

# SOCIEDAD HIPOTECARIA FEDERAL: Does the Mortgage Partial Guarantee Work? - The Proof is in the Pudding

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**OPINION**

By providing a new first loss partial mortgage guarantee, Sociedad Hipotecaria Federal (SHF) is harnessing the power of securitization to create liquidity in the mortgage industry. The newly created guarantee should also contribute to the standardization of Mexico's mortgage market, and lead to further improvements in liquidity by simplifying the analysis of mortgage securities by market participants.

The first loss mortgage guarantee can provide substantial credit enhancement in mortgage-backed and mortgage-related asset-backed transactions. This guarantee has no impact on the frequency of borrower default, but it serves to reduce the severity of loss when borrowers default.

This Special Report outlines Moody's view of SHF's first loss partial mortgage guarantee and the key credit issues surrounding the use of this guarantee in the securitization of a mortgage portfolio.



## THE DRIVING FORCE BEHIND THE CHANGE: THE HOUSING SHORTAGE

The development of SHF's new partial mortgage guarantee is in response to one of Mexico's most pressing social issues: the severe lack of available housing. In fact, the current housing shortage amounts to approximately five million housing units, which has forced many families to build their own (substandard) housing, or to live in cramped quarters with extended family members. The existing housing deficit will continue to grow, as some 700,000 weddings are expected to take place in Mexico each year, increasing the need for housing. Moreover, with half the Mexican population below the age of 22, housing demand is expected to mushroom within the next few years.

Housing demand in Mexico is fueled by the comparatively low median age of the population, the increasing purchasing power of potential homebuyers, the high rate of household formation, and the growth of urban areas. The Mexican government's goal is to build 750,000 houses per year by 2006 — more than double the number built in 2000. To accomplish the goal, the president of Mexico has taken the following steps:

- Set up the National Housing Program as a cornerstone of the recently announced National Development Plan.
- Established a new financial institution-SHF-to foster the development of the secondary mortgage market.
- Created the National Housing Council. The organization that is the planning umbrella for SHF, INFONAVIT,<sup>1</sup> FOVISSSTE,<sup>2</sup> and SEDESOL.<sup>3</sup> (Please refer to "Sofol Mortgage Companies-Well-Positioned Intermediaries in the Mexican Mortgage Market," dated May 2002).

## SHF PAVES THE WAY

The Mexican Government created FOVI in 1963. FOVI<sup>4</sup> was a Federal fund administered by the Mexican Central Bank (Banco de Mexico). FOVI's financing is made available only through banks and Mortgage companies (Sofols),<sup>5</sup> and is directed both to developers building popular housing (construction loans) and to the individuals who buy such housing (individual mortgages).

Hipotecaria Federal was created in October 2001 by the Secretaría de Hacienda y Crédito Público (Ministry of Finance and Public Credit, or "Hacienda"). The Hipotecaria Federal, which manages the funds previously held by FOVI, provides financing for qualified homebuyers with funds from the World Bank, the Mexican Government, and its own funding in the capital market.

Although the Hipotecaria Federal is independent from the Consejo Nacional de la Vivienda (National Housing Board, or "CNV"), the latter may make recommendations to the Hipotecaria Federal through the participation of the Secretary of the CNV in the Board of the SHF.

Hipotecaria Federal provides financing for qualified homebuyers through financial intermediaries (commercial banks and Sofols), which administer sponsored mortgage loans, including the disbursement of mortgage funds and the servicing of such mortgages. Mortgage financing from the Sociedad Hipotecaria is available for the upper end of the affordable housing market as well as for the lower end of the middle-income housing market.

The creation of SHF is important because it can raise more money for the housing market and it introduces the potential for a secondary mortgage market in Mexico. Furthermore, it fulfills an important role in Mexico's low-income housing market, as no established rental market exists in Mexico.

SHF is currently the only government entity (similar to Ginnie Mae in the USA) established in Mexico for the purpose of creating a secondary mortgage market. 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.

1 Infonavit is the administrator of a payroll deduction fund created in 1972 as a joint venture between the Mexican Government and the labor industry. It is a fund that operates as a low-income housing fund and a pension plan. It is funded by employers' contributions of 5% of their employees' gross wages.

2 Similar to Infonavit but for public employees and teachers.

3 The Social Development Ministry.

4 Fondo de Operación y Financiamiento Bancario a la Vivienda provides mortgages for households that earn between US\$3,600 and \$27,000 a year, now known as Sociedad Hipotecaria Federal (SHF).

5 Sofols (Sociedades Financieras de Objeto Limitado) are special-purpose financial companies, also known as "non-bank banks." The Sofols' main function is to extend mortgage loans to low-income individuals under the auspices of Sociedad Hipotecaria Federal (previously known as FOVI) financing programs, and to provide construction financing for developers of low-income housing.

The seven members of the board of the SHF are: the Secretary of Finance, the secretary of Social Development, the Governor of the Central Bank, the Undersecretary of Finance, the Housing Commissioner (secretary of CNV) and two more non government members.

SHF is expected to be a major force in the creation of a standardized mortgage-backed securities market. Moody's believes that SHF's goals will likely exert the influence and have the market presence necessary to make further improvements to the housing market, such as the following:

- Establish consistent mortgage origination standards.
- Consolidate consumer credit information across a large number of institutions.
- Develop standardized servicing guidelines.
- Provide a mortgage guarantee.
- Invest in securities issued by financial intermediaries (banks, insurance companies and Sofols) for the purpose of financing housing projects.
- Provide bond insurance through a timely payment on MBS or on financial intermediaries' debt issuances.
- Provide interest rate futures in order to fix the refinancing interest rate risk of the mortgages.

In addition, FOVI's guidelines for the maximum sales price of the house and for the loan-to-value ratio have changed as a result of the creation of SHF. Under FOVI the maximum loan-to-value ratio was 90%, and the maximum sale price of the house had been approximately US\$50,000. However, as shown in *Table 1*, SHF's maximum sale price has been increased to US\$150,000, thus enabling financial intermediaries to provide loans for the middle-income housing market, which has been non existent since the 1995 Tequila crisis. In Moody's opinion, these increases are key elements in providing an array of mortgage products for the Mexican housing market.

Type	Approximate Maximum Price	Maximum Value of Mortgage
Social	US\$15,000	70%*
Economic to Lower Middle	US\$75,000	90%
Middle	US\$105,000	85%
Upper Middle to Residential	US\$150,000	80%

\* Borrowers receive a US\$5,000 upfront subsidy.

## **BENEFITS OF THE NEW MORTGAGE PARTIAL GUARANTEE**

Although SHF will provide several financing tools that will expand Mexico's primary and secondary mortgage market, it is Moody's opinion that SHF's focus on the first loss partial mortgage guarantee is a major step in enabling the growth of mortgage securitization. The partial guarantee will provide clear benefits for both issuers and investors of mortgage-backed securities.

From an issuer perspective, the guarantee will allow issuers to structure the transaction more economically, as fewer capital will be required to make the transaction feasible.

From the investor's perspective SHF's guarantee may provide a certain comfort level, as a government entity is taking on a considerable amount of credit risk. The implication is, from the investor's perspective, that a third party has conducted a thorough analysis of the transaction's credit risk. More important, in Moody's opinion, the guarantee will considerably decrease the severity of loss associated with a defaulted loan. Furthermore, the amount of overall credit enhancement needed to achieve a certain rating will be less, because the first loss of the credit is shifted to SHF, similar to the mortgage insurance provided by the Veterans Administration<sup>6</sup> (VA) and the private mortgage insurers in the US.

That change should encourage an increase in issuer involvement in the mortgage market and, by extension, the capital markets. While the reforms are an important step forward, it remains to be seen how well the partial mortgage guarantee will work in practice.

<sup>6</sup> These loans are often made without any down payment at all, and frequently offer lower interest rates than ordinarily available with other kinds of loans. Aside from the veteran's certificate of eligibility and the VA-assigned appraisal, the application process is not much different than any other type of mortgage loan. And if the lender is approved for automatic processing, as more and more lenders are now, a buyer's loan can be processed and closed by the lender without waiting for VA's approval of the credit application.

## HOW DOES IT WORK?

SHF provides financial intermediaries (i.e., Sofols, banks, etc.) with a mortgage first loss partial guarantee for their mortgage loan portfolios. If a mortgage loan is delinquent for six consecutive months, SHF will pay to the financial intermediary or to the trust the following maximum amount:

- 25% of the outstanding balance of the mortgage loan, plus interest thereon, and unpaid servicer and insurance fees (amounts due);
- 70% of the outstanding balance of the mortgage loan, plus interest thereon, unpaid servicer and insurance fees for the loans that include an up front subsidy from the government.

Table 2 shows a pool of equalized loans in which every loan has an LTV of 80% and all the loans in Scenario 1 are covered by SHF. All the loans have defaulted (180 days past due), with an average loss severity of 35% with respect to the loan balance.

In Scenario 1, SHF will contribute 25% of the principal balance of each loan, causing the loss on each loan not covered by SHF to be 10%. The total loss for the pool not covered is also 10%.

In Scenario 2, the loss on the pool is much greater than in Scenario 1, because SHF does not provide any coverage. The pool experiences a loss of 35%.

	Scenario 1	Scenario 2
No. of Loans	100	100
Principal Balance		
Of each Loan	\$100,000	\$100,000
Loan-to-Value		
of each loan	80%	80%
SHF Coverage Level	25%	0%
Default Rate	100%	100%
Average Severity Rate	35%	35%
SHF Pays (*)	25%	0%
<i>(% of the loans' principal balance for each loan)</i>		
<b>Loss Covered by SHF</b>	<b>25%</b>	<b>0%</b>
<b>Loss not Covered</b>	<b>10%</b>	<b>35%</b>
(*) This example does not include accrued interest, unpaid fees, expenses and insurance.		

## PAYMENTS UNDER THE GUARANTEE

The payments under the guarantee according to SHF's "Condiciones Generales de Financiamiento" is unconditional. It is important to note that the mortgages have to be originated and underwritten according to certain criteria set by SHF. The criteria include, but are not limited to, debt-to-income and loan-to-value requirements, property type and value, and reporting requirements for the financial intermediaries. In establishing the criteria, SHF is standardizing the mortgage market.

If any loan is delinquent for more than six months and does not comply with SHF's criteria, SHF will still be required to pay under the guarantee. SHF's guarantee will even cover losses resulting from fraud, special hazard, and bankruptcy. However, it is in the best interests of the financial intermediary to ensure that the loans it is making comply with SHF's criteria. If the loans are not in compliance with SHF's criteria, the financial intermediary will be obligated to reimburse SHF for any payments made under the guarantee. In Moody's opinion, a financial intermediary that fails to meet its reimbursement obligation to SHF will jeopardize future funding from SHF.

Losses from fraud can be the result of appraisal fraud and of misrepresentations by borrowers of their income and/or assets. Special-hazard losses include those from earthquake damage and flood. Therefore, credit enhancement from other sources may not be necessary to protect against these risks. SHF will work out the reimbursement of its payment directly with the financial intermediary.

If the delinquent loans are resolved through the sale of the property and the loss is less than the 25% advanced by the SHF, then the financial intermediary will have to reimburse SHF only the positive difference between the amounts due and amounts received with accrued interest. In other words, the 25% advanced accrues interest up to the moment SHF is reimbursed. If the mortgagee makes the loan current, the intermediary reimburses the SHF in whole with accrued interest.

When the property is sold or foreclosed, the intermediary submits to the SHF the request for the settlement of the guarantee.

Finally, to obtain the guarantee, the intermediary has to have two ratings: one of "investment grade" or above in the national scale and another of "average" or "above average" as servicer.

### **WHO PAYS THE PREMIUMS?**

In securitized transactions, the premium for this type of guarantee is generally paid from the excess interest available from the underlying pool of mortgages.

### **CONCLUSION: AN IMPORTANT FIRST STEP**

In Moody's opinion, SHF's guarantee will lay the groundwork for the growth of the Mexican mortgage market by promoting standardization and by reducing capital requirements on the subordinated loans held by the originators of those mortgages.

SHF will promote standardization i) by holding the financial intermediaries ultimately responsible for the compliance with its criteria, ii) by demanding reimbursement of any guarantee payments on loans that did not meet its criteria, and iii) by jeopardizing the financial intermediary's future SHF funding.

Furthermore, the guarantee will allow for the true securitization of existing mortgage portfolios and new mortgage origination by providing credit enhancement in a transaction backed by mortgage collateral. With this guarantee, SHF's goal is to be transformed into an entity that will introduce greater discipline and efficiency in the primary and secondary Mexican mortgage markets, similar to the U.S. FHA<sup>7</sup> and VA guarantees.

7 Federal Housing Administration: An agency of the U.S. Department of Housing and Urban Development (HUD). Its main activity is the insuring of residential mortgage loans made by private lenders. The FHA sets standards for construction and underwriting but does not lend money or plan or construct housing.

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