil's efforts. "The Forums have permitted us to get to know one another...to share relevant housing experiences...to build a partnership concerning the development of effective housing policies and programs (Mein)." "We have come a long way in just two Forums. We have created an important reform agenda for housing (Klumb)."

Forum leaders at the table urged the American Chamber of Commerce in Sao Paulo and the Brazil U.S. Aspen Global Forum to establish Working Task Forces on Forum agreements and recommendations concerning: securitization; regulation and tax reform; housing strategies for low and moderate income citizens; and, information systems. The Task Forces would work over the summer and report back to a third Brazil-U.S. Aspen Global Forum on Housing in the early fall. Subsequent to review and approval of the Task Force reports by the Forum, a report concerning Forum recommendations would be widely distributed in Brazil and used as the basis for presentations to government, business and community leaders. Through this approach, the American Chamber of Commerce in São Paulo and the Forum help Brazil convert housing recommendations to action and housing dreams to reality. The American Chamber of Commerce and the Brazil-U.S. Aspen Global Forum agreed to work together to assure the creation and success of the proposed Task Force initiative.