

Brazil's New Mortgage Law and the Development of a Mortgage Market

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OPINION

By harnessing the power of securitization to create liquidity in the mortgage industry, the November 1997 passage of law 9514¹ marked a turning point in the long-term development of a viable housing market in Brazil.

With a single, sweeping flourish, the new law effectively overturned the legal obstacles that had long impeded the creation of a favorable economic environment for mortgage lending in Brazil. Law 9514 established a comprehensive legal framework for changing the face of the Brazilian mortgage industry, principally through the introduction of a new securitization vehicle that will improve liquidity in the mortgage market.

In addition, by defining how mortgages may be legally isolated from the risk of their originator, the new law will allow assets to be removed from the originator's balance sheet, thereby freeing up additional capital that can then be used to provide additional loans.

The newly created securitization vehicle will also likely contribute to the standardization of Brazil's mortgage market and lead to further improvements in liquidity by simplifying the analysis of mortgage securities by market participants such as investors and rating agencies.

Finally, law 9514 streamlined the foreclosure process by significantly reducing the time needed to seize and liquidate the property of defaulting borrowers in Brazil. This will also contribute to the growth of that nation's mortgage market by substantially reducing the costs associated with foreclosure.

¹ Although 9514 applies to both residential and commercial real estate, the focus of this article will be on the residential real estate market.



BACKGROUND

Prior to the passage of the *Plano Real*² (the Plan) in 1994, mortgage lending was not feasible in Brazil because of the high interest rates associated with the country's hyperinflationary environment and general economic instability. The stability engendered by the Plan led to an increase in the demand for housing and, in turn, to an increase in the demand for long-term funding. However, despite the more favorable economic environment for mortgage lending, Brazil's housing finance regime (codified under Brazil's Housing Finance System (Law 4380/64)) could not adequately accommodate this increase in demand.

The Housing Finance System relies on two basic funding sources:

1. Saving deposits held by the public with financial institutions authorized by the Central Bank of Brazil.
2. Mandatory deposits made by employers in accounts held in the names of their employees in the *Fundo de Garantia do Tempo de Serviço* or FGTS³.

However, many potential borrowers have been deemed ineligible to receive loans from these sources of financing due to concerns over the difficulty and expense involved in foreclosing on property. This ineligibility led to the creation of a new source of funding.

Real estate developers and builders, who typically sold houses and offices well before construction was started began financing construction costs by making installment loans to the buyers. These loans were effectively unsecured obligations of the borrower/buyer and therefore were not backed by a lien on any real estate or personal property. This loan had the advantage of not requiring a foreclosure process in order to obtain the property because the developer owned the underlying property.

The use of these developer-financed installment loans resulted in a large volume of receivables held by the building companies or real estate developers and funded by debentures, mortgage bills, foreign loans, and other debt instruments⁴. In fact, the developers have become such a dominant force in the mortgage lending arena that currently a remarkable 85% of Brazilian homes are financed by them.

However, this method of financing, too, proved less than ideal. The loans themselves suffered from a number of flaws, including high transfer taxes and difficulty in isolating the risk of the loan from that of the developer. In addition, while it was not necessary to institute a foreclosure proceeding, the eviction process could take as long as two years.

Further limiting the appeal of this instrument were the rather onerous rights of the borrower to rescind the loan in some cases. Thus, if the borrower was unable to pay and could not come to an agreement with the developer, the borrower could petition the court to have the loan rescinded. If the court granted such a request, the developer would have the obligation to return all of the prior payments less a rescission fee.

All these problems—the right of rescission, the transfer tax, and the structure of the loan—made it difficult to effectively securitize this instrument.

THE DRIVING FORCE BEHIND THE CHANGE: THE HOUSING SHORTAGE

More than anything else, the changes in Brazil's mortgage laws and housing industry have been occasioned by the country's severe lack of available housing. In fact, the present housing shortage in Brazil amounts to approximately 9 million housing units.⁵ This figure implies that 20% of the population (assuming 4 people per unit) lacks acceptable housing. The Brazilian Association of Home Loan and Savings Entities has estimated that approximately US\$400 billion of additional funding, or 13.5% of the Brazilian GDP, would be needed to satisfy the demand for housing.

2 Plano Real was an economic stabilization plan adopted in 1994. The plan was designed to reduce the budget deficit, lower the rate of inflation and introduce a new stable currency, the Real, the value of which is linked to the US dollar.

3 Workers' compensation fund administered by the Federal Savings Bank.

4 For example, some developers resorted to discounting such receivables with banks to obtain working capital. Also, a few developers have placed debentures backed by these installment loans in the domestic market and abroad, in the last two years (i.e. Rossi and Cidadela).

5 IPEA – Instituto de Pesquisa Economica Aplicada, as cited in Revista do Sistema de Financiamento Imobiliario Year 2, Issue 5.

The adoption of the Plan has enabled an increasing number of Brazilian families to secure housing. Perhaps even more important, it has enabled even more families to improve their purchasing power enough to be able to afford homeownership. This in turn has created a renewed demand for mortgage financing that Brazil's housing finance system was unable to satisfy.

ROLE OF SECURITIZATION COMPANIES

Law 9514 effectively established the legal framework necessary to resuscitate Brazil's mortgage industry. The law's pivotal contribution was to clear away the fog of legal uncertainty that had surrounded the securitization of mortgage loans by introducing to Brazil the concept of the "securitization company." This company is a limited-purpose entity designed to facilitate the securitization of mortgage loans by isolating them from the balance sheet of their originator and by issuing securities backed by the cash flow of the mortgages.

The law provides that the transfer of the loans to the securitization company will be, under certain defined circumstances, a "true sale." This means that the bankruptcy of the originator or seller will not have an effect on the securitization company. Therefore, the assets of the securitization company will be legally insulated from any claims by the creditors of the bankrupt seller/originator. At the same time, the mortgages are effectively removed from the seller/originator's balance sheet, which frees up capital that can then be used to make additional loans.

Law 9514 also introduced a new type of real estate investment instrument—the CRI (*Certificado de Recebíveis Imobiliários* or Certificates of Real Estate Receivables), which is a note issued exclusively by securitization companies. By issuing CRIs, these companies will raise funds in the capital markets that will be used to buy the real estate loans; the loans will then back the CRIs. Furthermore, the mortgage loans backing each CRI will not be subject to any claims or liens by either the creditors of the securitization company or the creditors of other CRIs issued by the same securitization company.

The issued CRIs will likely satisfy the need for medium- and long-term investments among Brazilian investors and will help fulfill the social mission of Brazilian pension funds. It is expected that the main buyers of the CRIs will be institutional investors, such as domestic and foreign banks, pension funds, investment funds, international investors, and insurance companies.

CIBRASEC PAVES THE WAY

CIBRASEC—*Companhia Brasileira Securitização* or The Securitization Company—was established simultaneously with the enactment of law 9514 and is currently the only securitization company established in Brazil for the purpose of creating a secondary mortgage market where mortgage loans are bought and sold. The creation of a secondary market allows for allocation of the risk and returns of the mortgage market across more market participants than would be possible in a primary market only.

CIBRASEC's shareholders consist of private sector entities (70%), including the major financial institutions in Brazil, as well as some foreign banks. The public sector holds 30% of the capital stock of CIBRASEC. Of that 30%, the government-owned Federal Savings Bank (*Caixa Econômica Federal*) holds a 10% shareholding participation, and the remaining 20% is held by the government of Brasilia/DF and by the states of Goias, Santa Catarina, Parana, and Rio Grande do Sul.

Although CIBRASEC does not have an exclusive right to issue CRIs, it is expected to be a major force in the creation of a standardized mortgage-backed securities market, given the involvement of major domestic and foreign financial institutions. As such, CIBRASEC will likely have the influence and market presence necessary to:

- Establish consistent mortgage origination standards
- Consolidate consumer credit information across a large number of institutions
- Develop standardized servicing guidelines.

The origination and servicing standards established by CIBRASEC may then be used by other securitization companies, which will lend further support to the development of Brazil's mortgage market. This standardization will make it easier for market participants to analyze and compare transactions.

FNMA and FHLMC⁶ created similar standardization in the US, allowing the US mortgage securities market to grow to be one of the largest capital markets in the world. The incentives are clear; nevertheless, it remains to be seen whether the many diverse owners of CIBRASEC will ultimately agree on consistent standards.

CHANGE IN FORECLOSURE LAWS

Another significant change introduced by the new law is the ability to seize and liquidate the property upon a debtor default in a more timely and efficient manner. The previous forms of mortgage loans were not attractive to lenders because of the obstacles to foreclosing on defaulting debtors, which sometimes delayed foreclosure for as long as seven years.

Under law 9514 the foreclosure process takes the form of a trustee sale (allowed under the *alienação fiduciária* or *deed of trust form of mortgage*) that allows the creditor to take possession of the property in a timely manner if a debtor defaults. Procedures to recover the credit are extrajudicial (out of court) and therefore easier to effect, as compared with the previous judicial foreclosure procedure.

Under the prior foreclosure regime (*garantia hipotecária*), the property was held in the name of the borrower, making it necessary for the foreclosure process to be carried out by the judicial system. The judicial foreclosure regime was subject to many delays, deferrals, and extensions due to the pro-borrower bias of the judiciary. Furthermore, under a judicial foreclosure process the defenses available to a borrower are much greater, thereby increasing the borrower's ability to delay the process.

Under the *alienação fiduciária*, by contrast, the property is held in the name of a trustee. It is estimated that the new law will reduce the expected time to foreclosure from an average of four years to between six and twelve months.

The faster foreclosure process will significantly decrease the severity of loss associated with a defaulted loan by reducing the interest costs of carrying the loan, minimizing any deterioration in the condition of the property and reducing the time the property is exposed to declining real estate markets. This change should encourage financial institutions to increase their involvement in the mortgage market and, by extension, the capital markets. While these reforms are an important step forward, it remains to be seen how well the foreclosure procedure will work in actual practice.

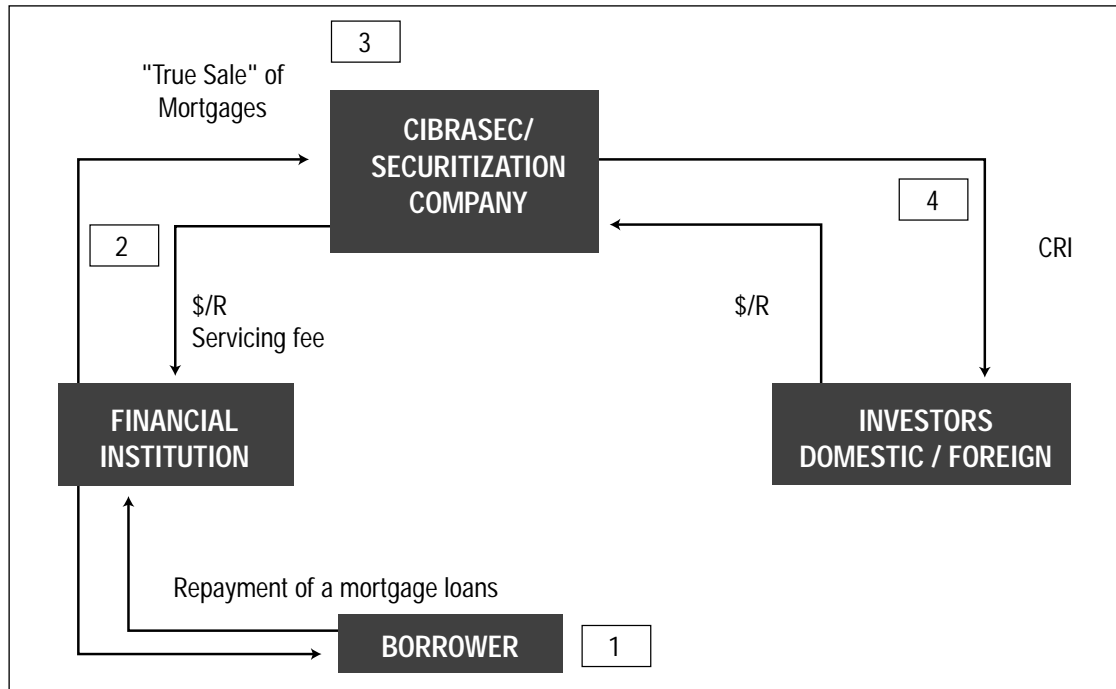
CONCLUSION: AN IMPORTANT FIRST STEP

One of the most critical aspects of a successful securitization market is an effective and comprehensive legal framework. Law 9514 is an important first step toward the development of a robust mortgage-backed securities market, which will likely increase the amount of long-term funding available to the Brazilian housing market by encouraging liquidity in mortgage loans.

The new law lays the groundwork for the growth of the mortgage market by creating a securitization vehicle and streamlining the foreclosure process. These seminal changes will make mortgage financing more efficient by eliminating originator insolvency risk, promoting standardization and reducing the costs associated with foreclosure.

⁶ FNMA (Federal National Mortgage Association) and FHLMC (Federal Home Loan Mortgage Corporation) are two government agencies established for the purpose of creating a secondary mortgage market in the US.

APPENDIX A: SECURITIZATION PROCEDURE



1. The borrower makes mortgage installment and insurance payments to the Brazilian mortgage loan originator.
2. The mortgage originator which can be a commercial bank, savings bank, savings and loan association, and/or mortgage company, will then sell the mortgage loans to a securitization company, like CIBRASEC or another securitization company or sell the loans directly to investors. The sale of loans to a securitization company has the advantage of removing the loans from the originator's balance sheet. In most cases, the originator will also service the loans for a fee.
3. The securitization company will purchase those mortgage loans that meet the specified criteria by issuing CRIs. Payments from the loans are pledged to support repayment of the CRI securities.
4. Initially, the CRI securities are expected to attract Brazilian investors, with the market later expanding to include global investors.

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