

HOUSING FINANCE MECHANISMS in Peru



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in Peru



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Housing Finance Mechanisms in Peru

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Acknowledgements:

Principal Editor and Manager: Xing Quan Zhang

English Editor: Tom Osanjo

Principal Authors: Alfonso García Mora and Paula Conthe Calvo

Design and Layout: Irene Juma

FOREWORD



At the dawn of this new urban era, UN-HABITAT research shows that by 2030, two-thirds of humanity will be living in towns and cities. We thus live at a time of unprecedented, rapid, irreversible urbanisation. The cities growing fastest are those of the developing world. And the fastest growing neighbourhoods are the slums. Indeed, the global number of slum dwellers is now at or close to the 1 billion mark. Excessive levels of urbanization in relation to the economic growth have resulted in high levels of urban poverty and rapid expansion of unplanned urban settlements and slums, which are characterized by a lack of basic infrastructure and services, overcrowding and substandard housing conditions.

Yet housing and the services that should be provided with it are one of the most basic human needs. It is enshrined in various interna-

tional instruments, including the *Habitat Agenda*. And reducing the number of slum dwellers around the world is a cornerstone of the *Millennium Development Goals* set to fight poverty around the world. So if we fail to achieve the Goals in towns and cities, we will simply fail to achieve them at all.

It was with this crisis in mind that the United Nations General Assembly decided in its resolution of 26 February 2002 to transform United Nations Commission on Human Settlements into a fully pledged programme. The General Assembly in its resolution called on UN-HABITAT to take “urgent steps to ensure a better mobilization of financial resources at all levels, to enhance the implementation of the *Habitat Agenda*, particularly in developing countries.” It also stressed “the commitments of member states to promote broad access to appropriate housing financing, increasing the supply of affordable housing and creating an enabling environment for sustainable development that will attract investment”.

The *Habitat Agenda* recognizes that housing finance systems do not always respond adequately to the different needs of large segments of the population, particularly the vulnerable and disadvantaged groups living in poverty and low income people. It calls UN-HABITAT to assist member states to improve the effectiveness, efficiency and accessibility of the existing housing finance systems and to create and devise innovative housing finance mechanisms and instruments and to promote equal and affordable access to housing finance for all people.

In our quest to reach as many people as possible, a cornerstone of our agency’s new Medium-term Strategic and Institutional Plan is partnerships. We have no choice but to catalyze new partnerships between government and the private sector. This is the only way to finance

housing and infrastructure at the required scale – the scale needed to stabilize the rate of slum formation, and subsequently reduce and ultimately reverse the number of people living in life-threatening slum conditions.

It is clear that in the coming 20 years, conventional sources of funds will simply be unavailable for investment at the scale required to meet the projected demand for housing and urban infrastructure. Many countries around the world continue to face deficits in public budgets and weak financial sectors. Local governments have started to seek finance in national and global markets, but this is only in its initial phase.

New mortgage providers have emerged, including commercial financial institutions and mortgage companies. But only middle and upper income households have access to such finance, while the poor are generally excluded. Although social housing is becoming less important in Europe and in countries with economies in transition, the need to provide shelter that is affordable to low income households still exists, including in developing countries.

This is why the exchange of information and knowledge on human settlements finance systems is so important. It is why it receives increased recognition in facilitating the development of human settlements finance systems and in turning knowledge into action for developing practical human settlements finance methods and systems for these pressing problems.

Our *Human Settlements Finance Systems* series documents the state, evolution and trends of human settlements finance in member states, and examines the factors and forces which drive the development of human settlements finance systems and the roles of different institutions and actors in shaping the systems and trends, and reviews human settlements finance systems. It presents an interesting review of policies, instruments, processes and practices. It examines the strengths and weakness of these systems and practices, their relations to the housing sec-

tor and the broad economic and social sectors, and lessons learned from practices.

Indeed, the country review studies we present are a valuable resource for member States because it is a body of work that also shows how human settlements finance systems and models can be applied to local use and thus provide a wider range of options for human settlements finance. The series also serves as guidebooks for policy makers, practitioners and researchers who have to grapple daily with human settlements finance systems, policies and strategies.



Anna Tibaijuka,
Under-Secretary-General
of the United Nations
Executive Director, UN-HABITAT.

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Chapter 1 - The Scope of the Housing Problem in Peru

1.1 HOUSING DEFICIT

The current population of Peru according to final results of the 2005 Census¹ is 26,063,621 people, of which 70% live in urban areas and more than 30% of the urban population is in the Lima metropolitan area and Callao. The number of dwellings in the country according to the same source is 5,858,148, of which 94% fall in the category of private homes and 5% serving as both homes and businesses. Close to 2 million, 29%, are located in the area of the capital.

Although the situation has been improving gradually for the past couple of years for certain segments of the population—largely as a result of mechanisms that will be presented in detail in following chapters of this report—the housing deficit in Peru, defined as the number of dwellings needed for all family units in the country to be housed adequately—is still ex-

tremely large. Numbers at first glance, however, greatly underestimate the actual scope of the problem: The 2005 Census, in fact, reports the existence of 6,053,680 family units, a figure which, when compared to the number of dwellings, only reveals a shortage of slightly under 200,000. This straightforward method of calculating Peru's housing needs, however, has obvious limitations and poorly reflects the country's reality.

The estimate of the quantitative housing deficit, for one, must not only consider the number of households without a home of their own, but also the number living in dwellings that have been built with precarious, nondurable materials and therefore must be considered short-term shelters, rather than homes.

In order to estimate this number, the Peruvian Institute of Statistics classifies construction materials for different parts of the dwelling

Dwellings built using precarious, nondurable materials			
Section of the dwelling	Categories considered precarious in INEI methodology	Number of Dwellings	% of Total Dwellings
Roof	Rush mat, straw, palm leaves, other	702,030	12.0%
Exterior Walls	Rush mat, other	82,280*	1.4%
Floor	Other	18,599*	0.3%
Total		802,909	13.7%

Source: Census 2005, INEI.

*Excluding dwellings included in above categories

¹ X Population and V Housing Census in Peru, undertaken in the summer of 2005 by the Instituto Nacional de Estadísticas del Perú (INEI, National Institute of Statistics).

Dwellings not offering minimum living standards			
Basic Services	Categories considered not connected in INEI methodology	Number of Dwellings	% of Total Dwellings
Electricity	Candle, generator, other, none	645,852	11.02%
Sewage system	River,ditch, none	930,516*	15.88%
Running water	River, irrigation channel, spring water, other	315,429**	5.38%
Total		1,891,797	32.29%

Source: Census 2005, INEI.

*Excluding dwellings included in above category

**Excluding dwellings already included in above categories

(roof, exterior walls, floor) into three categories: durable, medium quality, and precarious. Dwellings built with materials in this third category are included in the housing deficit².

In accordance with this criteria, the Census 2005 revealed that a minimum of 800,000 households (the actual number is probably much higher, considering many of these homes house more than one family unit) are inadequately housed.

Another aspect to take into consideration when considering the housing shortage is that, while many homes may have been built with adequate materials and using satisfactory techniques, they may still not meet minimum living standards and thus contribute to the country's qualitative housing deficit. The Institute of Statistics uses two criteria to determine when living standards are adequate: on the one hand, the access to services such as water, sanitation and electricity and, on the other, the degree of overcrowding.

The Census 2005 report brought to light that although notable improvements have been made over the past few years with regard to extensions of the electricity network, water and

² *Metodología de Cálculo del Déficit Habitacional en el Perú* published by the Oficina General de Estadística e Informática, Unidad de Estadística in 2004.

sewage systems across the country, over 30% of dwellings still do not have access to all basic services.

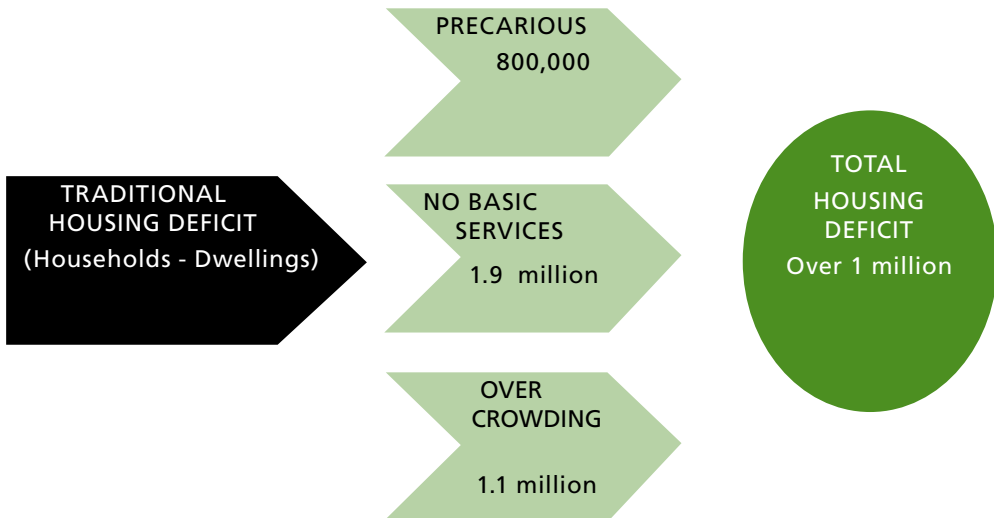
The second criteria in determining the qualitative housing deficit, degree of overcrowding, is quantified in terms of the number of people per room in a home. More than three people per room is considered by the INEI to justify the need for a bigger/additional home and thereby represents an unmet demand for housing that must be taken into account. Although the Census 2005 has not collected information on households' characteristics, the last Household Survey undertaken in 2004³ estimated the average number of members to be 4.5, rising as high as 5.4 for the lowest-income quintile and falling to 3.4 for the highest. Based on this figure and collecting the information on number of rooms and households per dwelling, the number of overcrowded dwellings in Peru at present appears to exceed 1.1 million.

Based on this pondered analysis and methodology, the housing deficit in Peru is found to be much higher than suggested by the difference between number of dwellings and households in the country, although the exact

³ Encuesta Nacional de Hogares 2004 (ENAH 2004). Instituto Nacional de Estadística del Perú.

Number of Rooms	Number of Households						Overcrowding
	1	2	3	4	5	6+	
1	1,090,673	5,284	872	225	81	51	1,097,186
2	1,387,900	12,288	1,455	337	94	33	14,207
3	1,223,721	22,389	3,059	364	89	42	3,554
4	967,670	26,988	5,162	702	99	39	6,002
5	488,862	20,075	4,942	1,120	178	35	1,333
6	261,757	12,831	3,746	930	268	40	308
7	127,672	7,238	2,457	730	195	61	256
8	78,439	4,716	1,725	577	134	69	69
9	35,115	2,392	1,042	372	92	55	55
10+	87,724	3,291	3,312	1,282	450	267	
							1,122,970

Source: Census 2005, INEI



number is difficult to determine since it would be reasonable to expect that many of the dwellings built with precarious materials are also the ones without many basic services and facing significant overcrowding.

Yet, although the information available does not allow the crossing of all these variables to come up with an exact figure, it would appear that using any one of these three methods, the Peruvian demand for dwellings is estimated at over 1 million in every case, i.e. almost 15% of households at present, and, in one case, even over 2 million or 30% of households. And, considering new household formation in coming years, this demand is only likely to grow. Indeed, all efforts directed towards reducing the current backlog in housing must also take into account the continuous increase in demand resulting from population growth. Based on demographic projections made by the National Institute of Statistics in 2001, the number of people between 20 to 30 years increases in about 500,000 every year, resulting in approximately 250,000 more couples demanding a home⁴.

1.2 DEFICIENT AFFORDABILITY CONDITIONS AND NEED FOR HOUSING FINANCE

The explanation behind the huge housing needs faced by Peru at present is extremely complex. On the demand side, massive internal migration movements from rural to urban areas, the economic crisis and natural disasters such as the recent El Niño phenomenon have undoubtedly contributed to the high unmet demand for housing in the country at present. On the supply side, the construction sector has suffered from—in addition to this limited demand—inadequate urban regulation and excessive bureaucracy, registering three consecutive years of

⁴This figure is obtained assuming almost everybody marries and there's a 1:1 female to male ratio. This figure will be higher if not everyone marries, as well as if other reasons to demand houses are also considered such as renovation of stock, second hand houses, etc.

negative growth from 1999 to 2001. This situation inevitable restricted availability of formal housing and led to large amounts of informal settlements.

Since 2003, however, the construction sector has flourished, although this recent spurge has not translated directly to a reduction in the housing deficit, a situation which seems to suggest that the source of the housing problem in Peru is to be found in low affordability conditions and a mismatch between existing demand and available supply, rather than in an outright lack of housing construction activity.

An analysis of the current supply and demand for construction in the Lima Metropolitan Area and Callao⁵ for 2004, broken down by price, reveals the noticeable mismatch between the two, with excess supply of expensive housing units and over 40% of unmet demand in the lower echelons.

This mismatch is hardly surprising given that construction, despite important changes brought about by Programs such as MIVIVIENDA and Techo Propio presented later on in this report, is still concentrated in profitable large projects while income levels in Peru remain extremely low. Poverty levels in the country are, indeed, very high. As presented in the 2006 IMF Country Report, 18.1% of the population lived on less than 1 USD a day in 2001, with the 2015 target set at 9.1%.

Assuming an average housing price of 30,000 USD, it would take a household in the B group (with an average monthly income per capita of 107 USD) almost 6 years to buy a home if it dedicated its entire income to the purchase. For those in the C strata, it would be 8, 13 for D and as high as 23 for the poorest section of the population, E.

⁵Housing activity data is unavailable for the country as a whole. Available information is exclusive to the Lima metropolitan area and Callao and is provided by the Peruvian Construction Chamber (CAPECO), an organization that has been funding studies on the construction sector in this area since 1996.

Supply and Demand of Housing Units in Lima Breakdown by Price

House Price (1.000 USD)	Supply		Existing Demand		Unmet Demand	
	Number	%	Number	%	Number	%
Up to 10	4,037	28.9%	93,977	42.7%	89,940	43.7%
10-15	209	1.5%	45,967	20.9%	45,758	22.2%
15-20	818	5.9%	37,340	17.0%	36,522	17.7%
20-30	3,829	27.5%	28,371	12.9%	24,542	11.9%
30-40	1,960	14.1%	9,498	4.3%	7,538	3.7%
40-60	1,547	11.1%	3,800	1.7%	2,253	1.1%
60-80	695	5.0%	616	0.3%	-79	0.0%
80-100	353	2.5%	205	0.1%	-148	-0.1%
100 +	500	3.6%	203	0.1%	-297	-0.1%
TOTAL	13,948	100%	21,9977	100%	206,029	100%

Fuente: CAPECO, 2004

The huge housing needs in the country and the unfavourable affordability conditions — with housing price to income ratios of as high as 23 in the Lima metropolitan area even for the richest quintile of the population — evidence the need for a housing finance system that can improve the Peruvian population's access to adequate housing.

In recognition of the magnitude of the housing deficit and affordability problem in Peru, the Government has historically been very active in promoting housing finance and improving households' access to housing in the country, at times with greater success than others.

Income distribution in Peru

Quintile	Average Monthly Income per capita (USD)*	Households (HH)		Average number of members per HH
		Number	%	
A	337	1.588.336	25,29%	3,5
B	107	1.317.897	20,98%	4,2
C	65	1.212.130	19,30%	4,6
D	40	1.131.307	18,01%	4,9
E	20	1.030.934	16,41%	5,4

Source: INEI, Encuesta Nacional de Hogares, 2004.

* 1 USD=3.2 nuevos soles corrientes

Chapter 2 - Housing Finance: A Historical Overview

2.1 EARLY ROLE OF GOVERNMENT IN PROMOTING HOUSING FINANCE

Institutional efforts to promote housing finance in Peru date back to as early as 1933, with the creation of the state-owned *Banco Central Hipotecario del Perú*, BCHP (Central Mortgage Bank). The bank was originally set up to grant mortgage loans to finance commercial or manufacturing activities, but by the 1960s most of its resources were being directed towards financing home purchases or new construction and by 1980 the entirety of funds were directed towards this purpose.

The BCHP's gradual shift towards housing finance was accompanied by the centralization of State support in this area and the emergence of mutual credit associations for housing, non-profit private associations created in 1957. Until then, public housing policies had been implemented through a variety of organizations such as *Corporación de la Vivienda*, *Fondo Nacional de Salud y Bienestar Social*, and the *juntas de Obras Públicas y Departamentales*. With the appearance of mutual credit associations, however—and following the predominant housing finance model in the Latin American region in the early 20th century, built around one or several savings funds and a state bank—the Peruvian government centralized its role in housing finance through the creation of *Banco de Vivienda del Perú*, BVP (Housing Bank) in 1962⁶, a second-tier bank with the mandate of promoting, regulating and financing the newly created mutual credit system and supporting the development

⁶ *Banco de la Vivienda* was one of the four entities that made up the *Banca Estatal de Fomento* (State Development Bank) along with the *Banco Agrario*, *Banco Industrial* y *Banco Minero*.

mortgage lending to low-income households. In this capacity, the BVP promoted public and private investment in social housing by placing mortgage bonds among construction companies and commercial banks and distributing the funds raised among the credit associations. Only a very small share of BVP's resources were placed directly with beneficiaries, activity that was essentially covered by the BCHP and the credit associations.

With BVP's support, the mutual credit associations grew rapidly over the following two decades and by 1981 they were considered sufficiently large players to require the financial supervision of the *Superintendencia de Banca y Seguros* (SBS). Their name was then simplified to *mutuales de vivienda*⁷ (housing mutuals) which are, in turn, commonly referred to as *mutuales*.

2.2 THE 1980S: PREDOMINANCE OF THE STATE

The BCHP's specialization in housing lending activity and the formalization of *mutuales* marked the beginning of a period characterized by a notable expansion of the mortgage market in which the State played a central role; almost all mortgage loans destined to financing home purchases or new construction during the 1980s were granted through these State-owned or supported institutions. In only two years, the amount of mortgage loans granted by the BCHP and mutuals practically doubled, with

⁷ It must be noted that the *Circular del Banco de Vivienda del Perú*, BVP No.119, Oct.7, 1981 regulating the *mutuales de vivienda* allowed these institutions to grant loans for purposes other than housing finance in order to foster the credit market. In addition to housing loans, mutuals could grant special loans to furnish homes, for health-related motives, to service electricity, water, sewage, etc.

placements of close to 200 million and 100 million USD, respectively, in 1982. The market faced some difficulties in the period from 1983 to 1985, particularly in the case of BCHP, which gradually lost market share to mutuals, but activity resumed once again in 1986, with mortgage loans granted in 1987 amounting to a record 500 million USD.

Despite its initial success, though, this housing finance system was doomed to fail as a result of a number of factors, several exogenous, but many endogenous to a public housing finance model that flourished in many Latin American countries in the second half of the 20th century only to later collapse by the end of the 80s. And Peru was to be no exception. In 1989, the number of housing purchases financed fell drastically, from 18,000 in 1987 to barely 2,000, and by 1990, the BCHP and mutuals financed the acquisition of scarcely 655 dwellings in total.

A large part of the blame for the Peruvian system's downfall in the 1980s is certainly to be placed on the effects of exogenous factors such as the economic crisis and hyperinflation. Indeed, a brief glance at the historical evolution of the mortgage market in Peru, as in most countries, provides clear evidence that the expansion of the mortgage market has generally been positively correlated with the economic cycle, evolving in line with peaks and troughs in GDP. The years between 1988 and 1990 saw economic activity decrease by 10% and inflation exceed 7%, a situation which led to a significant reduction in the population's income and, unsurprisingly, to the subsequent deterioration in the credit portfolio quality.

Yet although the relevance of economic factors is undeniable and abundant literature exists documenting the need for macroeconomic stability for a primary housing market to thrive, the endogenous weaknesses of a State-dominated housing finance market (and of public banking systems in general) are also largely to blame for the system's inability to cope with the crisis.

At best, these weaknesses aggravated the financial difficulties faced by the institutions during the crisis and accelerated their collapse.

One of the main problems faced by the public system was moral hazard. In a context of high inflation and falling incomes, households in difficulties were reluctant to spend their waning earnings in paying back loans that had been granted by the State, particularly since many considered the Government largely to blame for the recession. Default rates on mortgage loans, which were below 8% in the early 80s, had already reached 20% by the middle of the decade and increased even further at the height of the crisis, drastically reducing capital inflow into mutuals and BCHP. Costs, in the meantime, were still very high due to inadequate administrative and financial management. In the case of mutuals, for instance, operational costs were as high as 34% of financial revenues during the second half of the decade (Rivas Gómez y Castro Suárez, 1997), largely due to the lack of competition, as a result of market distortion and the crowding out effect of the private sector—unable to compete with advantageous rates offered by State subsidies—, which provided few incentives for improvement. The growing number of non-performing loans combined with high costs resulted in a significant reduction in revenues for the Peruvian housing finance institutions.

At the same time, BCHP and mutuals faced significant restrictions in funding, which were traditionally limited to only three sources: (i) savings deposits, on which they offered more attractive rates than other financial intermediaries in order to raise sufficient funding to direct towards housing finance; (ii) resources from external sources; and (iii) subsidized credit lines from BVP, whose funds, in turn, generally came from Fondo Nacional de Vivienda (FONAVI)⁸.

⁸ FONAVI was an institution created in 1979 to provide housing loans at preferential rates to its contributors. It received regular contributions from government employees and other segments of steadily employed workers, as well as residential construction companies.

Faced with an economic crisis, external sources were cut off and the Government re-oriented funds traditionally directed towards promoting housing to other sectors considered of greater priority, thus limiting the sources of funding strictly to one, deposits, which were hard to come by at the time due to the general reduction in household incomes. Further, the Government's poor management of the crisis led to the loss of public confidence in anything State-related and, most notably, in the state-owned and supported BCH and mutuals. The few individuals which had savings to place at financial institutions chose private commercial banks over state institutions, despite the higher interest rates offered by the latter. Unable to compete in the deposits market, public housing finance institutions saw their market share fall from more than 50% in the early 1980s to only 6% in 1990.

The severe cut back in funding and revenues, combined with the gradual erosion of the assets resulting from high inflation (as high as 7.7% in 1990) and fixed interest rates on loans, eventually led mutuals to go bankrupt and forced the BCH to close down.

2.3 1990S: PRIVATE COMMERCIAL BANKS STEP IN

In the early 90s, the SBS's intervention of housing mutuals and the BCH and the official liquidation of *Banco de Vivienda* brought the housing finance market to a standstill and marked the beginning of a major transformation in the Peruvian housing finance system. With the disappearance of what had once been the central pillars of the housing finance system, mortgage activity in Peru virtually disappeared in the early 90s, re-emerging only after 1995 when private commercial banks moved into the business.

The growth in mortgage lending in the second half of the 90s was driven by greater eco-

nomonic stability—Peru witnessed a decline in inflation after the hyperinflationary crisis of the 1980s—and the consolidation of the financial sector's reform. In the aftermath of the economic crisis, the early 90s witnessed the liberalization of the Peruvian financial market through the implementation of a battery of measures: lifting of restrictions to entry for foreign participants into the financial markets, privatization of banks, elimination of barriers to entry/exit of capital and of interest rate controls, etc. With the subsequent emergence of new institutions—many of them with some degree of participation of foreign capital that provided the required experience, know-how and credit scoring tools and methodologies from headquarters abroad—and greater availability of international funding, the credit market expanded and the competition between market players increased. This, in turn, drove down interest rates, thereby improving conditions being offered on loans, increasing effective demand and further stimulating credit growth.

The low delinquency rates being registered on mortgage loans (less than 5% in 2002, as opposed to 6, 7.9 and 8.5% registered on consumer, commercial and SME loans, respectively) and the many advantages in terms of profitability and efficiency that banks discovered housing finance brought in tow (increasing synergies, economies of scales, customer fidelization, etc.) also contributed to further deepening the mortgage lending market in Peru. The result was the significant growth of the housing finance market, which went from being practically non-existent in the early nineties to amounting to over 1,000 million USD in 1998.

Two observations must be made, however, when evaluating the notable expansion of the mortgage market in Peru in the late 90s. On the one hand, it must be noted that the high growth rates being registered were due to the low levels they were being compared to initially. In absolute and even relative terms, the mortgage market in Peru still remained well below

international and regional standards. The banking sector in itself, in fact, was still very limited in size and scope.

The second observation to be made is that the mortgage market growth was quite misleading in terms of judging the success of the housing finance system, since the 1990s saw scarce improvement in the population's access to housing or in the reduction of the housing deficit. A huge percentage of the population—more often than not, the group with the greatest need for housing—was unable to meet conditions on conventional loans and was left outside the growing mortgage market in the 90s.

2.4 ANOTHER FAILED HOUSING FINANCE MODEL

After the expansion of second half of the nineties, the mortgage credit market began to experience a slowdown in 1999. One of the reasons for this decline was, yet again, the country's macroeconomic situation. The Asian crisis that shook the global financial markets in 1997, swept across Latin America and took its toll on Peru as well, where financial institutions inevitably experienced the credit crunch.

But financial market fluctuations were once more only partly to blame for this stall in mortgage lending activity in Peru. The growth of the private sector housing finance system in the 1990s was fuelled by the scarce few who could afford and meet conditions on loans. Once these wealthy groups' needs were met, the number of mortgage loans being granted began to wane, inevitably slowing down the housing finance market.

In fact, what the crisis brought to light was that despite the initial surge—driven primarily by demand from the highest income groups—the burgeoning private sector mortgage market, while offering important advantages with respect to a State-dominated scheme, still faced significant limitations to its development and, even more importantly, as has already been

pointed out, achieved very little in terms of improving the population's access to housing. Indeed, although commercial banks' involvement in mortgage lending guaranteed independence from State funds and the whims of changing governments, in addition to significantly improving financial and administrative management, the new system was unable to cope with a number of factors that limit the effective supply and demand of mortgage loans in developing countries.

By the late 1990s it was apparent that neither the State dominated housing finance system of the 1980s nor the solely private system were able to adequately deal with the housing problem in Peru or the challenge of boosting the development of the financial market while at the same time alleviating the population's housing needs. However, important lessons were learned and applied in the design of an innovative housing finance Program which has achieved great success in Peru in the first years of the 21st century, Crédito MIVIVIENDA.

Mortgage Finance for Medium and Low Income Households: Fondo and Créditos MIVIVIENDA

2.5 ADDRESSING HOUSING FINANCE MARKET NEEDS

The development of the private sector housing finance system in Peru during the 1990s unfortunately achieved little in terms of resolving housing and affordability problems for a majority of the population and evidenced the need for public support in coping with the issue. At the same time, however, the crisis of the 1980s cautioned against an excessively invasive role of the State that might eventually lead to the market distortion and inefficiencies plaguing public banking institutions around the world. Having learned from the experience of the previous two decades, the Peruvian Government faced the challenge of continuing to promote the development of the private sector housing finance

system, while at the same time still managing to ensure that medium and low-income households had access to loans they were traditionally being denied by this sector, thereby also improving access to housing.

In this context, the Fondo Mivivienda was created in 1999 to address two of the main obstacles hindering the development of an effective private housing finance system in Peru. First, the lack of long-term funding available to financial institutions and, second, the high credit risk perceived for middle and low-income groups (largely as a result of the relevance of the informal sector and inadequate credit information mechanisms), which discouraged banks from servicing this sector of the population.

2.6 CREATION OF FONDO MIVIVIENDA

The Fondo Hipotecario de Promoción de la Vivienda - Fondo Mivivienda (FMV) began operations on January 16th, 1999 as a state entity affiliated to the Ministry of Economy and Finance (Ministerio de Economía y Finanzas, MEF), although Law N°27792 later assigned the Fund to the Ministry of Housing, Construction and Saneamiento (Ministerio de Vivienda, Construcción y Saneamiento, MVCS) in July 2002. In terms of resources, FMV received an initial—and single—transfer of S/. 1,500 million (USD 514 million) from *Fondo Nacional de Vivienda*, FONAVI (National Housing Fund), to be directed towards improving the population's access to housing.

Mandate and Organizational Structure

Law N°26912 gave FMV the mandate of facilitating the population's access to private housing and encouraging savings through the design of financing mechanisms with private sector participation. In accordance with this directive, the FMV has worked in two directions: funding lenders in the private sector and promoting targeted savings by households for

home purchases.

The struggle to avoid earlier pitfalls and maintain the balance between ensuring the development of the Peruvian primary mortgage market through the private sector without leaving social interests behind has permeated the entire Fund's organizational structure, beginning with the Board of Directors, which was designed to include members representing both the Government and private financial institutions. The Executive Committee, the Investments Committee and the Executive Secretary make up the institution's remaining governing bodies.

2.7 MECHANISMS TO PROMOTE MORTGAGE MARKET AND IMPROVE ACCESS TO HOUSING

FondoMivivienda has introduced a number of key mechanisms to promote the development of the mortgage market whilst improving access to housing for middle and lower income households. To list a few:

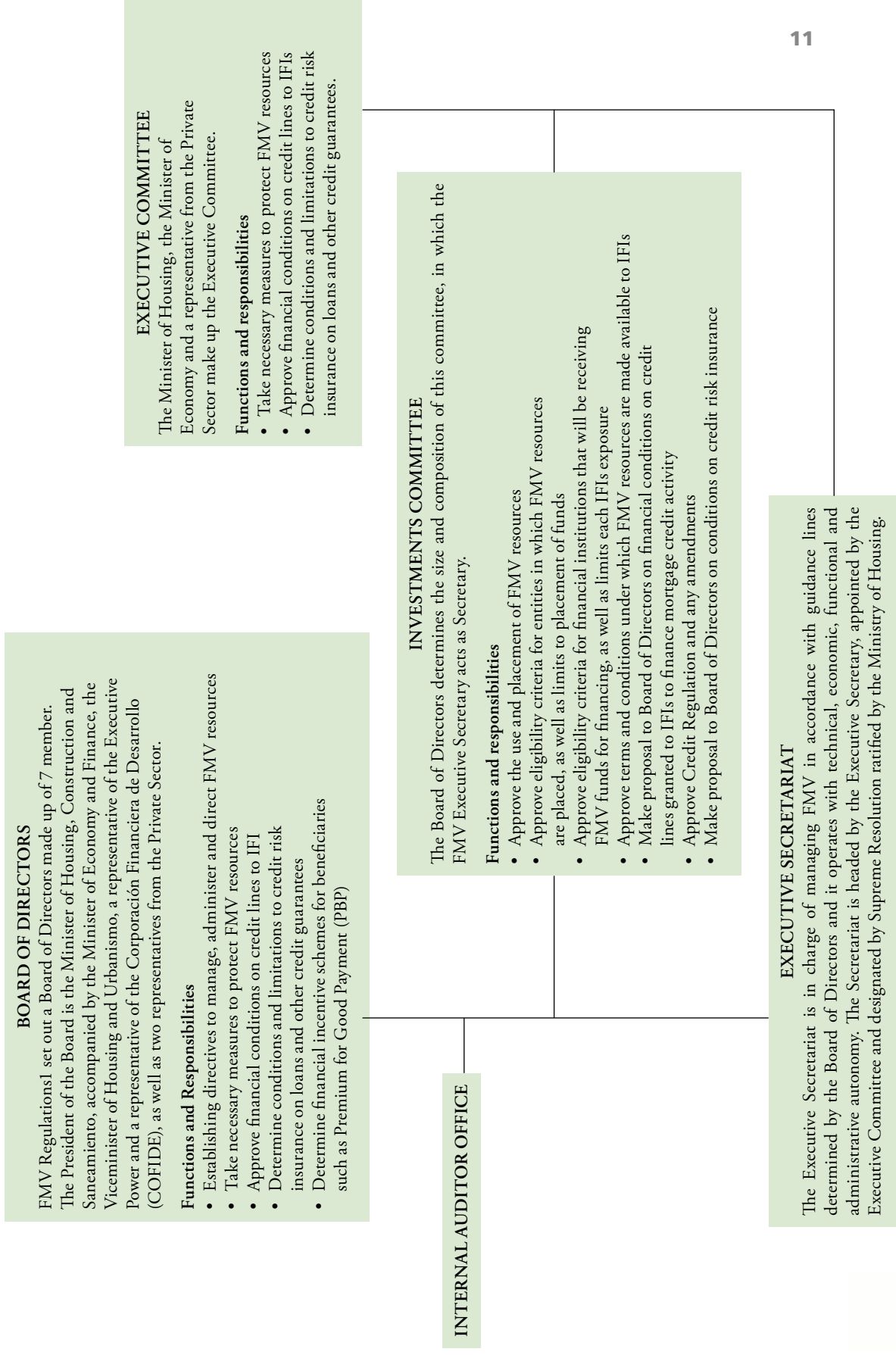
Funding lenders in the private sector

Crédito MIVIVIENDA program's resources to date have been used exclusively for second-tier financing. Peru's *Corporación Financiera de Desarrollo* (Development Finance Corporation)—often referred to as COFIDE—acts as the financial agent, placing the program's funds with qualified financial intermediaries that use these State resources to finance loans to individuals for construction and housing purchases, under conditions established by FMV Regulations. Through this mechanism, private sector commercial banks have access to long-term financing at advantageous rates.

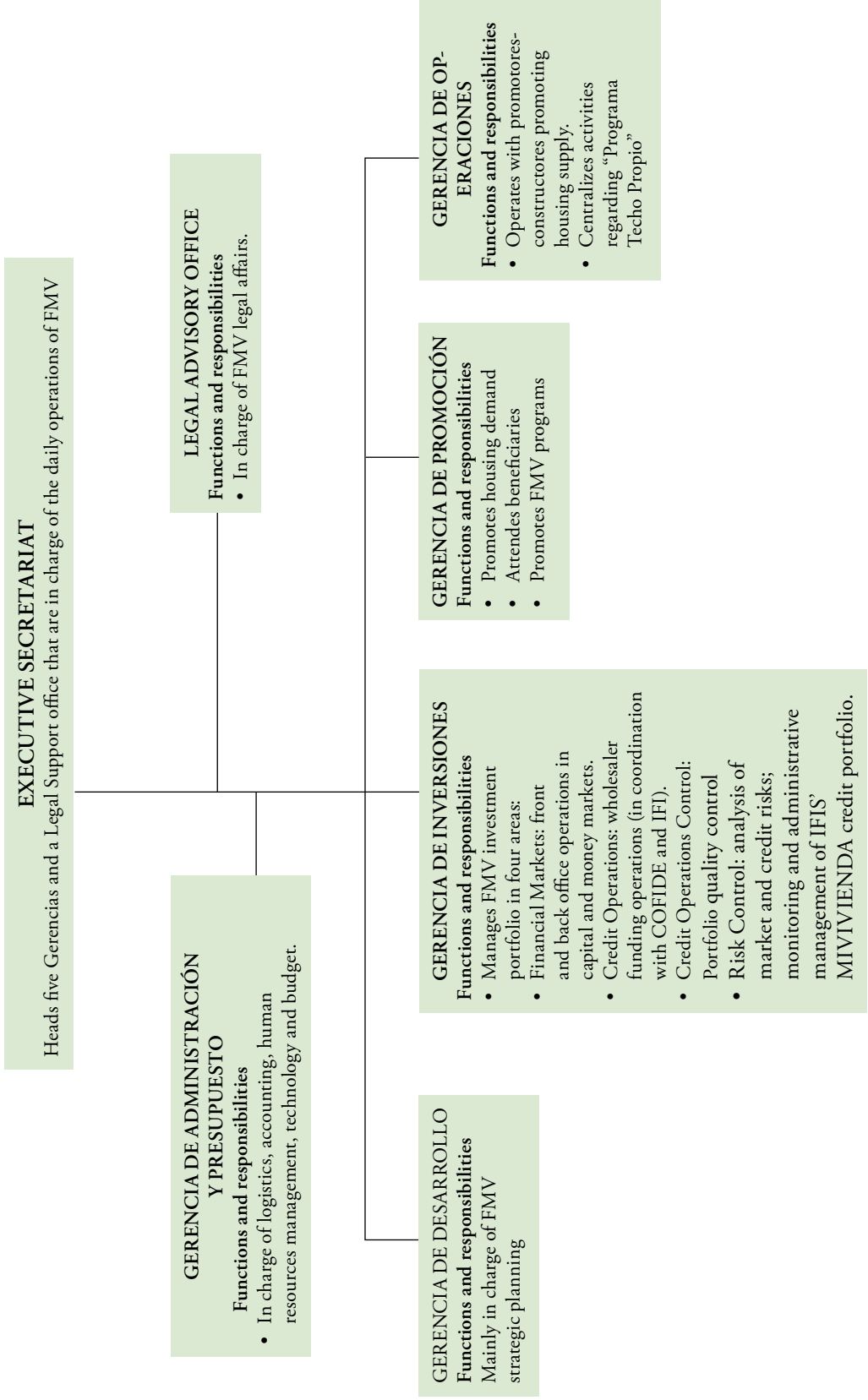
Encouraging banks to downscale through Credit Risk Insurance

Having access to long-term funding might

FONDO MIVIVIENDA ORGANIZATIONAL STRUCTURE (I): GOVERNING BODIES



**FONDO MIVIVIENDA ORGANIZATIONAL STRUCTURE (II):
MANAGEMENT AND DAILY OPERATIONS**



foster the growth of banks' long-term lending activity but is not necessarily sufficient to encourage banks to service lower income groups. To address this issue, the FMV provides *Cobertura de Riesgo Crediticio* (Credit Risk Insurance), commonly referred to as CRC, which reimburses financial institutions with 1/3 of subordinated loss in case of default.

Promoting targeted savings by households for home purchases

Given the size and scope of the informal economy in Peru, many households and individuals are left outside the mortgage market due to the difficulties they face in proving to banks their access to a regular source of income. A number of savings mechanisms have been developed to help resolve this issue.

Ahorro Hipotecario Previo (Pre-Mortgage Savings Account)

In the numerous instances in which potential beneficiaries of Crédito MIVIVIENDA may be able to afford the loan but do not have any proof of regular income in the form of a pay slips, contracts or even monthly invoices (given the low levels of bancarization), they may resort to *Ahorro Hipotecario Previo*. This mechanism allows individuals without proof of formal income to qualify for loans by making regular deposits in a savings accounts for a fixed period of time. With an initial down payment of 30% of the property value, in order to qualify for a Crédito MIVIVIENDA the potential beneficiary must previously deposit in a savings account every month, for a minimum of three months, an amount equivalent to the mortgage's monthly instalment, as well as the amount of the down payment. With a down payment of anywhere between 20 to 29% of the property value, the potential beneficiary must make the monthly deposit of an amount equivalent to the mortgage payment for a period of six months.

Programa Quinto Suyo (The Fifth Region Program)⁹ and Savings from Remittances

A growing trend in recent years given the large number of Peruvians living abroad and sending money back home to their relatives has been the promotion of savings from remittances and their use in home purchases through the *Quinto Suyo* Program. Thanks to agreements signed with foreign financial intermediaries, several Peruvian commercial banks¹⁰ currently offer Peruvian migrants in a growing number of countries (currently, US, Spain, Italy and Japan, but soon also Chile) advantageous conditions on remittances that are directed towards financing Créditos MIVIVIENDA for relatives back home. The Fondo Mivivienda and the Ministry of Housing are participating in these efforts, appearing in numerous conferences and fairs abroad, along with representatives from participating commercial banks, to promote this savings mechanism which, based on the same principle as *Ahorro Hipotecario Previo*, offers migrants the possibility of purchasing a home for relatives in Peru that do not have access to mortgage lending. The next step, given the market potential and most migrants desire to return to their home country in the future, is to modify MIVIVIENDA regulation and allow Peruvians abroad to become the direct beneficiaries of the program, but a number of issues are still to be resolved in this regard.

⁹ *Suyo* is quechua for region or province. The name of the Program, the Fifth Region, refers to the four regions into which the Inca Empire was divided and which made up the *Tahuantinsuyo* (Four United Regions). The large part of the Peruvian population abroad is considered to conform this fifth region and the program has evolved over the years into an important channel of communication and a link between Peruvian communities in foreign countries.

¹⁰ To date, Interbank and Banco del Crédito de Perú participate in this Program, although interest from other commercial banks is growing. Regarding remittances, the Postal Services of Peru (SERPOST) also offer advantageous conditions on remittances sent back home by Peruvians abroad, although without specifying any use to the funds.

Creating incentives to prompt payment and undercutting adverse selection

In spite of advantageous long-term financing provided, credit risk insurance and targeted savings mechanisms, households outside the formal sector and without a long credit history in a developing country like Peru continue to be a relatively high risk which is reflected in high interest rates being offered by banks, who, in the absence of adequate credit information infrastructure, cannot discriminate a priori between good and bad payers. One way to get around this problem has been, the introduction of the *Premio al Buen Pagador* (Premium for Good Payment), commonly referred to as PBP.

In this scheme the loan is divided into two segments: *Tramo no concesional* (Segment “without prize”) and *Tramo concesional* (Segment “with a prize”). The first segment, which accounts for 80% of the loan, has a monthly quota calculated in the same manner as any other mortgage loan. Payments for the second segment (20% of the loan) however, are calculated biyearly. If the borrower pays all six monthly payment corresponding to the first segment on time, s/he will not have to make the payment on the second segment corresponding to that half a year. If however the borrower is late for any one of those six payments, s/he will have to add the payment on the second segment the following month. Effectively a borrower that pays all payments on time will see the interest rate on the loan reduced by 20%.

In this manner, PBP can be used as a posteriori method to allow risk segmentation among medium and low-income households. PBP is also good news to financial institutions, since it provides beneficiaries with significant incentives to timely payment. Further, this premium for good payment has also played quite a positive role in helping overcome the initial weariness with which many Peruvians first look at the banking sector and has proven to be an effective marketing tool.

2.8 CRÉDITOS MIVIVIENDA PROGRAM

Despite the huge need for housing finance in Peru at the time of FMV’s creation, the *Créditos MIVIVIENDA* program did not meet with immediate success. In the first two years, only 548 loans were granted for a total value of little more than 10 million soles. And it was not until 2002—when conditions to apply for loans were relaxed and new characteristics such as *Premio Buen Pagador* (Premium for Good Payment) were introduced—that the *Créditos MIVIVIENDA* program actually took off.

Conditions offered on *Créditos MIVIVIENDA*

Requirements for beneficiaries

The beneficiaries of a *Crédito MIVIVIENDA* must be Peruvian, of age and with residence in the country. Neither them nor their spouses or younger children may be the owners of a home and they cannot have been past beneficiaries of any other State housing program (such as those managed by FONAVI, Enace or Banco de Materiales). Before 2002, beneficiaries had to be contributors to FONAVI but this restriction, along with a series of other conditions, was removed. In terms of income, the beneficiaries must be able to make a down payment of 10% of the final value of the dwelling and they must also qualify for credit at the institution giving them the loan.

Types of purchases financed

Créditos MIVIVIENDA finance (i) first-time purchases of dwellings that are finished or at any stage of construction and (ii) construction of a dwelling on property owned by the beneficiary. These credits do not finance the purchase of land or independent parking spaces exclusively. Further, in order to receive FMV financing, the dwelling must meet two conditions. The value of the dwelling may not exceed

35 UITs¹¹ (approximately 32,000 USD), while the total value of the dwelling may not exceed 50 UITs (approximately 45,700 USD).

Additional characteristics: PBP, CRC and Bien Futuro

In addition to the specific requirements beneficiaries and purchased properties must meet in order to qualify for a loan, Créditos MIVIVIENDA differ from conventional loans in their offer of PBP (Premium for Good Payment) and CRC (Credit Risk Insurance). Another characteristic of these loans is they finance *bien futuro* (future house). MIVIVIENDA offers a 12 month grace period on payment for homes that are planned or under construction. This means that, for example, the beneficiary

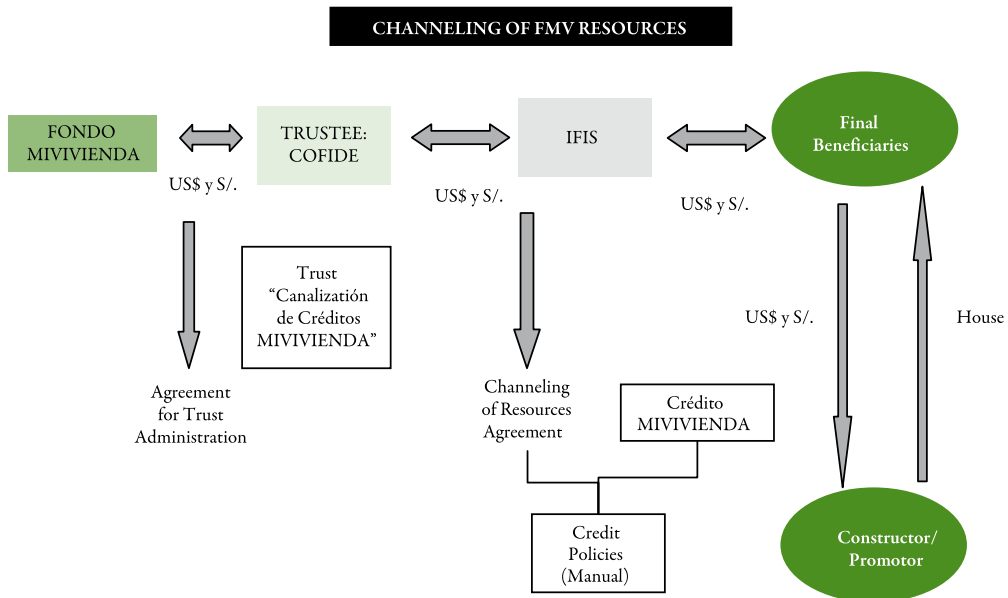
of the loan can mortgage his/her apartment 12 months prior to its completion in order to pay the constructor

Procedural and Operational Aspects

Peru’s *Corporación Financiera de Desarrollo*, COFIDE (Development Finance Corporation), acts as the financial agent, placing the program’s funds with qualified financial intermediaries (IFIs) and is in charge of collecting payments from them.

The IFIs are eligible to receive FMV resources under certain conditions:

- They must be under supervision of the SBS, either directly or indirectly
- They must not be under surveillance of



¹¹ UIT (*Unidad Impositiva Tributaria*) Peruvian Tax Unit used as a reference in fiscal regulation to maintain taxable amounts, deductions etc in constant terms. Currently equivalent to S/3,200.

Conditions on Financing for Financial Intermediaries (IFIs)

- Loans in foreign (USD) or local (S/.) currency
- Interest rate: 7.75% in USD
6.25% + VAC in soles
- Maximum term 20 years (if loan for > or = to 10 years, offer PBP)
- Loan to beneficiary must cover up to 90% of total value of the dwelling (maximum 35 UIT)
- Initial minimum quota payment of 10% of loan to beneficiary
- 12-month grace period for dwellings under construction
- COFIDE Fee: 0.25% flat at payout
0.25% of balance monthly

the SBS nor be subject to any sanctions or process of financial restructuring required by SBS or any other legally recognized supervisory authority

- They must not have any litigious disputes or legal actions pending regarding FMV
- Any other conditions deemed necessary by the FMV Board of Directors

The channelling of resources from Fondo MIVIVIENDA to the final beneficiary works in the following way:

The conditions offered to financial intermediaries on financing are as follows:

2.9 EXTRAORDINARY GROWTH IN RECENT YEARS

The impressive growth experienced by Créditos MIVIVIENDA over the past three years has made up for its slow initial start. In 2002 only 5,500 households were beneficiaries of a Crédito MIVIVIENDA, while at the end of 2005 this number has risen to almost 30,000. The total volume outstanding of MIVIVIENDA loans has also followed this same trend and at end 2005 amounted to approximately 200 million USD, more than six times the 2002 volume.

Although one of MIVIVIENDA's aims was to involve a greater number of players in the mortgage market, commercial banks (de-

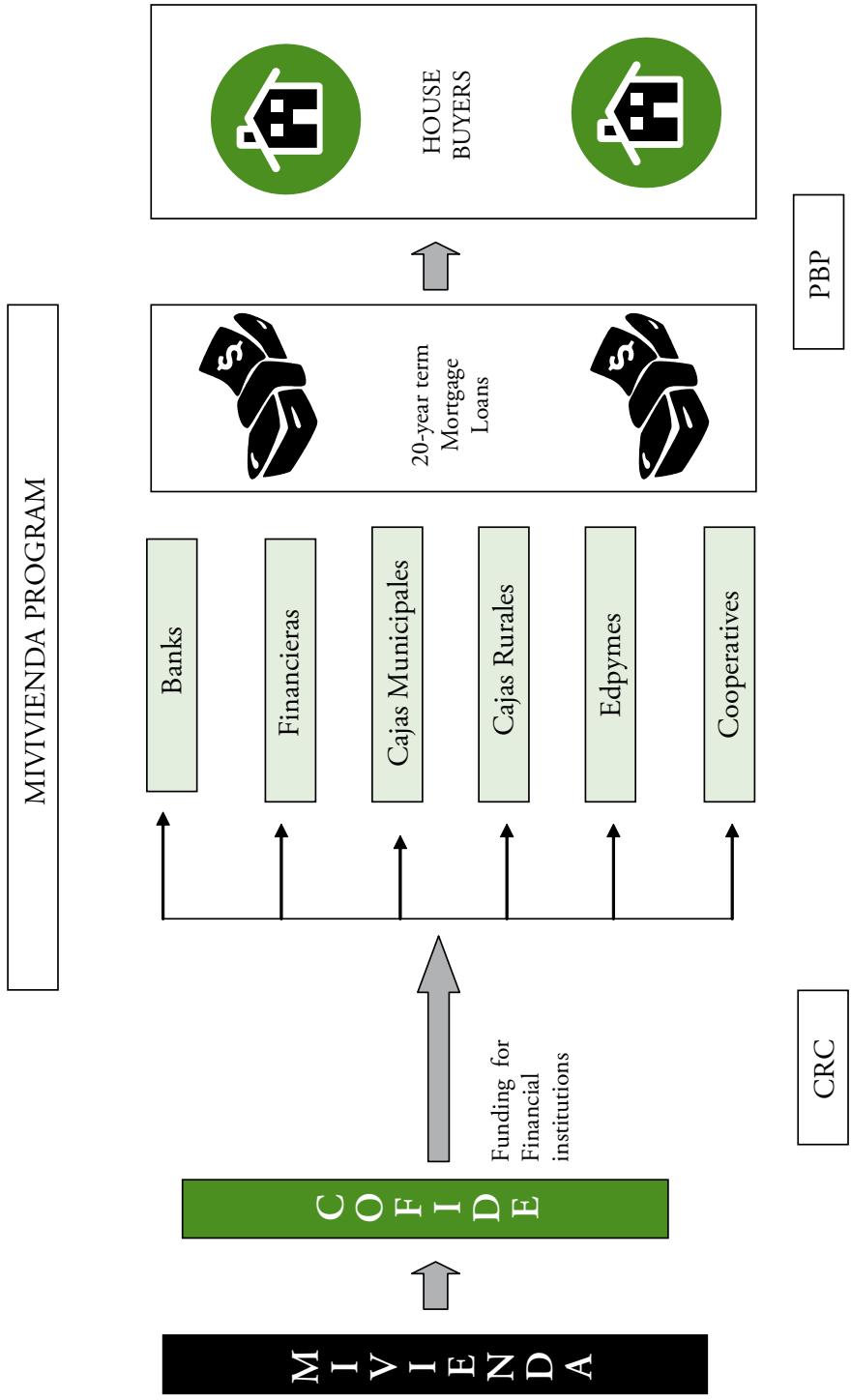
nominated *banca múltiple* in Peru) have been responsible for most of the Program's activity, granting 90% of Créditos MIVIVIENDA. But although their share of the market has been relatively constant, this has not been the case for other entities such as CMAC, CRAC, Edpymes or Financieras. CMAC are quickly becoming the second biggest players in the market, having granted almost 5% of all MIVIVIENDA loans over the past three years, while the CRAC for their part have lost much of their relevance (from a share as high as 14.2% in 2000 to barely 2% in 2005). Edpyme and Financiera's share in the market is less noticeable but their progress has also been steady over the past few years.

Incidentally, there is little difference in MIVIVIENDA players' share of the market in terms of debtors and of volume outstanding, which suggests that MIVIVIENDA loans being granted are fairly homogeneous in terms of volume regardless of the type of lender.

In terms of geographic distribution, there is a strong concentration in the area of the capital. Close to 80% of Créditos MIVIVIENDA have been granted in Lima. Trujillo and Arequipa follow far behind with less than 5% of total loans having been granted there.

2.10 THE SECRETS TO SUCCESS

After the failed experiences of the previous



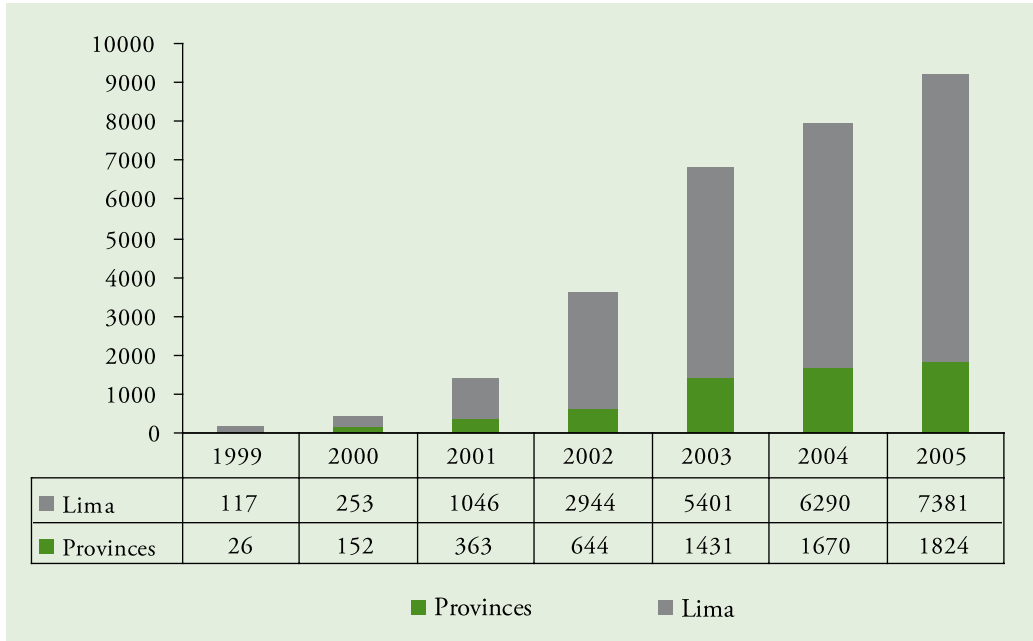
Number of debtors MIVIVIENDA by lender (Cumulative)

	Bancos	CAC	CMAC	CRAC	Edpyme	Financiera	Total			
1999	128	90%	1	0,7%	-	14	9,8%	-	0,0%	143
2000	466	85%	1	0,2%	-	78	14,2%	3	0,5%	548
2001	1.685	86%	1	0,1%	-	210	10,7%	58	3,0%	1.957
2002	4.793	86%	1	0,0%	221	361	6,5%	135	2,4%	5.545
2003	10.825	87%	42	0,3%	642	510	4,1%	229	1,9%	12.377
2004	18.186	89%	59	0,3%	1.007	570	2,8%	334	1,6%	20.337
2005	26.938	91%	88	0,3%	1.288	617	2,1%	405	1,4%	29.542

Volume outstanding MIVIVIENDA by lender (Cumulative)

	Bancos	CAC	CMAC	CRAC	Edpyme	Financiera	Total			
1999	2.403.966	92%	13.000	0,5%	-	200.063	7,6%	-	0,0%	2.617.029
2000	8.819.793	88%	13.000	0,1%	-	1.170.892	11,6%	60.100	0,6%	10.063.785
2001	30.206.976	87%	13.000	0,0%	-	3.512.724	10,1%	1.007.604	2,9%	34.818.504
2002	92.577.473	87%	13.000	0,0%	4.886.517	6.207.328	5,8%	2.321.683	2,2%	106.792.692
2003	210.421.819	87%	682.339	0,3%	14.343.513	8.921.859	3,7%	3.834.035	1,6%	240.830.194
2004	369.420.128	89%	1.058.413	0,3%	23.126.638	10.125.521	2,5%	5.651.354	1,4%	413.116.464
2005	571.994.760	91%	1.853.203	0,3%	30.029.897	11.161.824	1,8%	6.971.191	1,1%	626.416.873

Geographic Distribution of Créditos MIVIVIENDA



two decades, Fondo MIVIVIENDA seems to have found the key to encouraging a successful private-public partnership. The Crédito MIVIVIENDA Program has managed what prior housing finance models failed to do in the 1980s and 1990s, align the interests of all agents involved and ensure private financial sector development while still improving the low and medium income population’s access to housing.

Advantages to Participating Financial Institutions

FMV’s greatest challenge in designing the Program was inducing financial institutions to overcome their initial cautiousness and offer loans to medium and lower income groups that were not being serviced by the financial sector. The advantages Créditos MIVIVIENDA offered to these institutions included:

- Possibility of matching assets (loans) and

- liabilities (funding) in terms of currency and maturity
- Obtaining financing at fixed interest rate
- Provides incentives for debtors to pay on time through the Premio al Buen Pagador, PBP (Premium for Good Payment)
- Offers Cobertura de Riesgo Crediticio, CRC (Credit Risk Insurance)
- Freedom to determine financial margin, since IFIs set the active interest rate on the loan

The advantages associated to mortgage lending and expanding clientele, as well as the low delinquency rates being registered for Crédito MIVIVIENDA loans in the first few years did the rest in terms of stimulating further participation of financial institutions in the program.

Advantages to Beneficiaries

Once participation from IFIs was guaranteed, the high demand for Créditos MIVIVI-

ENDA was only to be expected, given that the program caters exclusively to a sector of the population in grave need of housing finance but otherwise unable to obtain a mortgage loan from commercial banks. *Créditos MIVIVIENDA* offer, nevertheless, attractive advantages to beneficiaries and creates incentives to encourage prompt payment

On the one hand, *Créditos MIVIVIENDA* offers the *PBP or Premium for Good Payment*. On the other, *Créditos MIVIVIENDA* also offers *Bien Futuro*, which allows for a 12 month grace period in the cases of homes that are planned or under construction.

Advantages to Construction Companies

Thanks to *Bien Futuro*, the constructor may sell housing units before completion and is thus able to finance the construction project without having to use its own funds (equity) or ask for loans at present higher rates.

Outreach and Marketing Campaign

In spite of the many advantages offered by *Créditos MIVIVIENDA* to all agents involved, the importance of the well coordinated marketing campaign, customer service efficiency and the extensive network of *MIVIVIENDA* offices across the country¹² must not be underestimated in gauging the program’s success, particularly in light of the section of the population *MIVIVIENDA* caters to.

Indeed, many of *MIVIVIENDA*’s current beneficiaries had had no prior contact with financial institutions before approaching them for a housing loan. As a result of the crises experienced in the past two decades and the general distrust in the financial markets, many preconceptions and prejudices had to be overcome in order to encourage these clients to approach the banks, ask for information and apply for credit.

¹² In mid-2006, Fondo Mivivienda has three offices in Lima and another 7 in the cities of Arequipa, Chiclayo (Lambayeque), Cuzco, Iquitos (Loreto), Huancayo, Piura and Trujillo (La Libertad).

FMV Offices across Peru



Further, the general perception of “expensive” loans and informal income not counting, led to many individuals self-excluding themselves from the mortgage market.

The *Gerencia de Promoción* has orchestrated a campaign promoting *MIVIVIENDA* in publishing and broadcast media, through the web, financial institutions and construction projects, presence in fairs and related events, both locally and abroad, etc. The extensive network of representative offices throughout Peru has further contributed to making *MIVIVIENDA* a well recognized and prestigious trademark among the Peruvian population.

2.11 CREDITO MIVIVIENDA’S MAIN ACHIEVEMENTS

Although it made a slow start, the *Créditos MIVIVIENDA* program has proved to be an absolute success in Peru during the past few years. Among its main achievements are many

of those tasks it originally set out to accomplish: facilitating access to housing to moderate and low-income groups that were not been serviced by the private sector, promoting the development of the primary mortgage market and construction of affordable housing, etc.

In meeting with these objectives, FMV has also reaped benefits that are not exclusive to the field of housing, or even finance, but which have reached the country as a whole. Indeed, among the program’s many benefits—to name only a few—are the entrance into the mortgage market of key players such as *Caja Municipales (CMAC)* or *Empresas Financieras* and the resulting increase in competition and innovation, the thousands of Peruvians with informal earnings that have been brought into the financial system and the increased bancarization, the upsurge in construction activity that is spurring economic growth, the development of the capital markets, etc.

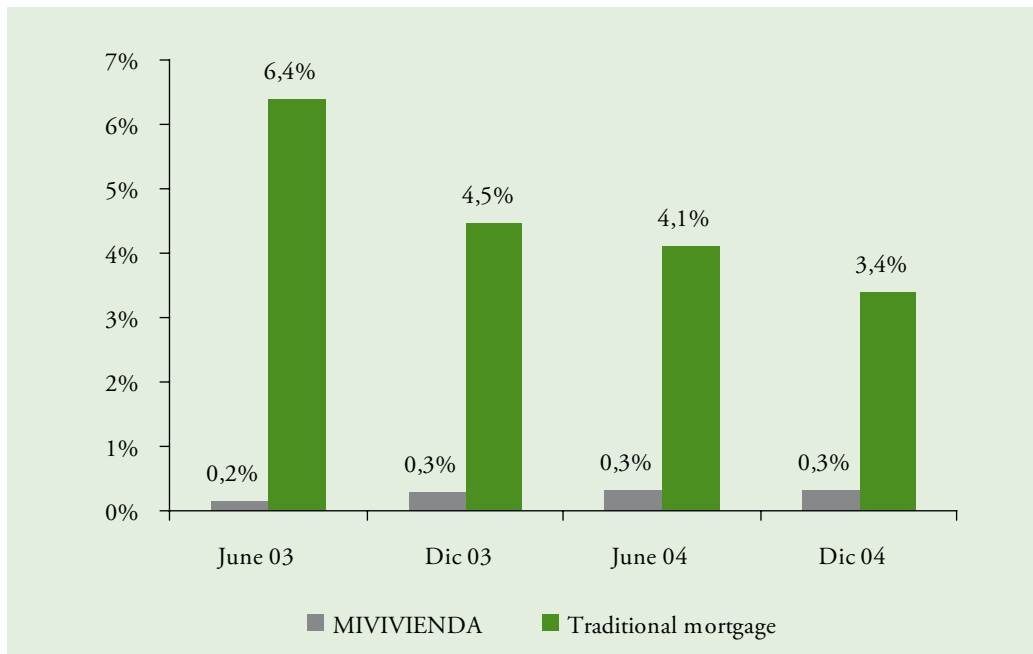
Improved access to housing

Créditos MIVIVIENDA have come to the rescue of a significant percentage of the population in dire need of housing but which is unable to obtain conventional mortgage loans. Although the 29,562 households that had benefited from Créditos MIVIVIENDA as at end December 2005 represent only a very small percentage of the close to 2 million households in need of a home or housing upgrade, it is a very important step in the right direction.

Development of the primary mortgage market (and the financial system)

Indeed, the number of MIVIVIENDA loans has been growing at impressive rates over the past two years, with more yet to come. And all this has been achieved by private commercial banks, without the need to resort to State-owned banks as was done in the 1980s and thus with a greater guarantee of sustainability. Since

Non Performing Loans in the Mortgage Market



2002, the mortgage market has expanded at 15% yearly (and 75% of this total growth can be traced to Créditos MIVIVIENDA).

Further, by providing long-term financing and credit risk insurance, FMV has not only encouraged larger banks to downscale but has also brought key new players into the profitable business of mortgage lending. In 2002, CMAC, CRAC, Empresas Financieras and Edpymes were barely present in the mortgage market. In 2005, they jointly account for to 4% of the market, and their share is growing. The entrance of new players has resulted in increasing competition, which is not only providing institutions incentives to cut back costs and improve efficiency, but is also driving down interest rates.

Crédito MIVIVIENDA has also proved to be valuable influence in terms of promoting innovation in the mortgage market. One of the Peruvian commercial banks is already offering a premium for good payment product that works in much the same way as FMV's PBP¹³.

The excellent results in terms of performance of Créditos MIVIVIENDA in addition to the other numerous advantages (cross-selling banking products, building and improving relations with clients, etc), is also encouraging further growth of financial institutions in the mortgage market. Créditos MIVIVIENDA have registered very low default and NPLs.

Financial sector development and bancarization of the economy

Crédito MIVIVIENDA has provided the necessary mechanisms to compel Peruvians with an informal income to approach financial institutions, thereby encouraging the population into the banking system. This new situation provides innumerable benefits. To list only a few: deepening of the financial sector, building of credit history for people traditionally outside the banking system, formalization of the economy, etc.

¹³ Pago 11 by Interbank

Spurring construction activity

After registering negative growth for three consecutive years (1999-2001) the construction sector finally resumed activity in 2002 and has maintained high growth rates for the past three years. Although private infrastructure projects such as Camisea and the Central Hidroeléctrica de Yucán have contributed to this growth, much of it can also be traced to the upsurge in the mortgage market in recent years.

Economic growth, improved general well being and reduced poverty

Construction accounts for much of Peru's economic growth and is a powerful engine for further development. The acceleration in this sector's activity, spurred by programs such as Techo Propio and Crédito Mivivienda, has led to better prospects for the economy.

Further, Fondo Mivivienda's success extends far beyond the scope of housing finance and demonstrates the relevance of this issue for a country's economic soundness, development and well-being. Indeed, not only is construction activity an engine for growth but housing ownership has other desirable effects such as reduced poverty and improved civic behaviour (Erbas and Nothhaft 2002), to say nothing of FMV's vital contribution to the development of the financial system and the capital market, with the presence in the market of a large investor that manages resources of close to 500 million USD.

Chapter 3 - The Role of Direct Subsidies and Other Initiatives for Low Income Households

Fondo Mivivienda's program of Créditos MIVIVIENDA has been extremely successful in facilitating a large number of households' access to housing, fostering the development of the private housing finance market and bolstering affordable construction activity. However, given current income levels, interest rate-subsidized loans still leave a large share of the Peruvian population out of the market. Additional housing finance mechanisms have therefore been necessary to improve the lowest income groups' access to adequate housing.

Building on past experiences in other Latin American countries, which have shown conclusive evidence that direct housing subsidies are the most successful method through which to create effective housing demand among lower income groups¹⁴, the State established three programs in Peru meeting these characteristics. In 2002 and under the auspices of the Interamerican Development Bank, the Government launched: *Techo Propio*, managed by Fondo Mivivienda, while three additional programs, *Programa Vivienda Básica*, *Programa Vivienda Progresiva* and *Programa Vivienda Nueva* were placed under the responsibility of Banco de Materiales. Unfortunately, these programs have not met with the success of Créditos Mivivienda, and important changes have been announced in recent months. Expectations are high in particular for the revamped *Techo Propio* program, operative since summer of 2006.

To further address the needs of the lowest income households who are not serviced by Créditos Mivivienda and given the relevance of the qualitative housing deficit, it is also worth noting that the Peruvian State has directed substantial

efforts towards improving low-quality and deteriorated urban environments through a number of complementary programs managed by the Ministerio de Vivienda such as *MiBarrio*, *La Calle de MiBarrio*, *La Canchita de MiBarrio*, etc.

3.1 TECHO PROPIO

The *Techo Propio* program was launched in 2002 by the Ministerio de Vivienda with a loan from the Interamerican Development Bank¹⁵ and placed under the administration of FMV. The *Bono Familiar Habitacional*, *BFH* (Housing Family Bond)¹⁶ is a direct subsidy granted to households with an income below 1,000 soles (approximately 312 USD) to finance 1) the purchase of a home, 2) construction on own land or 3) home improvement.

The terms, conditions and requirements on the bond each household receives vary in accordance to the use that will be given to the funds, as well as the value of the dwelling, as presented in the attached table. Since the Bond is a direct subsidy, its value is highest for housing with the lowest price.

Type 2 and Type 3 bonds are still in an experimental phase and little data on them is available. At end December 2005, the track record of bonds to finance the purchase of new construction—for thirteen calls for applications that have taken place in the period between September 2002 and August 2005—is as follows:

The biggest obstacle faced by *Techo Propio* in recent years has been the limited supply. Large construction companies are not inter-

¹⁵ Through Resolución Ministerial N°054-2002-VIVIENDA.

¹⁶ Law N°27829, later modified by Law N°28210, and approved by Supreme Decree N°014-2005-VIVIENDA.

¹⁴ Abundant literature on the subject backs this conclusion.

Techo Propio Program and Housing Family Bond

Value of dwelling	Value of BFH	Minimum Savings
TYPE 1: PURCHASE OF NEW CONSTRUCTION		
8,001-12,000 USD	1,800 USD	10% of value of dwelling
4,000-8,000 USD	3,600 USD	10% of value of dwelling
Less than 4,000 USD	May not exceed 90% of value of dwelling	10% of value of dwelling
TYPE 2: CONSTRUCTION ON OWN LAND		
8,001-12,000 USD	1,400 USD	5% of value of dwelling
Maximum of 8,000 USD	2,800 USD	5% of value of dwelling
TYPE 3: HOME IMPROVEMENT		
Maximum of 8,000 USD	1,200 USD	10% of cost budgeted

ested in participating in Techo Propio given the low cost of the homes being financed (less than 12,000 USD) and prefer to focus on other more lucrative businesses. The small and medium firms that are interested in moving into this sector, however, often do not have enough capacity to undertake the projects. This leads to a situation where beneficiaries apply and are granted a bond to purchase a home but given the important delays and problems in the construction, many are still waiting.

In light of these unsatisfactory results, the program's weaknesses have been reviewed in-depth and important changes have been made. The creation of a new specialized trust (*Fideicomiso Techo Propio*), administered by a private bank, is expected to remove key obstacles and bolster Techo Propio in coming months.

3.2 PROGRAMA VIVIENDA BÁSICA, PROGRESIVA Y NUEVA

BANMAT manages three programs that are focused on improving access to housing for the lowest income groups in Peru. The first, Vivienda Básica, is directed towards housing associations and cooperatives, while Vivienda Progresiva is directed to individuals who would like to improve or upgrade their homes and Vivienda Nueva is focused on households who own a piece of land but require funds to initiate construction.

The requirements to become a beneficiary for each of these programs differ slightly in accordance to the modality, as do the terms and conditions.

The most complex in terms of operational procedures is Vivienda Básica, where a promot-

	Individual Application	Collective Application
Bond being processed	4,279	0
Bond approved but not paid out	8,755	797
Bond paid out	3,942	497
Receipt Act	1,798	0

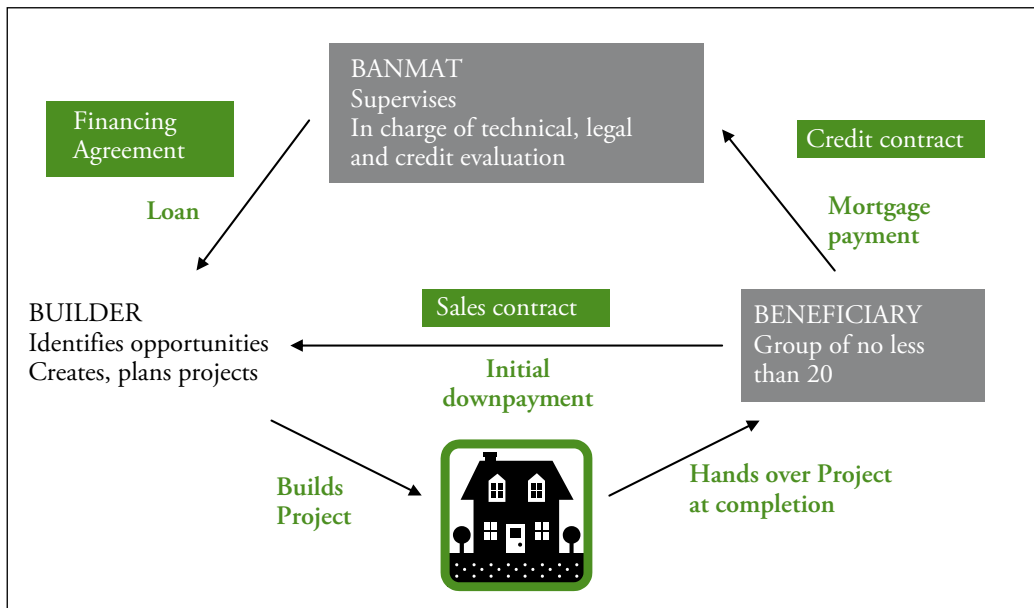
er-builder is responsible for the construction of the project and beneficiaries must be grouped in an associations of no less than 20 (e.g. a group of teachers, post office staff, etc.). The beneficiaries must be under 60 and be able to prove ownership of a piece of land by one of the individuals or by the association. The Vivienda Básica program fund up to 90% of the project, to a maximum of 14,000 USD. Loans are granted with a maturity of 20 years, without any prepayment penalties, and the annual interest rate charged is approximately 9%. The monthly payment to income ratio must be below 3 and beneficiaries must have saved the initial 10% quota.

The guarantees on the loan for BANMAT in the case of Vivienda Básica are twofold. On the one hand, the beneficiaries mortgage the property. On the other, the builder offers a letter of guarantee.

During construction, the role of BANMAT is to grant funding and supervise. Once the builder has completed construction and beneficiaries have received their homes, the only relationship that remains is that of BANMAT-beneficiary, as is the case in Vivienda Progresiva and Vivienda Nueva.

3.3 OTHER INITIATIVES

In recent years, the Ministerio de Vivienda, Construcción y Saneamiento in Peru has launched a number of programs which do not offer direct financing of home purchase, construction, or improvement for individuals—and can therefore not be considered housing finance mechanisms as such—but which contribute nonetheless to the enhancement of housing and living conditions of lower income groups in the country and thus play an important role in the reduction of the existing housing deficit.



Programs to improve low-income population's housing and living conditions

MiBarrio	The program of Mejoramiento Integral de Barrios (Complete Improvement of Neighborhoods) is dedicated to improving the housing and living conditions of the population of low-income urban neighborhoods. The success of the program requires the joint efforts of the beneficiary community, the municipality requesting the project, Banco de Materiales and the Ministry.
La Calle de Mi Barrio	La Calle de Mi Barrio is a pilot program funding projects in selected low-income areas that include key improvements such as the pavement of streets, construction of roads, planting of vegetation and painting of façades.
La Canchita de Mi Barrio	La Canchita de Mi Barrio Program finances the construction of sport facilities in low-income neighborhoods, with the objective of promoting sports and recreational activities within the community. This program is a joint initiative of Ministerio de Vivienda, Construcción y Saneamiento, el Patronato Nacional de Deporte and Banco de Materiales.
MiAgua	The MiAgua project is dedicated to the construction and improvement of already existing water and sanitation systems in selected areas. In addition to ensuring the population's access to drinking water and sewage systems, the program also covers the capacity strengthening of authorities responsible for administrating, operating and maintaining these systems and offers support in the design of adequate institutional structures and mechanisms to guarantee their operations. One of the Program's key components is also dissemination among the community of adequate and sustainable use of water and sanitation, adoption of hygiene health practices, etc.

Chapter 4 - The Residential Mortgage Market Today: Segments and Constraints

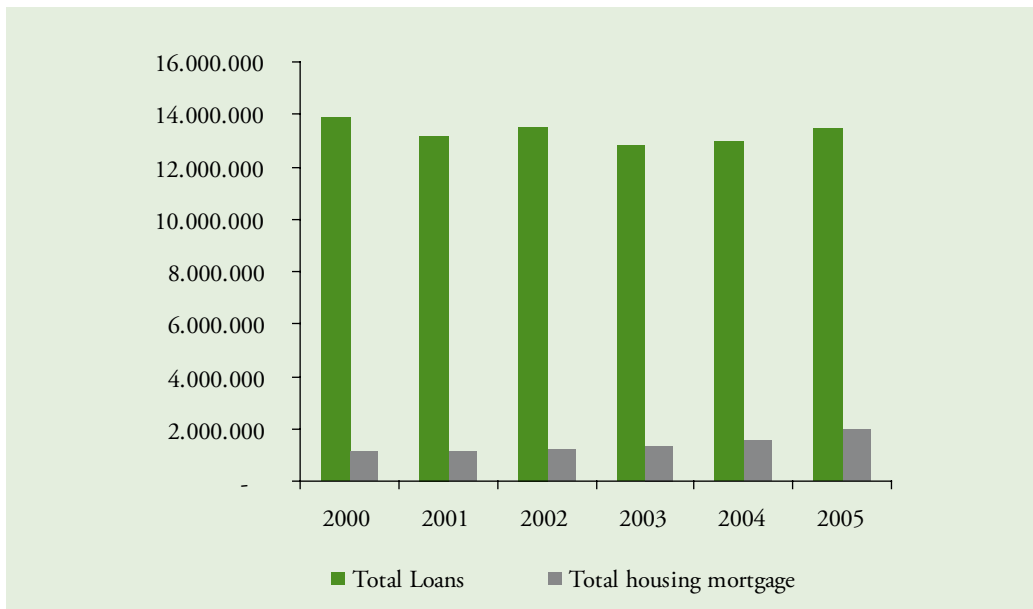
4.1 CHARACTERIZATION OF THE PERUVIAN MORTGAGE MARKET: EVOLUTION, MAIN PLAYERS AND SEGMENTS

The housing finance market in Peru at end-December 2005 amounted to 6.7 billion Nuevos Soles (over 2 billion USD), almost doubling its size from 2001 and averaging an annual growth rate of 15% over that period, an expansion that is particularly remarkable when taking into account the stagnation of the overall credit portfolio. This growth of the Peruvian mortgage market was spurred by a combination of factors: the accompanying—and uninterrupted—rise in GDP per capita in Peru, the increased competition in the banking sector, which, in a scenario of improving macroeconomic funda-

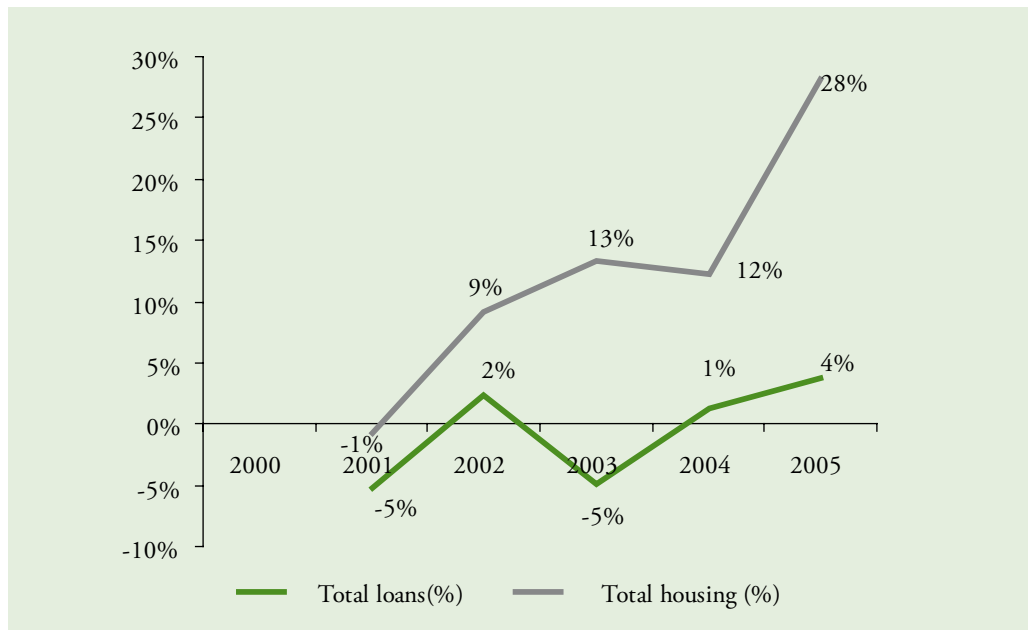
mentals and financial stability, has allowed the banking sector to offer much improved conditions and terms and, finally, the takeoff of the very successful government sponsored housing program, Créditos MIVIVIENDA.

One of the factors contributing to the growth in housing finance in Peru in recent years has undoubtedly been the rise in GDP per capita levels, from 2,036 USD in 2001 to 2,806 USD in 2005, which has increased the number of households that can afford a mortgage loan and, thereby, the effective market demand. Another has been the increasing competition among banks and the favourable macroeconomic scenario, with a reduction of the base rate by the Central Bank. This reduction has led to a continued decrease in the interest rates charged on mortgage loans, in particular in the

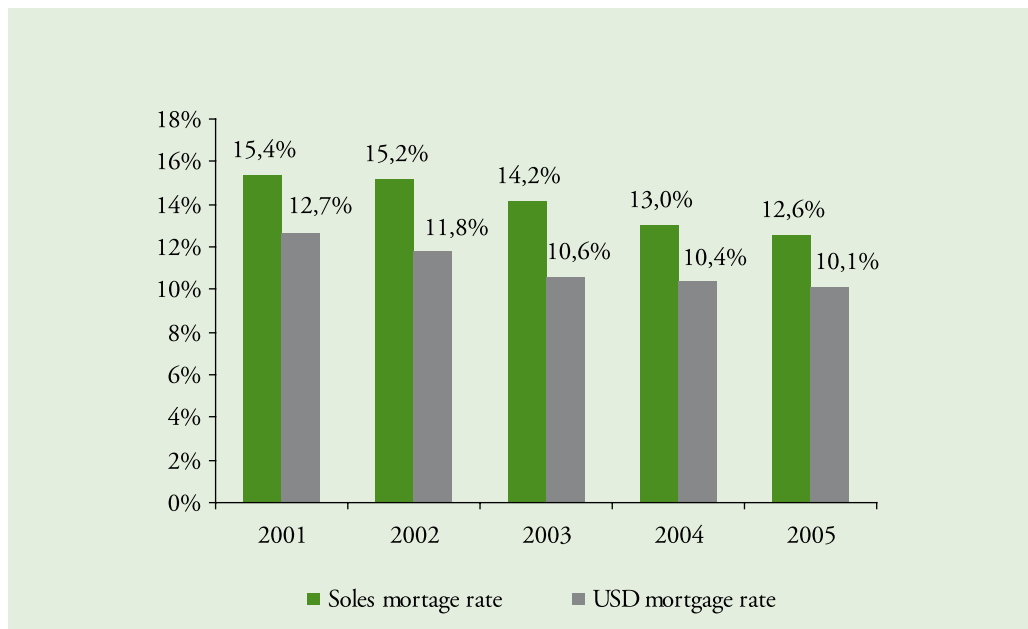
Total Loans and Mortgage Portfolio (Volume in USD Thousands)



Total Loans and Mortgages (annual growth rate in %)



Interest rates in Soles and USD mortgage loans



case of soles-denominated mortgage loans, although these currently represent only 4% of the total mortgage portfolio.

The crucial contribution to mortgage market expansion in Peru at present, however, has come from the success of Créditos MIVIVIENDA, which has stimulated banks' expansion into the mortgage business through innovative instruments, as well as ensuring the existence of effective demand for mortgage loans and thereby guaranteeing the sustained expansion of the market (versus what happened in earlier episodes in the nineties). Effectively, the program has also divided the Peruvian mortgage market into two complementary but very different submarkets: conventional mortgages and MIVIVIENDA loans.

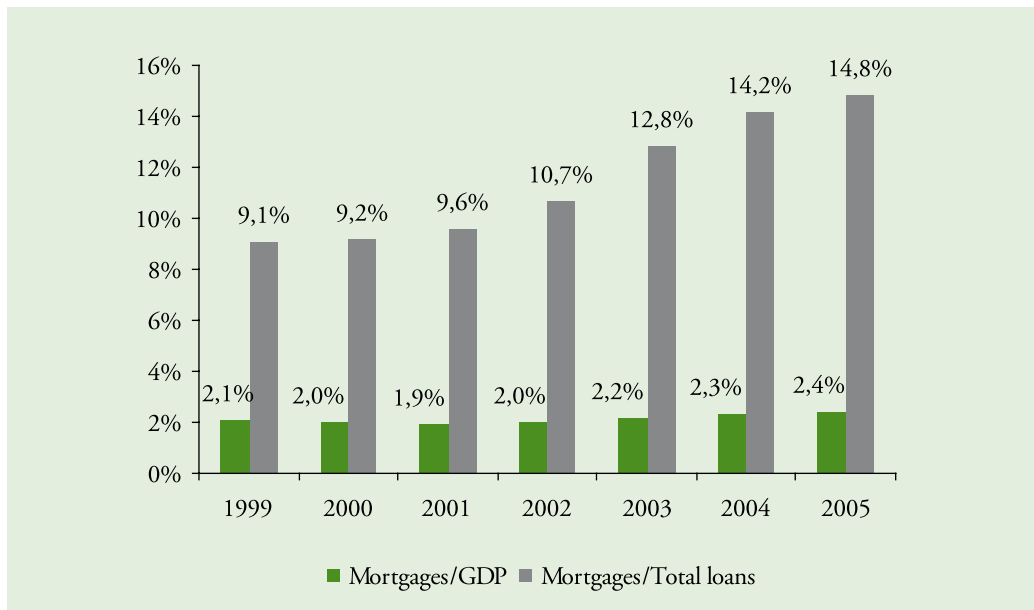
Market Segmentation

The traditional mortgage market at present is still significantly larger than the MIVIVIENDA market, both in terms of volume out-

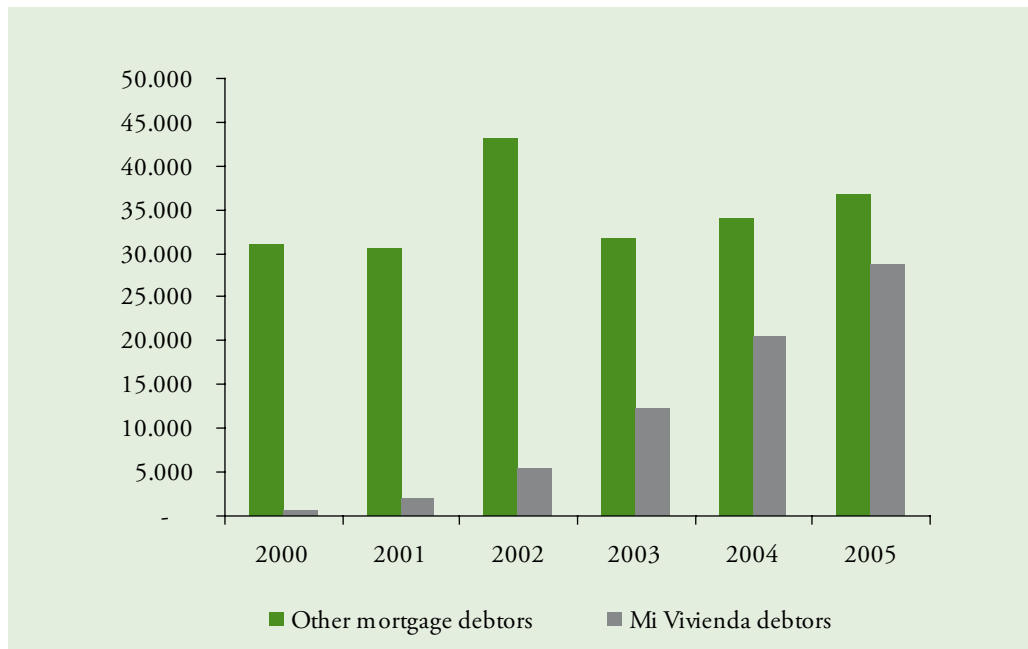
standing and number of household debtors, although the distance is quickly being reduced, with MIVIVIENDA at the source of 75% of the growth experienced by the overall mortgage market in Peru in recent years.

Indeed, the Peruvian mortgage market has expanded at the pace of the MIVIVIENDA program. In 2000, MIVIVIENDA credits represented barely 1% of the total mortgage portfolio, amounting to 11 million USD of a total portfolio of less than 1 billion USD. In 2005, this Program's share had risen to 32%, accounting for 626 million USD in a market that has doubled in size in the past few years and is still on the rise. With regard to the number of debtors instead of volume outstanding, MIVIVIENDA's relevance is even greater. In 2000, the number of Credito MIVIVIENDA beneficiaries amounted to barely 600. By end 2005, 28,781 households were beneficiaries of a Crédito MIVIVIENDA, a number that accounts for 44% of total households with a mortgage loan (of a total of 65,400). In the period spanning from

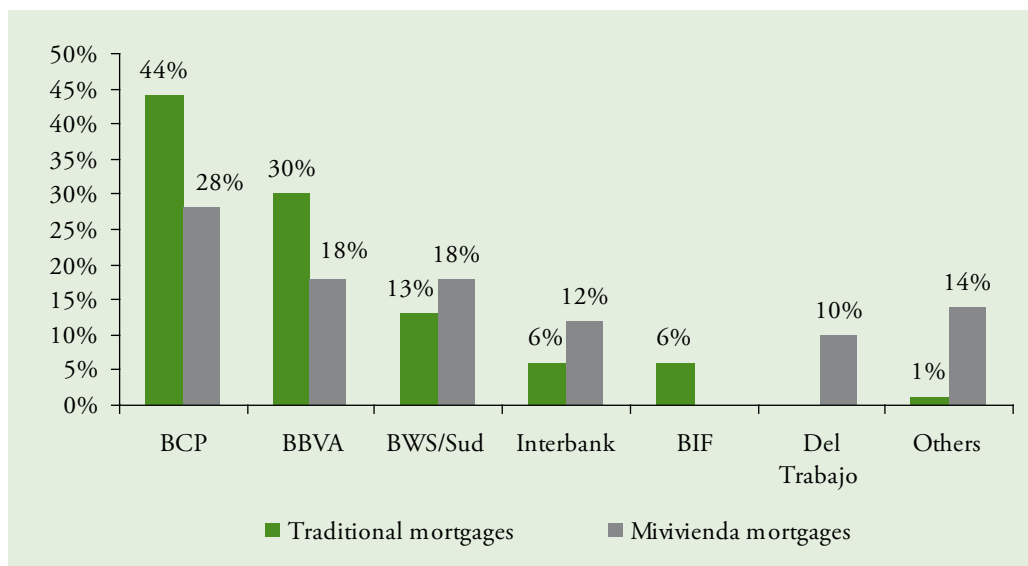
Evolution of Credito MIVIVIENDA and share over total mortgages



Mortgage debtors (MIVIVIENDA vs. Conventional market, in units)



Main players in Peruvian mortgage market (market share)



Terms	Current Conditions
Rate	TM: Adjustable rate (banks discretion) MIV: Fixed rate
Currency	Mostly in USD Some in soles VAC (adjusted by inflation)
Maturity	TM: Up to 25 years MIV: Up to 20 years
Minimum requirement	Maximum LTV: MIV: 90% TM: 80% Minimum income: MIV: USD 400 TM: USD 800 Maximum PTI: 30%
Other	Incentive for good payers Restricted lending for constructors

TM: Traditional mortgage
MIV: Credito MIVIVIENDA

2002 to 2005, 68% of volume outstanding and 72% of new debtors may be traced to MIVIVIENDA.

With a 96% total market share, commercial banks (“Banca Múltiple”) unquestionably dominate the Peruvian mortgage market as a whole, although some differences arise between submarkets. In the case of traditional mortgages, the commercial bank predominance is even greater, with practically a 100% share. In the case of MIVIVIENDA, however, CMAC, Cajas Rurales and Edpymes represent a growing, although still very small, share of the market portfolio (60 million USD).

With regard to terms and conditions on loans, as is to be expected, there is still signifi-

cant differentiation between traditional mortgages and Créditos MIVIVIENDA. Both must still be improved however in order to meet international standards applied in OECD countries.

Based on all the above, it is not surprising that the marked segmentation of the mortgage market in Peru is very visible in terms of the customer profile.

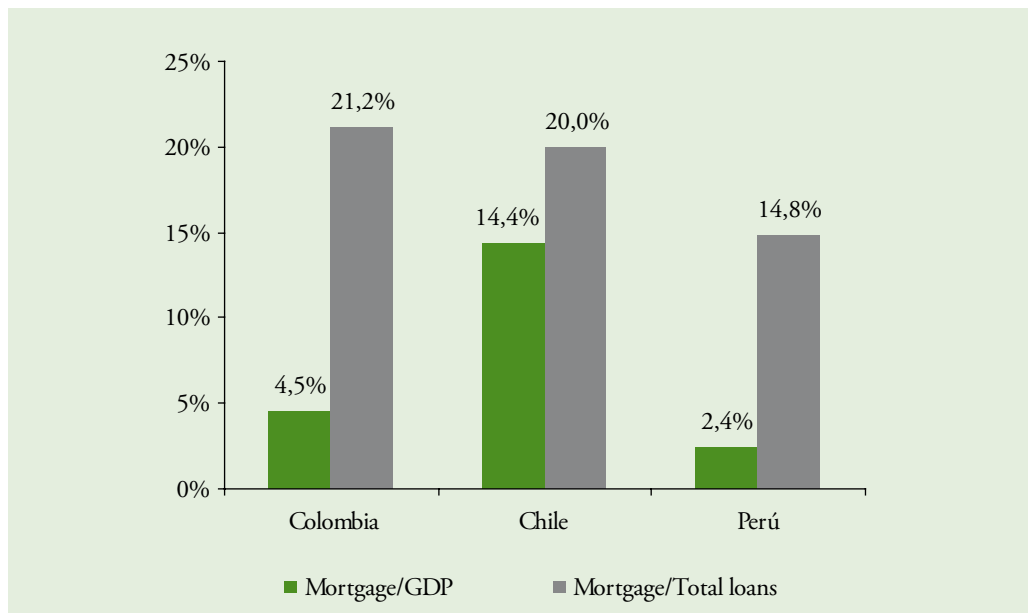
Potential for Growth

It must be noted, however, that despite its spectacular expansion during the past few years, given its low initial levels, the Peruvian mortgage market is still very small, compared

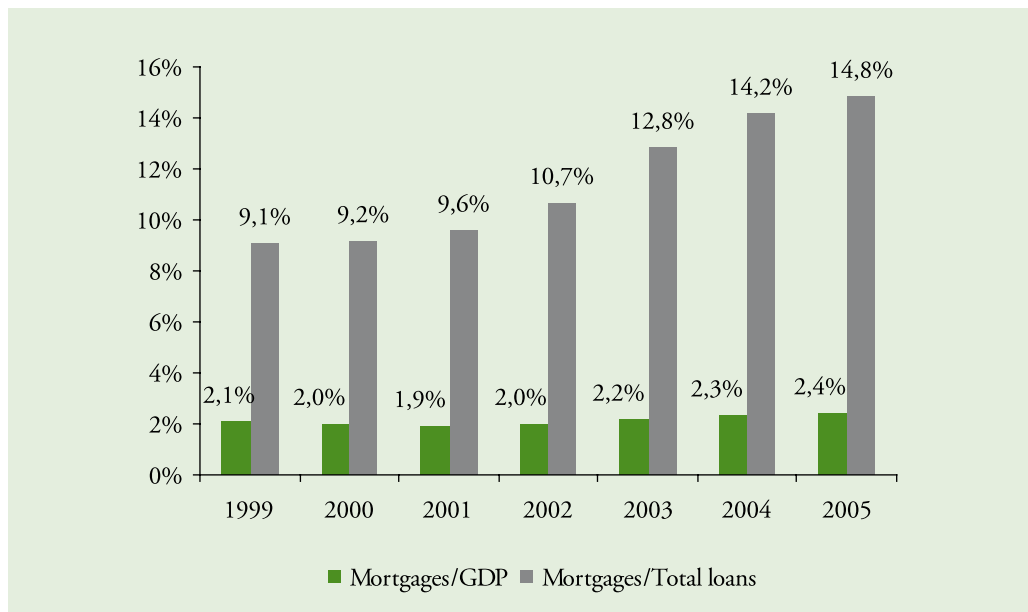
Customer Profile: Conventional vs. MIVIVIENDA

	Traditional mortgage	MIVIVIENDA
Loan amount	45,000	20,500
Value of the property	90,000	26,500
Maturity	12	15
Customer age	45	41
Average HH income (USD)	1,300	1,000

Mortgages and Total Loans relative to GDP in Latin America



Evolution of Mortgages/GDP and Mortgages/Total loans in Peru



not only to OECD standards but also to other Latin American countries.

One of the factors to take into account is the low level of bancarization of the economy and that fact that lending activity in general is very limited. Although the Peruvian banking sector has experienced significant growth in size and scope during the past four years, current bancarization ratios continue to be well below international, and even regional, levels. Total loans, for instance, currently represent only 15% of GDP in Peru, whereas this percentage exceeds 20% in neighboring countries such as Chile or Colombia and over 100% in EU countries and the US. This limitation is best illustrated by the fact that although mortgages as a percentage of total loans have risen from 9.1% to 14.8% from 1999 to 2005, their size relative to GDP has only increased in 0.3 percentage points over the same period of time.

And even taking this into consideration, the percentage of mortgage loans to total lending continues to be low, 14.8% in Peru versus 21.2% in Colombia, and 20% in Chile. The good news is that the potential for growth of the mortgage market in Peru continues to be huge, a conclusion also backed by the scarce amount of households that have a mortgage loan at present. Only 65,400 households are mortgage debtors, barely more than 1% of total households.

4.2 CONSTRAINTS

For growth in the Peruvian mortgage market to continue, however, a number of obstacles must be dealt with, many of which are already being addressed by current and new State-designed housing finance mechanisms, but a number of which do not pertain exclusively to the area of housing or finance and face difficult solutions in the short-term.

The main issues at hand are the scarce effective demand for mortgage loans, combined with banks' cautiousness in expanding their

mortgage activity and a series of other risks that affect the financial system as a whole, such as the existing currency and maturity mismatch, as well as the limited funding available for the continuation of housing finance programs.

Scarce effective demand for mortgage loans

In spite of the existing quantitative and qualitative housing deficit, effective demand for mortgage loans is still low in relative terms and, as we have seen, in many cases even the subsidized mortgage market is insufficient to improve most Peruvians access to housing. The fundamental reasons that explain the scarce effective demand for mortgage loans in Peru—and in other emerging markets—are three: the population's inability to (i) pay, (ii) show proof of income and (iii) show proof of ownership.

Inability to pay

The slow foreclosure procedures and inadequate market risk management available to many banks results in banks offering very demanding financial terms on mortgage loans. In the current context of low income levels and high housing prices, conventional mortgage loans are thus unaffordable to more than 90% of the Peruvian population. And with 50% of the population living below the poverty level, even subsidized State-supported instruments such as Crédito Mivivienda and Techo Propio cannot reach all of the population.

Informal economy and unemployment

In addition to the high percentage of the population that cannot afford a loan outright, there is also a considerable number that can afford the monthly payments but is unable to show adequate proof of regular income—such as a pay slip or a contract—to the bank in order to obtain it. This is the case, for example, of the estimated 1,670,000 Peruvian (10% of the adult population) that live on remittances received from relatives working abroad in North

America, Europe, Japan and other Latin American countries¹⁷ or those working in the informal economy. Although its size is difficult to determine, the high rates of unemployment suggest that the informal sector—as is the case in many other emerging markets—irregularly employs a significant share of the working population.

The size and scope of the Peruvian informal economy and the low level of bancarization and relation with financial institutions justifies bank's caution in asking for reliable proofs of income before granting loans to new customers (particularly in the absence of adequate credit information sharing mechanisms), but it makes underwriting criteria applied by banks, albeit theoretically meeting international standards, particularly restrictive since the constraint is no longer being able to afford the loan, but rather being able to prove it. Fondo Mivivienda and Ministerios de Vivienda's initiatives such as *Ahorro Previo* and *Programa Quinto Suyo* have so far achieved remarkable progress in this regard and allowed a high percentage of the population access to loans they could previously afford, but were being denied. Efforts must still be made, however, to formalize large sectors of the economy.

Lack of registered property

A large part of the population is cut out of the market as a result of legal issues, namely the lack of ownership titles on built property that is often in dire conditions and could greatly benefit from money invested in improvements. The large number of Peruvians that do not have adequate proof of ownership of the homes they live in is largely a result of migration movements during the past fifty years. Since 1960, Lima's

¹⁷ Although this percentage is lower than in other countries in the region (38% in Dominican Republic, 28% in El Salvador, 18% in Mexico), the close to 2,500 million USD which entered the country in 2005 are the main source of income for approximately 1 in 10 adults in Peru. The average remittance in Peru is estimated at 166 USD and is received nine times a year. Source: Inter-American Development Bank. (Nota de Prensa diciembre 2005)

population has quadrupled from 1.5 million to almost 7 million¹⁸. Most of this massive expansion has been driven by poor migrant families from the Peruvian countryside who have built their homes on the outskirts of the city, without legal title or formal recognition and, more often than not, in dismal conditions. Over time, many of these informal settlements have developed into full-fledged urbanized areas, some with running water and electricity, but no legal formalization has taken place.

In the absence of registration documents, these “owners”-builders have no collateral to offer to banks and thus find themselves outside the mortgage market despite the fact that many earn some type of informal income and often save up during years to be able to finish their self-built home or make necessary additions. This group of people would actually be able to afford small, short-term loans to make home improvements and enhance their living conditions, perhaps even build additional constructions in their family plot to house relatives, if they had proof of property.

Caution from the supply side in granting loans

The obstacles to further development of the housing finance market are not only limited to demand but closely linked to supply as well. Indeed, the scarce effective demand for housing loans is largely determined by the conservative underwriting criteria and demanding financial terms offered by commercial banks, who often cater exclusively to the highest income groups and effectively leave most of the population outside the private mortgage market (as was the case during the 1990s). Which is not to say, however, that under current conditions banks can be blamed for not fostering population's greater access to housing. Peruvian banks' cautiousness in granting loans is legitimized by, on the one hand, inadequate credit and market risk management associated to a lack of credit his-

¹⁸ 2005 Census.

tory for medium/low income households and a high degree of informality in the economy and, on the other, slow foreclosure procedures.

Deficient foreclosure procedures

The financial costs of recovering a guarantee in Peru are relatively low when compared to the region but the process can be considerably lengthy. The average duration of recovering a guarantee is 31 months, although the process can be as short as 18 months if the liquidation of the property takes place at the first auction or exceed as much as 36 months, if the appraisal and allocation of the property in the auction are appealed numerous times, as tends to be the case among debtors attempting to lengthen the procedure in order to postpone eviction as much as possible¹⁹.

Difficulties in recovering mortgaged collateral when borrowers' default on a loan impact very negatively on the housing finance market, since lenders are reluctant to give out mortgage loans or do so only at very unattractive conditions which make these loans unaffordable to most of the population.

Limited long-term financing sources

The private nature of the housing finance system and the resulting independence from State funding reduces financial institutions' risk of seeing their resources directed elsewhere during a crisis, but makes it harder for them to find long-term financing particularly in the case of those institutions that are not foreign-owned and do not have headquarters abroad towards which to turn to sources and in the absence of developed capital markets.

FMV's role as a specialized second-tier financing institution has been crucial in providing bank's long-term access to financing although, as will be discussed at length in the following section, this situation is no longer sustainable and other options have had to be taken.

¹⁹ Foundations of Housing Finance. Chapter 15

Chapter 5 - The Next Step: A Secondary Mortgage Market

5.1 NEW RISKS AND EVOLVING MARKET NEEDS

The MIVIVIENDA Program has done extremely well in sustaining the development of the housing finance system over the past few years and its success is without question. However, as is only to be expected, the many benefits this Program has brought to Peru have not been without additional consequences or risks. The expansion of the mortgage market in the absence of sufficiently developed capital markets—which, albeit growing, have been unable to keep pace with bank’s increasing mortgage activity—has led, on the one hand, to a significant maturity mismatch in the banking sector, while, on the other, the Peruvian population’s insistence in obtaining USD-denominated loans, with salaries denominated in local currency, has resulted in banks assuming a very high credit risk.

In addition to these new risks, in the past few years it has also become apparent that market needs have evolved. Growing competition has led to a significant segmentation of financial institutions by size, market share of

deposits and availability of funding, a situation which policy makers must necessarily take into account when designing new housing finance mechanisms, particularly since the depletion of FMV funds requires a profound revision of housing policies and mechanisms in Peru.

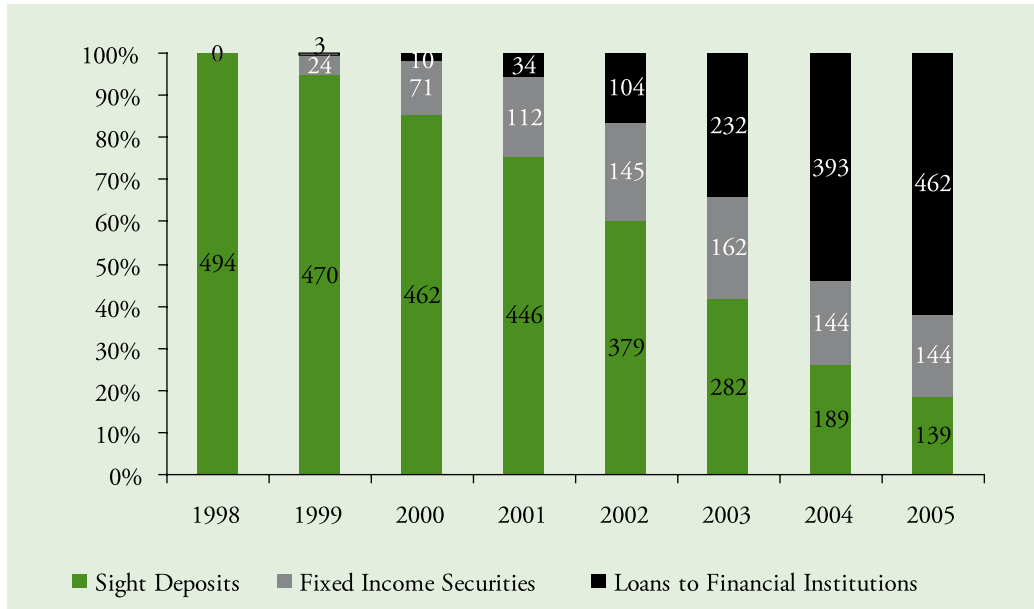
Foreign Exchange Risk

The Peruvian currency’s turbulent history and its appreciating trend with respect to the US currency has resulted in practically all mortgage loans granted being USD-denominated. This phenomenon does not translate into foreign exchange rate risk for the banking system—i.e. an assets and liabilities foreign currency mismatch which is relatively common for many other developing countries—because most banks liabilities are USD-denominated as well given that most households save in this currency. However, it has other important consequences. Foreign exchange risk is effectively transferred to the borrower, who earns an income in *soles* but must make payments in USD. The banking system faces, therefore, a much higher credit risk than would initially appear, since any variation in the exchange rate can dangerously

Foreign Exchange Rate Risk in the Banking System

	Banca Múltiple		CMAC	
	USD	Soles	USD	Soles
Total Assets	65%	35%	37%	63%
Total Loans	70%	30%	35%	65%
Mortgages	96%	4%	99%	1%
Total liabilities	65%	35%	38%	62%
Sight and saving	60%	40%	40%	60%
Term Deposits	69%	31%	33%	67%
Securities	75%	25%	-	-

Evolution of MIVIVIENDA's Portfolio



increase the number of non-performing loans and defaults. In essence, the banking sector has increased its vulnerability to foreign exchange rate fluctuations and to shocks in the system.

Maturity Mismatch and limited capital market development

The funding structure of the Peruvian mortgage portfolio differs considerably for conventional mortgages and Credits MIVIVIENDA. In the case of MIVIVIENDA, loans granted have been perfectly matched with FMV funds in terms of duration, thus avoiding any maturity mismatch and also allowing banks to offer fixed rate mortgages. In the conventional mortgage market, however, given the limited access to long-term funding due to the capital market's early stages of development, increasing activity has been funded through traditional customer deposits and CTS deposits²⁰, a situation that has favored a segmentation of the supply in the Peruvian mortgage market as well as a significant

maturity mismatch.

Indeed, larger banks have sustained their mortgage business expansion thanks to their readily available and growing market share of deposits (mostly short-term and generally highly concentrated), while smaller institutions have been limited to MIVIVIENDA. Since mortgage loans are being granted at increasingly longer terms, this situation has created a significant assets and liabilities maturity mismatch²¹ which introduces a liquidity and refinancing risk into the system. Although these risks are currently not a source for concern given the positive evolution of the financial sector in recent years, they may have very negative consequences if the situation were to change.

²⁰ CTS are deposits made by employers

²¹ Although the analysis of the duration of assets and liabilities does not reflect a significant interest rate risk, since only MIVIVIENDA loans are fixed-rate denominated and these are perfectly matched in terms of duration, there is a large amount of long-term maturity assets that are exclusively funded by short-term deposits.

FMV funds being depleted

Until now, the scarce development of capital markets and long-term funding needs for the banking sector in their mortgage market expansion were resolved through the use of FMV funds, which allowed banks to extend the maturity of their funding without issuing long term securities.

The funds of FMV are not limitless, however, and by end of 2005, with 900 Crédito Mivivienda loans being granted every month, the resources left barely guaranteed the program for coming months.

Further, the funding problem must be resolved through mechanisms that are sustainable in the long-term and do not require a state institution to periodically replenish funds and increase the number of wholesale loans.

With the mortgage market already jump-started, the State's role in the process must change. In this new scenario, the role of the FMV has evolved and new housing finance mechanisms have been developed to not only accommodate previous objectives of sustaining further improvement in medium and low-income households' access to housing while continuing to promote the involvement of the private sector, but also of addressing new financial and credit risks and ensuring the system's long-term sustainability.

5.2 FMV S.A. AND TWO NEW PRODUCTS

In this scenario of new risks and rapid reduction in FMV's liquid capital (the capital which has still not been directed towards credit lines for financial institutions) and taking into account the market's evolving needs and what had been the Program's key elements to success, the institution undertook a profound revision of itself and the products it offered in early 2005.

The basic elements of FMV's transformation were:

- No longer acting as a second-tier bank for MIVIVIENDA loans
- Decreasing the premium for good payment
- Modifying the offer of credit risk insurance, decreasing its coverage
- Charging a fee for these two products, PBP and CRC (which, until then, were including in the financial terms of the loans)
- Securitizing Créditos MIVIVIENDA in order to facilitate funding to those institutions that need it, an action that would previously involve the homogenization of underwriting criteria and financial conditions on all MIVIVIENDA loans which would allow their securitization.

With these objectives in, the FMV has redesigned its structure and functions, as well as the existing funding product (consisting of a bundled credit and guarantee) and has created two new products. The first was introduced in June 2006, while the second is expected to become operational later in the year²².

*Product N°1: Credit Risk Insurance (Cobertura de Riesgo de Cambio, CRC) coupled with the Premium for Good Payment (Premio al Buen Paga-dor, PBP)*²³

In this new phase, Crédito MIVIVIENDA will maintain the same incentives that have contributed to making the program huge success, but 1) in a less subsidized scheme and 2) paying particular attention to the main issues pointed out in the last Financial Sector Assessment Program (FSAP) of the IMF and World Bank and joining the Governments efforts in

²² The first standardized Crédito MIVIVIENDA was granted in July 2006 by Caja Metropolitana de Lima. A sufficient number of loans are expected to be generated in coming months to allow a securitization in the next 12 months although June 2006 election results may modify this schedule.

²³ This section is based on the reports made by Analistas Financieros Internacionales, Macroconsult and AIS, in a FIRST funded project, with the aim of the defining the financial structure of the new products for FMV S.A.

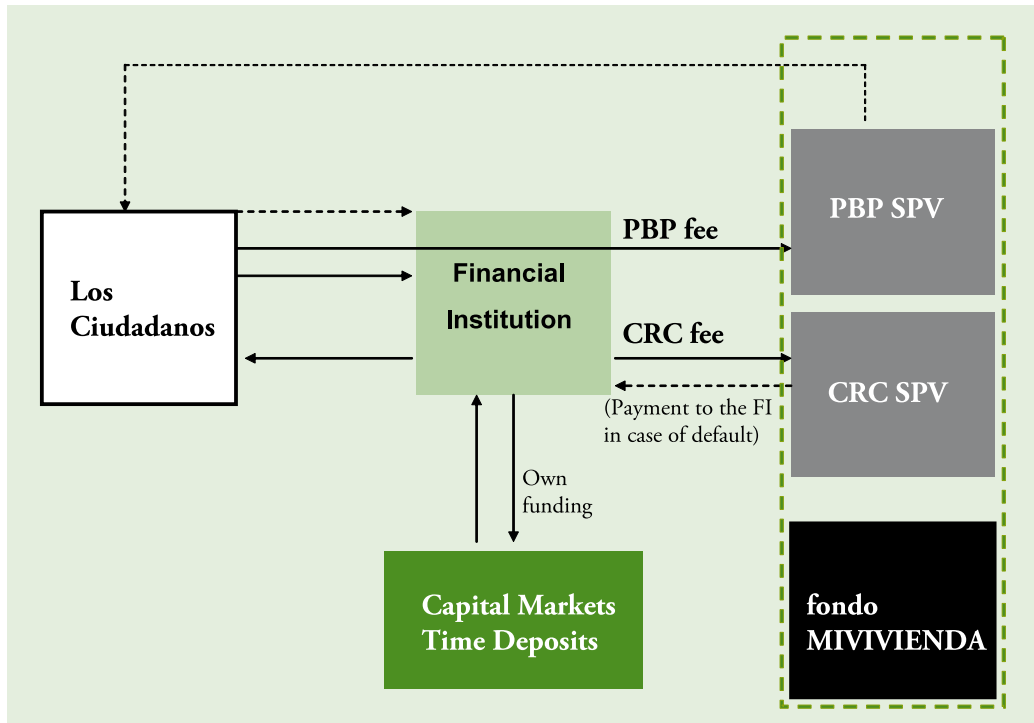
working towards resolving them, offering advantages, for instance, to soles-denominated loans with the objective of reducing the dollarization of the economy. To manage this product. FMV has created two distinct funds, one for PBP and another for CRC, each separately administered and with individual investment policies that will ensure their respective payment capacities.

More specifically, with regard to CRC, the new product reduces the existing guarantee in order to ensure financial institutions participate in all potential losses and thereby align their interest with those of FMV and ensure they maintain the utmost standards in the origination and administration process. In this new scheme, CRC is reduced from covering one third of the subordinated of the loan balance to simply covering one third of the losses (after

execution of the property), to a maximum of one third of the outstanding volume.

In addition to this effort to undercut moral hazard, another important change is that the fee charged for CRC will vary in accordance to the maturity of the loan, i.e. a loan with a longer maturity will be charged a higher fee. Fees, in all instances are determined in each specific case by a financial model that takes into account Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD). Although it may appear that charging a fee means that CRC is no longer subsidized by the State, one of the key inputs in the model in determining this fee is actually the capital held by the CRC fund. Since this initial capital is provided by the State (through FMV), a subsidy still clearly exists even if FMV is charging a fee.

Product 1: CRC and PBP



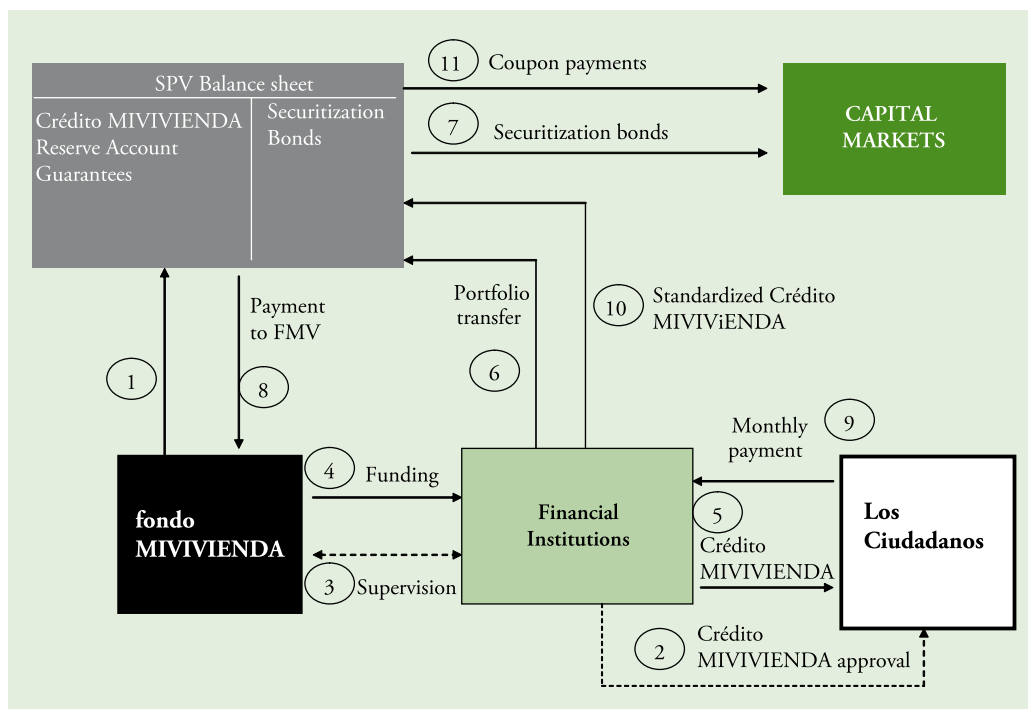
The Premium for Good Payment (PBP) has also been reduced under this new scheme, from 20% to 15%. As is the case with CRC, the maturity of the loan has also been taken into account when calculating the fee to be paid by the financial institution (and transferred to the consumer). Even though the PBP does not require a subsidy, FMV will maintain a partial and temporal subsidy, in order to avoid a possible slowdown of the mortgage market. FMV will therefore only subsidize the PBP of loans denominated in local currency and with a 20 year maturity that will not be securitized, effectively decreasing the interest rate on these loans and therefore contributing to the process of dedollarization of the economy and decreasing the credit risk of borrowers who earn their income in soles and in most cases belong to the lowest income groups.

Product N°2: Standardization and Financing of Mortgage Portfolios

Since FMV will not act as a second tier bank in this new phase, new problems may arise. Larger banks will continue to have ready access to liquidity thanks to their expanding deposit base and the possibility of direct issues to the capital market. Medium and small financial institutions, however, with a lower market share of deposits and insufficient rating may face liquidity problems if they continue their current rate of expansion of mortgage activity. Further, they will be crowded out by larger institutions with the possibility of obtaining financing at much more advantageous rates.

In order to avoid this segmentation of the market, FMV has developed an alternative mechanism for those institutions that are not well-capitalized and lack the capacity to attract low-cost long-term funding on their own to

Product 2



support mortgage lending. In Product 2, FMV will provide credit enhancements to securitization of MIVIVIENDA loans, based on a specifically designed financial model that determines initial capital required to face different stress scenarios and thus reduces the financial cost of process, making it a viable and attractive option for medium and small banks.

5.3 MORTGAGE MARKET OUTCOME AND POTENTIAL FOR GROWTH

The products have yet to be implemented but prospects are positive. With this new scheme, FMV will effectively mobilize private sector capital for middle and low-income housing, ensuring the sustainability of the Program for as long as it is needed and with only a relatively limited subsidy from the State.

It is expected that large banks will continue to use their own funding to offer MIVIVIENDA loans, while contracting PBP and CRC (Product 1) separately in order to reap the benefits of the subsidies and maintain the popular MIVIVIENDA product in their portfolio. Medium and small financial institutions, for their parte, are expected to contract both Product 1 and Product 2.

With FMV's new products, larger banks that have access to liquidity, through their expanding deposit base and direct issues to the capital market, will be able to purchase the guarantee in itself.

This report examines the nature and scope of the housing problem in Peru. It reviews the evolution of the housing finance systems and main players of the housing finance system and driving forces for the change. It introduces mortgage finance development for medium and low income households with two case studies: Fondo and Creditos MIVIVIENDA. It examines the residential mortgage market and its segments and constraints. It looks at factors constraining the development of housing finance mechanism and policies and strategies to overcome the bottlenecks for housing finance. It looks at the role of direct subsidies and other initiatives for low income households. Finally it looks at the alternatives for developing housing mechanisms in Peru, with focus on the development of a secondary mortgage market.



UNITED NATIONS HUMAN SETTLEMENTS PROGRAMME

P.O. Box 30030, GPO Nairobi 00100, KENYA;

Telephone:+254-20-7623120; Fax:+254-20-7624266/7 (Central Office)

E-mail:infohabitat@unhabitat.org; Website:<http://www.unhabitat.org/>