PERU

Considerations for the Development of a Mortgage Market in Peru

by Gerardo M. Gonzales

TRENDS AFFECTING HOUSING FINANCE

The future of housing finance in Latin America and in Peru will be influenced by a number of prevalent and current trends. First, Latin America is immersed in a process of remarkable changes, many of which are associated with the world phenomenon of globalization.This process has two important effects on residential finance. On one hand, the real estate sector, typically considered as a non-tradeable sector with very low liquidity, is becoming less a local market in nature and increasingly integrated with the global economy, with the growing importance of cross-border capital flows. Mortgage markets are thus more and more exposed to the evolution of international finance. Since these capital inflows are intermediated through the domestic financial and capital markets, the reduced capital inflows registered during international financial crises have resulted in a severe external shock, thereby reducing liquidity and the terms of transactions and, ultimately, restricting the availability of long-term financing required for housing.

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The second important trend is related to structural reforms and institutional developments. In many Latin American countries, the focus of financial sector reforms is on liberalization of the market by privatizing or liquidating government financial entities, stimulating competition among intermediaries, adopting prudent banking regulation and supervision standards and, more recently, fostering the merger of institutions. Also, new regulations on the operation of agents and instruments in the capital market have been adopted. But, within this framework, reforms of pension systems, already underway in several countries, are remarkable, since they feature the accumulation of growing domestic savings and the increasing importance of institutional investors. These developments exert an important pressure on the creation of instruments for long-term investment.

A third trend is the transformation of the institutional and operating methods for housing finance. The traditional scheme consisted of mobilizing short-term family savings transformed into long-term mortgage loans that are maintained on the balance sheet and are relatively unadjusted during a lifetime of the loan. This scheme is being displaced by an intermediation method that will not only mobilize the resources of the financial market through traditional mechanisms such as the public's savings, but it will also create linkages with the capital market to mobilize the domestic long-term savings that institutional investors administer. This trend signals a substantial change in the mortgage business. First, the change will lead to greater specialization among agents with increasing economies of scale. In the new business model, the originator of the credit will not necessarily take charge of its administration. Also, originators will be able to replenish funds for mortgage lending more rapidly through securitization. Second, lenders will be able to better handle the risks involved in mortgage finance—among them, the credit risk, liquidity risk and interest rate risk—diffusing risk among participants in the capital market.

The reform of the role of the public sector constitutes a fourth trend. The traditional role of direct lending with subsidized interest rates, even in competition with private lenders, is being increasingly replaced by a role as facilitator of private sector involvement. Second-tier banking institutions, already in existence in many countries of the region, will have a greater role as instruments to achieve a more efficient attainment of resources for the originators of credits and will stimulate the formation and consolidation of a housing finance market. They may foster the development of a secondary market for securitization, support the liquidity of the private intermediaries through the rediscount of mortgages, and issue debt or obtain lines of external credit whose resources can be intermediated by the private financial system. This facilitator role of the government should also be supplemented with the use of programs of direct housing subsidies to convert potential demand for housing to effective demand. In this way, the government will stimulate the growth of the potential market of mortgage borrowers by reducing the amount of necessary indebtedness to purchase housing. The latter can also help to distinguish between those who lack sufficient purchasing capacity and require government support and those with adequate purchasing ability whose demand for housing and credit can be met through market mechanisms and private lenders.

SAVINGS MOBILIZATION TOWARD THE HOUSING SECTOR

A crucial factor for the development of a mortgage market is savings mobilization, keeping in mind that the foundation of all financial systems is savings. It is essential that housing finance systems compete for resources in the financial and capital markets, through instruments that offer attractive rates, maintain borrowers' access and provide safety to savers. It implies the existence of mechanisms that protect savings from inflation, the existence of appropriate instruments for a mobilization of long-term resources and the readiness of sources of funds that can be invested at long terms in order to achieve proper asset-liability management balance.

Financial systems must offer mechanisms that protect savings for housing from the adverse effects of inflation. This has been the failure of traditional methods of housing finance and it has caused distortions in the mortgage market, among them the establishment of negative real interest rates, which has resulted in the disappearance of the long-term credit and a decrease in sectoral investment. To counteract these effects, several countries of the region have adopted, at different times, diverse indexation systems.

Another problem facing Latin American housing finance systems is the liquidity risk that arises when long-term mortgage credits are financed with short-term savings. Therefore, it is necessary to head toward a balance of terms between assets and liabilities, using instruments that allow to raise long-term resources. In Chile, the introduction of letters of mortgage credit in the 1980s radically changed the old savings and loan model that formerly provided funds for housing. The securitization of mortgages is also useful for this purpose.

In addition, it is also necessary to have long-term sources of funds. In several countries of the region, institutional investors are arising—such as private pension funds and life insurance companies—that administer long-term funds. In Chile, the letters of mortgage credit instrument used to finance housing at market costs constitutes one of the most important investment alternatives for private pension funds, channelizing enormous resources for housing finance.

Given the necessity to raise long-term funds and the potential that these sources of funds offer, in the future savings mobilization toward the housing sector will come from general savings in the economy. This saving can be through family deposits in multiple banks, pension funds or savings of the rest of the world, by means of an innovation in the instruments of intermediation of the financial sector, such as mortgage securitization. It will imply a reduction in the relevance of mandatory savings devoted to housing finance, because this segmentation method is limited in the volume of resources that it can mobilize and is inefficient in its operation.

ORIGINATION OF MORTGAGE LOANS

A basic feature of a solid mortgage market is the ability to recover principal in real value and, in this way, to allow the financing of new housing. Unfortunately, inflation is a phenomenon that precludes loan recovery from becoming the main source of funding for the housing finance systems in many cases, and it has caused the decapitalization of financial intermediaries. In light of such situations, indexation systems have been adopted, in different countries at various times, in order to adapt the conditions of recovery of the mortgage loans to an inflation situation.

In Latin America, diverse indexation schemes have been applied. Some base the correction on a measure of inflation (e.g., the Unit of Development-UF in Chile, and more recently the Unit of Constant Value-UVC in Ecuador and the Unit of Investment-UDI in Mexico). Others base the calculation of the monetary correction on function of the prevalent interest rates in the market (e.g., as was the case of the Unit of Constant Purchasing Power-UPAC in Colombia). Others use the variation of wages as an index of readjustment (e.g., the Adjustable Unit-UR in Uruguay). Still others apply a double indexation regime that indexes the balance of the credit to the interest rate and the monthly payment to the evolution of wages (e.g., in Mexico). And other countries use the dollar as an index of readjustment when mortgages are denominated in this currency (e.g., Argentina, Bolivia and Peru).

Certainly, none of these methods is exempt from problems. For example, inflation-indexed regimes can cause problems when the evolution of wages lags prices, causing payment problems for debtors. In the case of the double indexation, the variability of the term makes the flow of payments less predictable, hindering the securitization of the mortgages. Thus, the main lesson from these experiences is that a recipe does not exist for the design of an indexation system, as each owes its design to circumstances peculiar to the country, and must be consistent with other aspects of economic policy.

In Latin America, mortgage credits have been denominated in one of three major ways, two of which will have permanency. Mortgages can be originated in dollars, in national currency with some indexation regime or in national currency in nominal terms. This third group will begin to disappear due to the risks of eventual devaluation and inflation which make such instruments very difficult to intermediate. Ultimately, mortgage credit will have to be indexed to some domestic indicator or dollarized. From the perspective of mortgage securitization, it will probably be easier to internationalize those dollar-denominated mortgages than those originated with some index of domestic adjustment.

In order to harmonize the objectives of recovering the mortgage credits in real value and, at the same time, to protect the payment capacity of the debtor, it will be necessary to consider some mechanism to compensate for any payment inability that arises due to inflation and/or devaluation. For example, in Mexico FOVI has recently designed a mortgage denominated in units of constant value that are readjusted with inflation, combined with a covering fund to absorb temporary shortfalls in the payment capacity of the borrower.[1] The objective is to improve access to housing finance while offering a better recovery of the credits, and to create a more suitable product for future securitization.

FOUNDATIONS FOR A SOLID PRIMARY MORTGAGE MARKET IN PERU

The development of a market of mortgage credit in Peru will require a change of housing policy and housing finance that grants to the government a role as facilitator and subsidiary to private initiative. This facilitator role is to offer the possibility of favorable conditions for larger and more efficient private investment, based on profitability of operations, as well as competition and greater transparency in the real estate and housing finance markets. The subsidiary role is to offer equality of opportunity to obtain a housing solution generated by the market, expanding in this way the number of families that can obtain housing through the formal market. In this context, the application of direct housing subsidies (SHD) can have several advantages, some of them directly related to the same development of the mortgage market:

- They contribute to an increase in the potential market of mortgage borrowers.
- They stimulate the saving and effort of the families; and
- They accentuate and they do not distort the operation of the housing finance market, as is the case from subsidies to interest rates.

Two other advantages of the SHD, more related with the performance of the government, are that they allow a better targeting of fiscal resources, and they are transparent and appraisable for the government and for the beneficiaries.

Another key element will be the mobilization of long-term savings and not only of family savings but also institutional ones. A deep and efficient primary market is needed to develop a secondary market, but the primary market cannot be developed without the funding that the secondary market provides. As long-term savings managed by institutional investors become more important, it will be useful to design instruments that allow the channelling of resources from the capital market toward the mortgage market.

Additionally, and with the perspective of penetrating the lower-income market it will be important to stimulate family small-sized savings. At the moment, in the Peruvian financial market there is an absence of banking products for lower-income families as savings thresholds prevent them from participating. Also, the existing products in fact stimulate the opening and maintenance of accounts of more value.

Therefore, other methods of saving for housing must be developed, because these are an excellent way to capture the saving of lower-income families since they ease the access to a durable good like housing. Some countries require previous saving in the banking system as a pre-requisite to participate in the SHD. In Chile, it has been possible to stimulate the formation of an important number of small-sized saving accounts for housing (i.e., average balances of US$500-600).

The design of products that stimulate the formation of previous savings for housing through the financial system for the subsequent attainment of a mortgage loan can contribute to making credit more accessible to the population with scarce resources. They can enlarge the base of potential clients by incorporating those groups that traditionally are rejected by lenders due to an inability to demonstrate permanent income. In this sense, it is appropriate to mention the experience of mortgage societies in Mexico, which administer programs of previous savings directed to the independent workers' sectors. Through these plans of regular contributions, a financial record can be obtained that allows families to demonstrate their payment capacity and to produce the downpayment for a credit granted later.

In other words, these programs not only help to identify but also "to qualify" borrowers. Also, statistics indicate that the behavior of the debtors that have been channeled through a program of previous saving is better than that produced through the process of traditional qualification. In this way, the mortgage societies have enlarged the spectrum of their clients and they have occupied the space left by the banks after the "Tequila Crisis." In Peru, it would be an excellent addition to the Mivivienda Program if participant banks designed products to attract possible borrowers to save the initial downpayment, which is a minimum of 10% of the housing unit price.[2]

The primary mortgage market in Peru is an incipient market. This can be verified through the volume of the banking mortgage portfolio totalling only US$1 billion as of the end of 1999. This is a small volume compared to the relative size of the Peruvian economy. Two Latin American countries with similar economic dimensions possess mortgage portfolios that are substantially bigger: in Chile this amounts to more than US$6 billion and in Colombia to almost US$8.3 billion. Also, the activity of mortgage credit is not very ingrained in Peruvian banking: the mortgage portfolio only represents 7% of the total banking portfolio, while 78% of the total of the mortgage portfolio is concentrated in only four banks. Furthermore, this portfolio is focused on the middle- and upper-income strata of the population, a factor that limits the potential growth of this portfolio.

Keeping in mind the existing situation in Peru, and the approaches advocated in this document, a clear opportunity exists to both expand and consolidate the mortgage market. It will be fundamental, for both housing policy orientation and for resource mobilization toward housing, that the design of mortgages harmonize two not necessarily compatible aspects: on one hand, the profitability for the lender and, on the other hand, the protection of the payment capacity of the borrower during the life of the loan. The prevalence of profitability criteria is fundamental for the appearance and permanency of mortgage lending and to enlarge the volume of securitizable mortgages. But, at the same time, it must be kept in mind the need to have available a range of products specific to the characteristics and payment capacities of different strata of the population.

Although the current size of the mortgage market in Peru is a constraint, seen from another angle, it offers a unique opportunity to head toward the standardization of mortgages, so useful in the development of a secondary market. This does not mean that all loans must be for an equal amount, but rather all the loans are comparable. In this sense, there should be more standardization in underwriting approaches and in documentation. Thus, it will be necessary to develop detailed information records, particularly regarding the payments and prepayments of mortgages, the conditions of the loans, as well as the characteristics of the debtors and properties, all of which will facilitate the capture and use of the information that is required for the future securitization of mortgages.

NOTES

[1] See the article by M. Zepeda in September 1999. *Housing Finance International.*

[2] See "The Mortgage Industry in Peru: Entering the New Millennium," by Alex Niezen, in this issue of *Housing Finance International.*