

Latin American Housing Finance Summit

Pablo García, Central Bank of Chile

The changing face of housing finance in Chile



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Main trends

February 2008

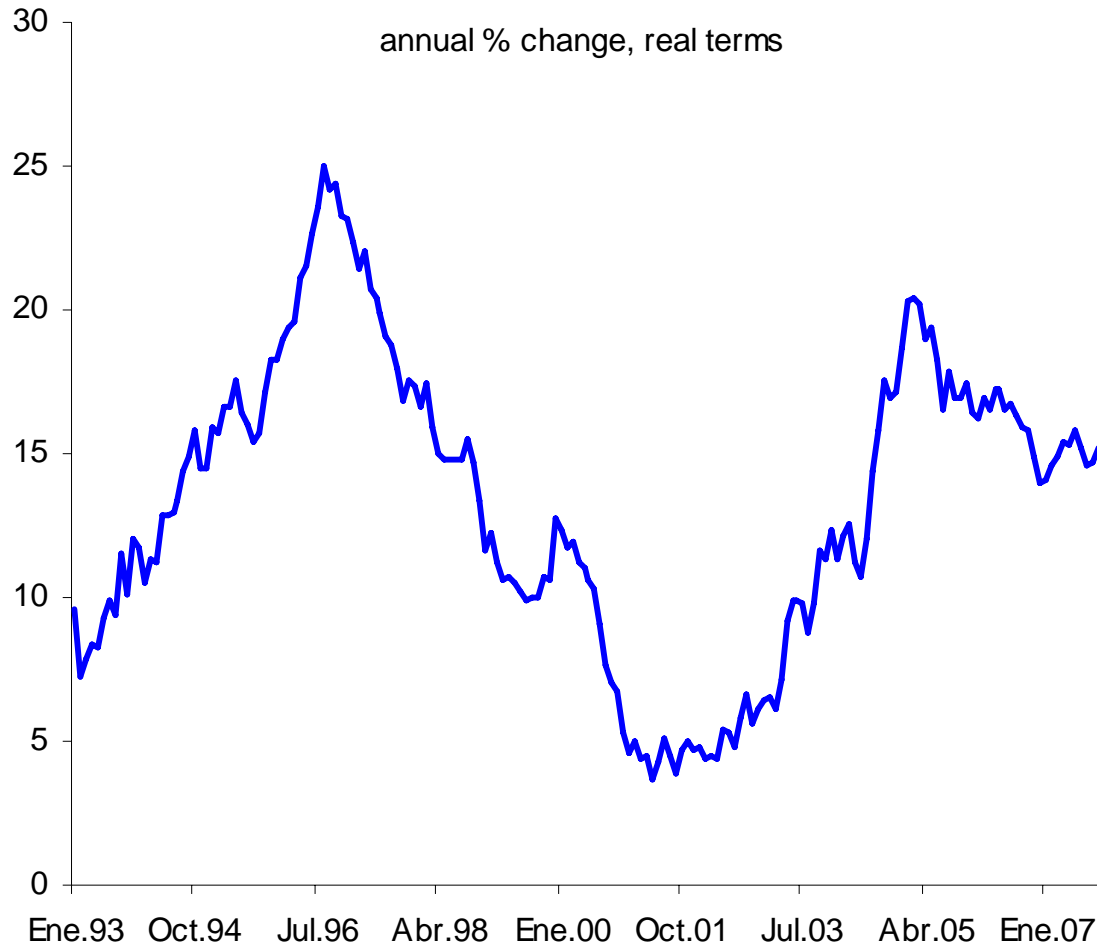
- Resilience of supply and demand in spite of changing macroeconomic conditions.
- High (but not torrid) mortgage growth in the last three years.
- Steady increase in share of GDP, from 7% in 1995 up to 18% in 2007.
- Prepayment boom of traditional instruments and development of new types of mortgage loans, entry of new participants.
- Low rates of default.



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Mortgage credit growth has fluctuated between 5% and 25% in real terms over varying macroeconomic and financial conditions.

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Letras hipotecarias

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■ The traditional product: Mortgage bill (“letras”).

- A decades-old product born from the financial liberalization of the mid seventies
- Standardized contract regulated by the Central Bank
- fixed interest rate,
- expressed in indexed units (UF), and
- ceiling on loan-to-value ratio (75%) and dividend to income (25% in case of properties of <3000 UF - USD100k).
- Originator retains credit risk but transfers interest rate risk to investors
- High traditional demand from institutional investors to match liabilities (pension funds and insurance companies)
- Accepted as collateral by the Central Bank for liquidity provision and monetary policy implementation



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Mortgage rates fell sharply and to historic lows in 2003-2004... February 2008

% ; Real terms



Low global interest rates

Monetary policy easing following sluggish growth in 2001-2002.

Continued fiscal and quasi-fiscal consolidation led to public debt reduction

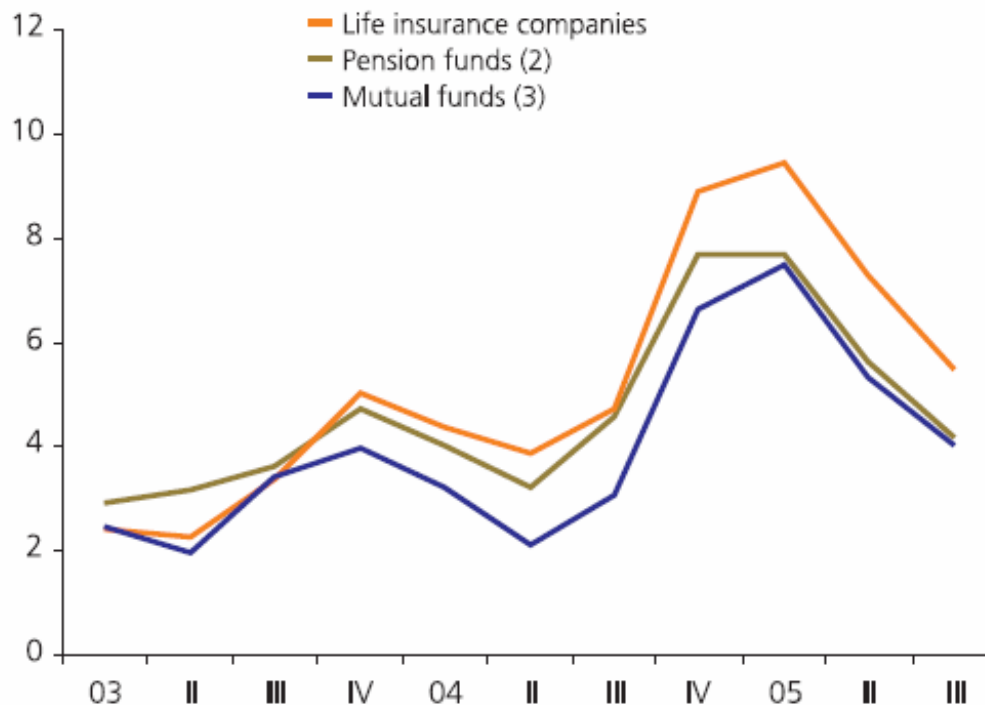


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...leading to a wave of prepayments of mortgage bills (“letras”) in 2005, affecting institutional investors.

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Prepayment of mortgage bills (1)
(percent of initial stock)



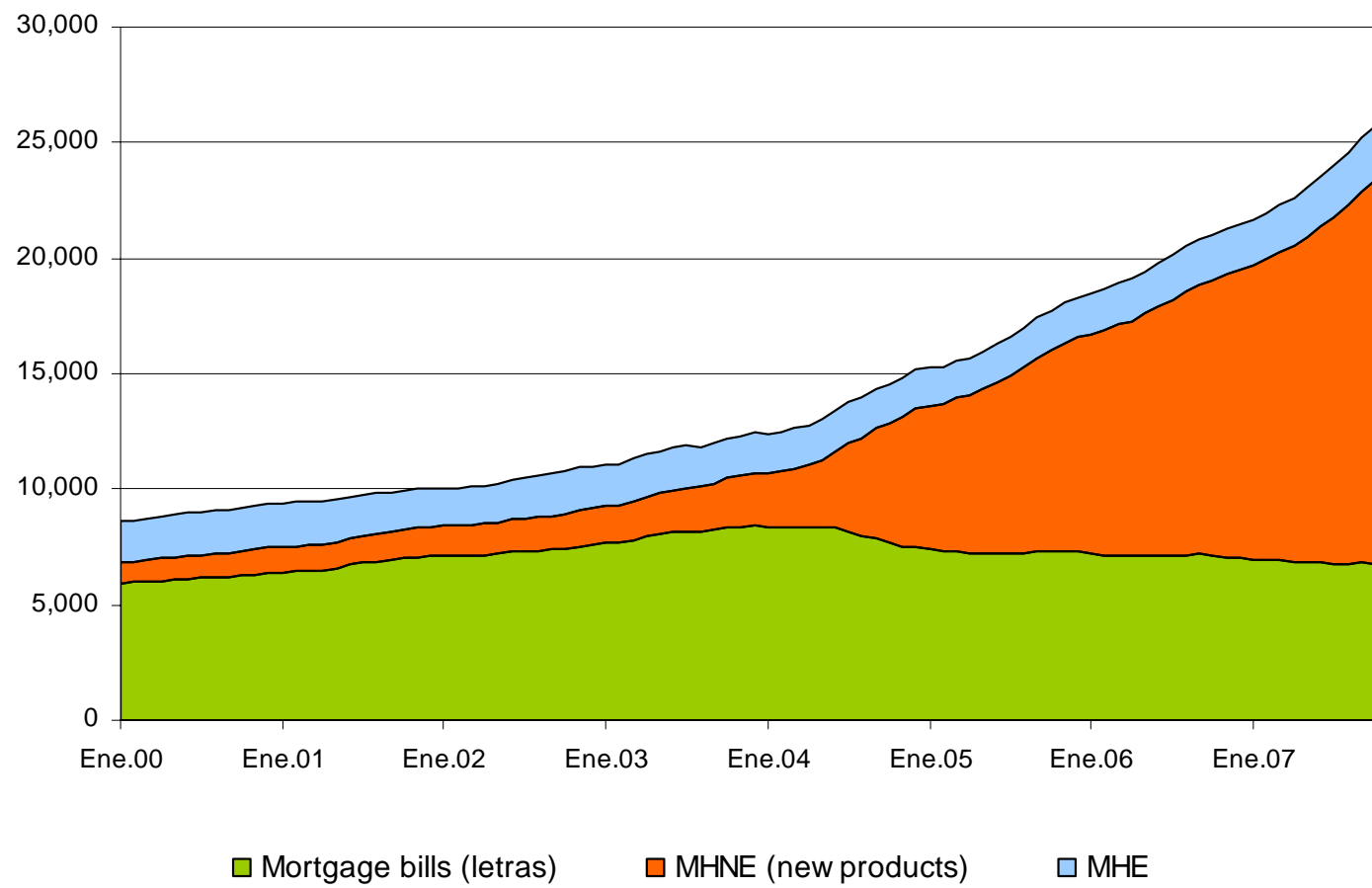
(1) Quarterly prepayments over the initial stock of mortgage bills in each period.



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A significant shift of mortgage products towards “new” products and away from *letras* since 2002 (in USD mill, CLP at \$500).

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New products

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■ Intense attractiveness of *Mutuos hipotecarios no endosables*.

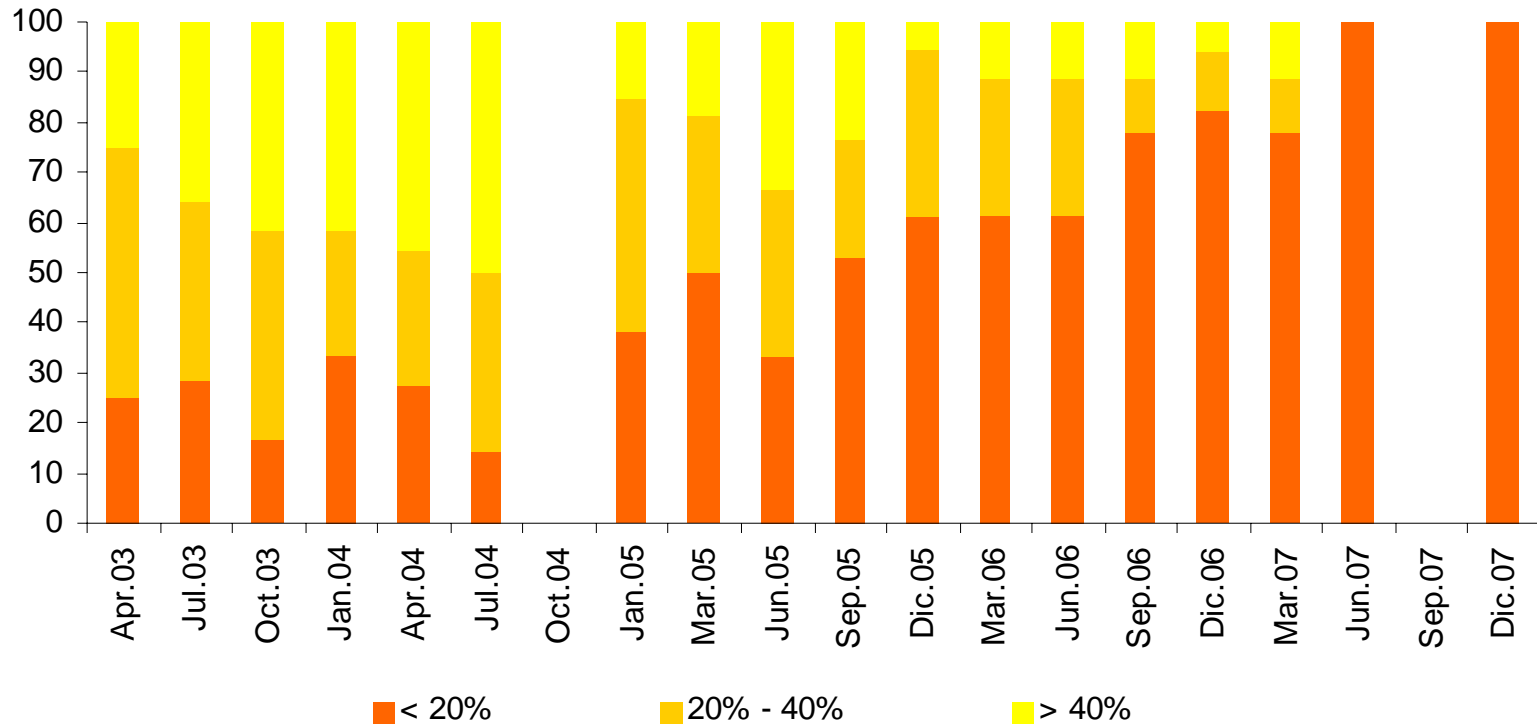
- Conditions freely determined between the parties regarding:
- Loan to value (up to 100%)
- Insurance
- Fees
- Periods of grace
- Flexible interest and possibility of interest ceilings
- Nominal as well as indexed
- Kept on-balance by banks
- Funded through longer dated deposits and subordinated bonds: participation of AFPs and other institutionals.



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A significant share of the existing stock of mortgage loans was refinanced in 2003-2005

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Shows the breakdown responses from loan officers to the question of which share of existing mortgages was being refinanced at each period. Source: Quarterly survey of banks credit conditions, Central Bank of Chile.

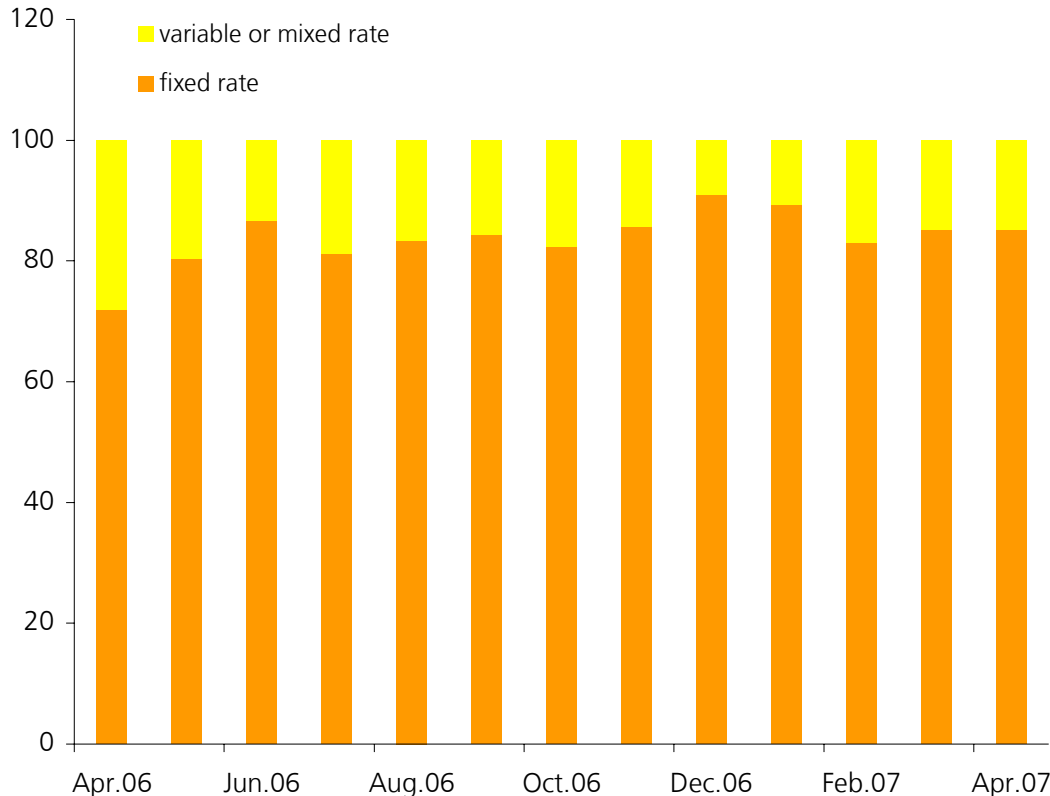


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More recently, the shift towards variable rate mortgages has eased...

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percentage of total credits



Currently stands slightly over 10% of the flow of new mortgages, compared to close to 1/3 in early 2006 and likely higher in 2005.

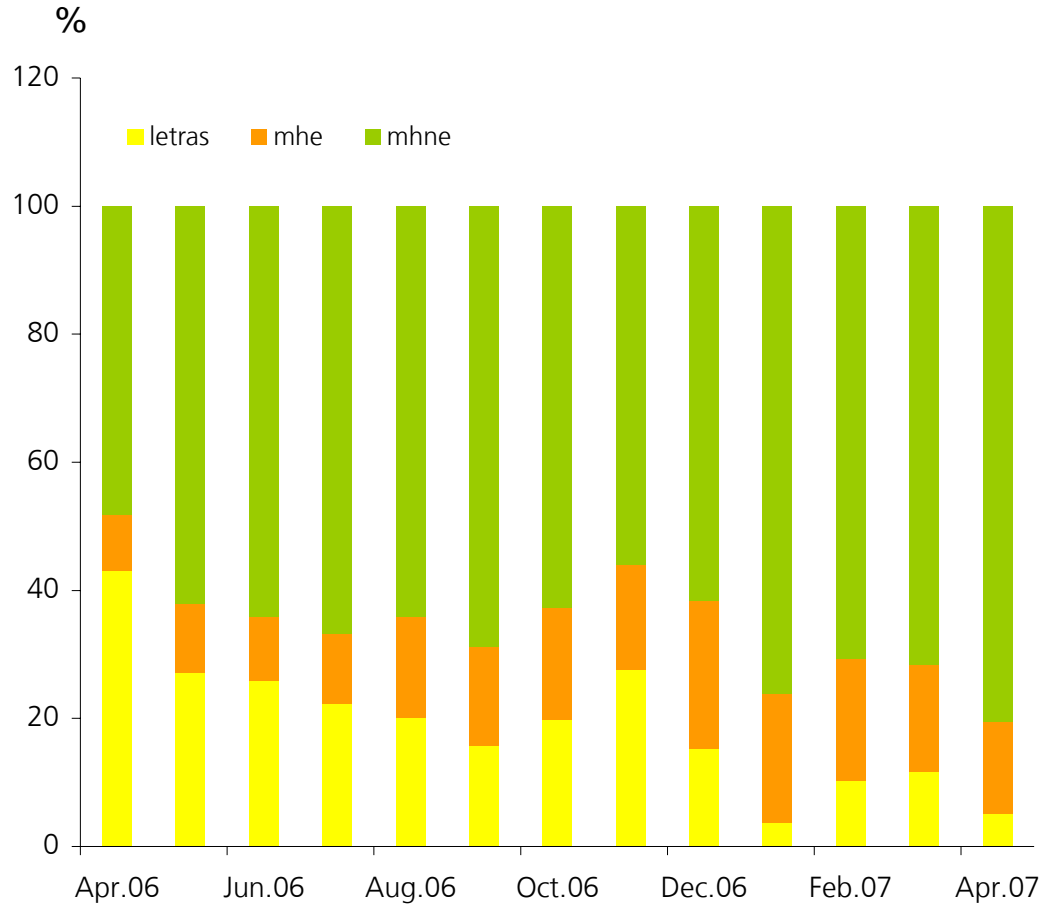
Sources: SBIF and Central Bank of Chile



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But the decline in the attractiveness of bills (“letras”) seems here to stay.

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Sources: SBIF and Central Bank of Chile



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Household debt and housing prices

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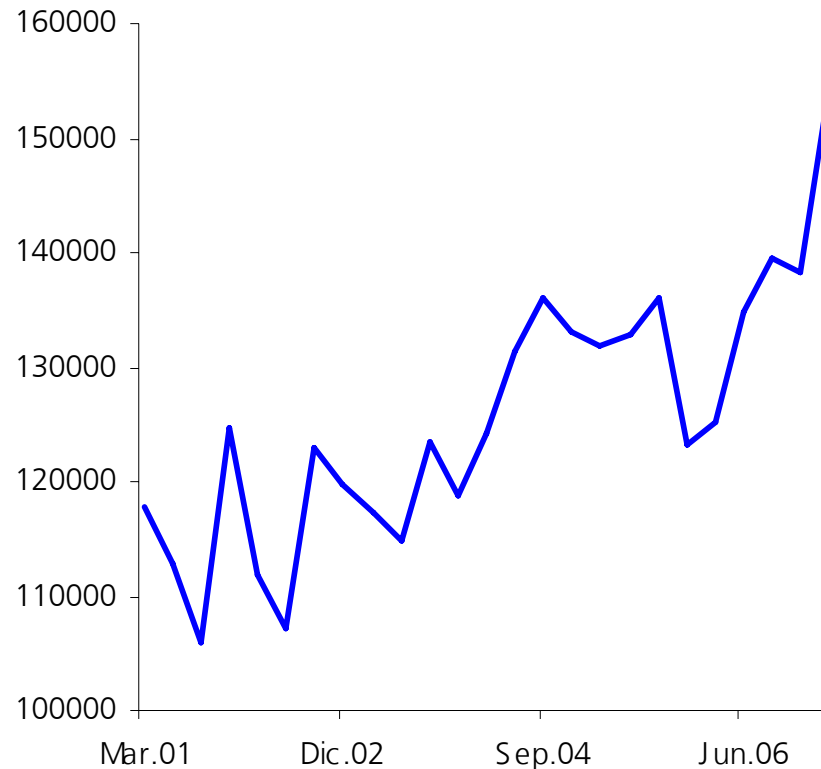
- Household debt has been systematically growing faster than disposable income since 1999.
- The ratio of total household debt to disposable income reached 60% in 2007.
- House prices remained constant since June 2004, but started to increase steadily since March 2006.



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House prices have increased 4% annually in this decade

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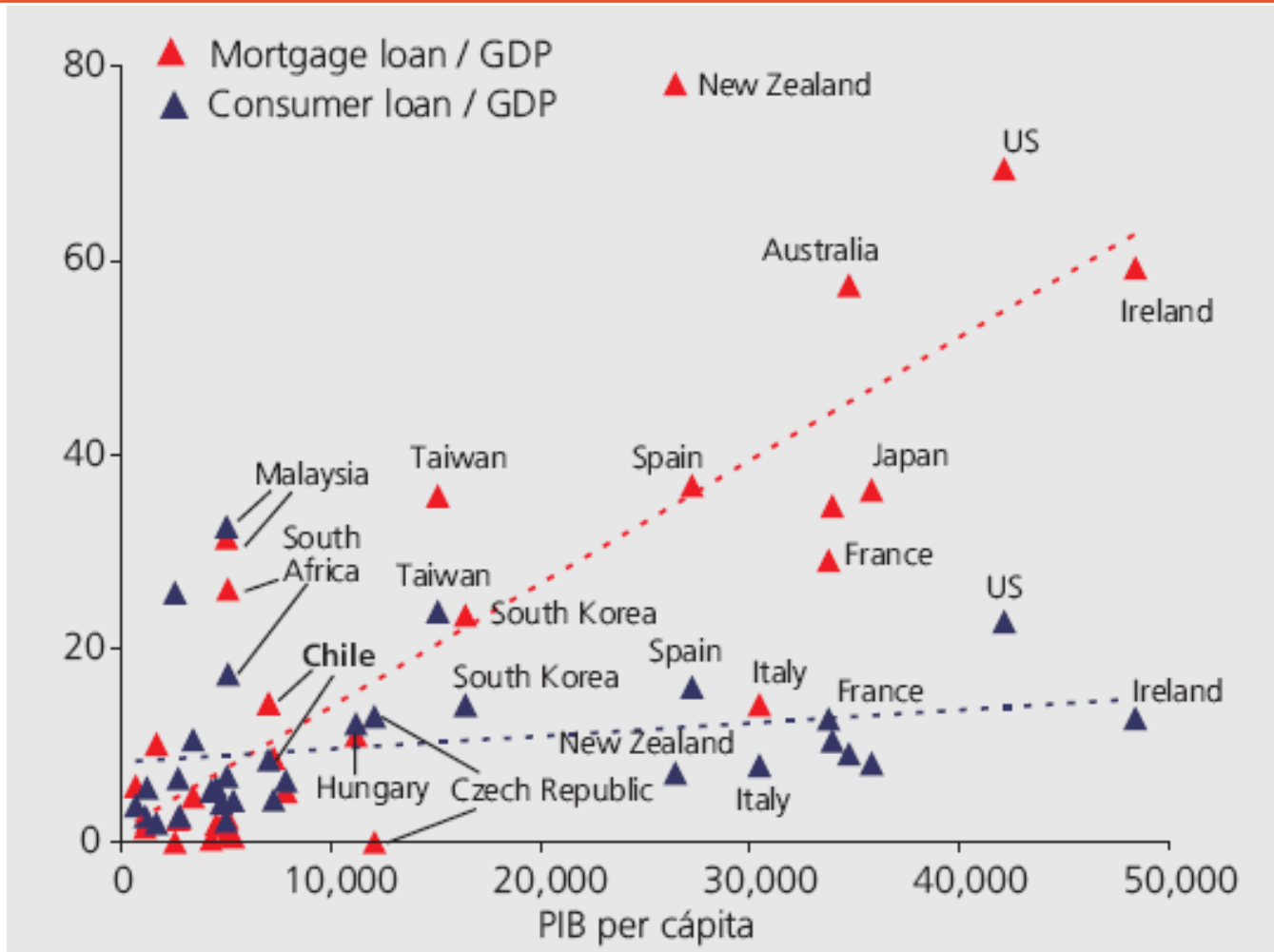
Source: Central Bank of Chile, measured in constant USD dollars and adjusted for local inflation. Indicator constructed from the median of transactions recorded in Santiago. See Financial Stability Report 2005.2



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There is scope for further growth in mortgage credit as the economy grows, but not so much with consumer credit.

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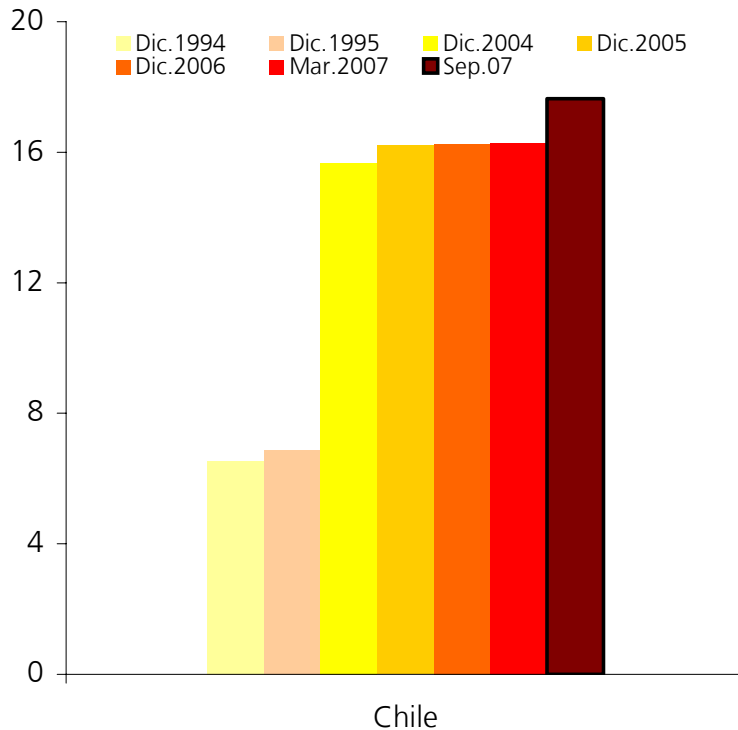
Source: Financial Stability Report 2006.1

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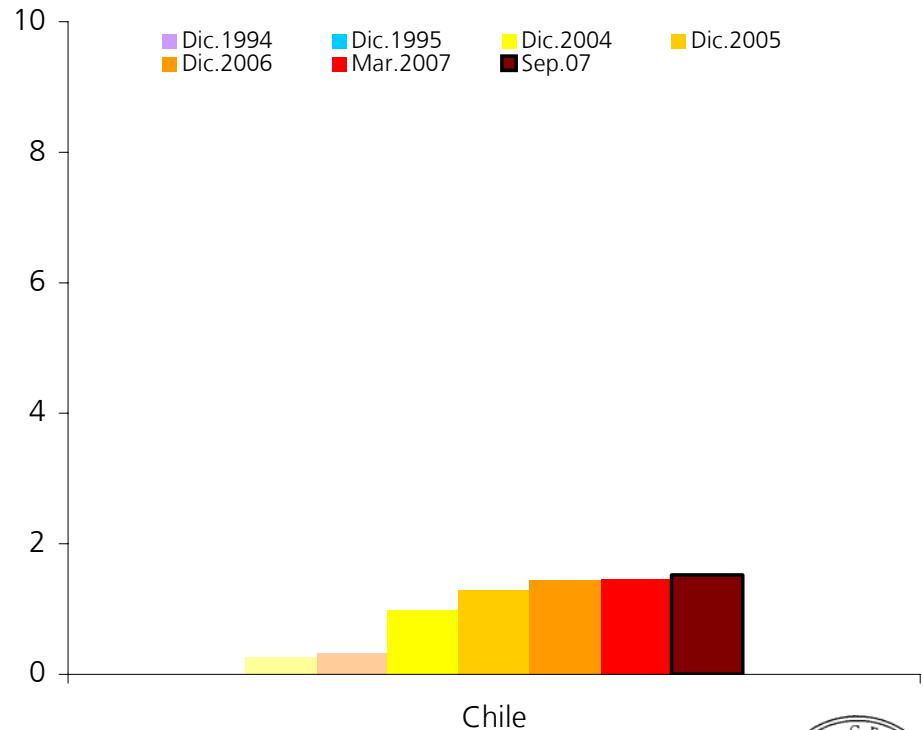
Mortgage Debt

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As a percentage of GDP



Per capita (thousands of USD)



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Borrowers' considerations

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- Half of the total loans are below USD 15.000, but they represent only 11% of the total *mortgage* debt issued by banks, from 18% in 2004.
- 24% of total loans between USD 33.000 and USD 100.000 represent 44% of total amount.

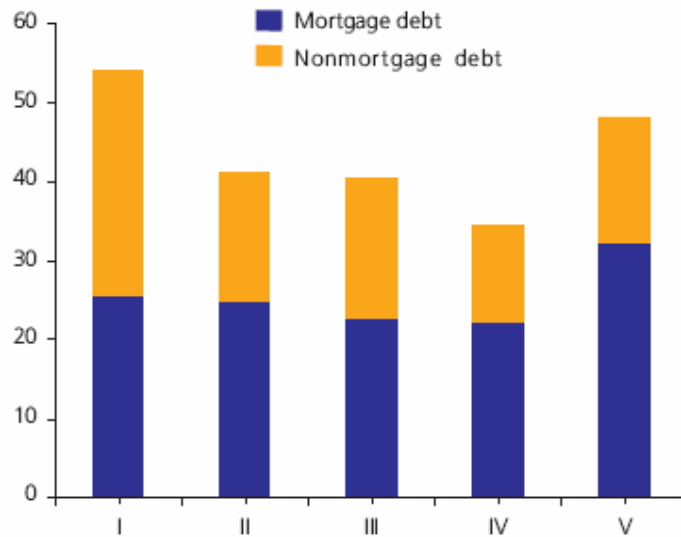


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Although debt to income ratios is somewhat evenly distributed across income quintiles, real estate assets are highly concentrated.

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Debt-to-income ratio, by household income quintile
(households with debt; percent)



Assets by household income quintile
(percent of corresponding asset)



Source: *Financial Stability Report 2006.2*



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Challenges ahead – the medium run

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- Changes in pension fund regulations have significantly increased the scope for their investments abroad
- Some limit should result for local banks tapping traditional wholesale sources of funding for on-balance sheet mortgage positions. Caveats:
 - Capitalization processes in several banks over 2007 went smoothly
 - New regulations in 2007 authorize the issuance of structured notes to institutional investors
 - Sharp growth of sight deposits and retail time deposits



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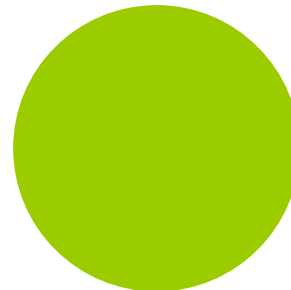
Banks remain dominant, but competition is here to stay

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Composition of mortgage lending

1999

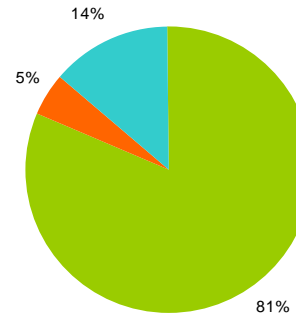
USD8bill



100%

2002

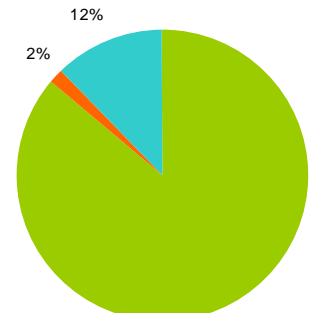
USD10bill



81%

2007

USD29bill



86%

bank
non bank
securitization



•Competition under shifting market conditions led to rapid innovation

A cultural shift has occurred on both sides of the market, driven by the prepayment/reprogramming boom in 2004-2005

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Challenges ahead – the medium run

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- A larger role of capital markets could be expected going forward:
 - As off today: Central Bank constrains banks selling protection through credit derivatives, structure of *letras* remains rigid
 - Improvements in market infraestructure in securities settlement and payment through legal initiatives aiming at the establishment of central counterparties and/or clearing houses
 - Although capital gains and withholding taxes have been lifted for non resident investors in equities, they remain applicable to fixed income investors

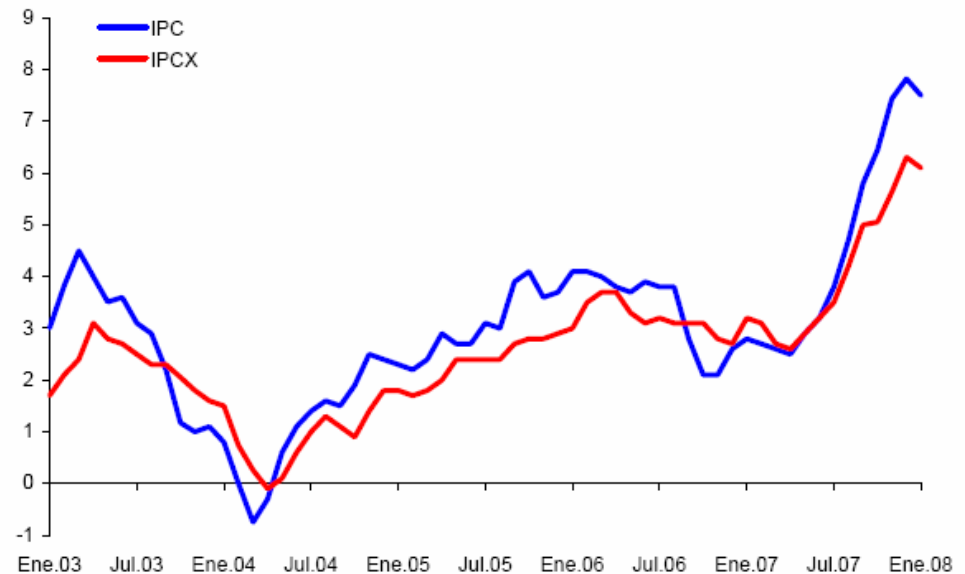


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Challenges ahead – the short run

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- Inflation has risen well above the Central Bank target of 3% +/- 1 due to supply shocks
- Increase in policy rates initiated in mid 2007: monetary policy rate stands at 6.25%
- Further hikes cannot be ruled out
- Long term inflation prospects are benign
- Moderate economic growth and the dampening effect of peso appreciation limits upside risks to inflation
- Higher inflation has kept yields on indexed instruments (including mortgage instruments) in low levels, similar to the ones observed a year ago.



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Challenges ahead – the short run

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- Global worst case scenarios would in any case affect the economy:
 - ◆ Growth reached 2-4% in 2001-2003, export prices plummeted
- Financial resilience has however improved
 - ◆ Fiscal surplus in 2007 reached 8,7% of GDP, current account surplus at 3,8% of GDP.
 - ◆ Ongoing process of capitalization of the Central Bank
 - ◆ Consolidated government and country as a whole post positive net foreign assets
- Sound supervision and regulation of financial intermediaries



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Welcome to the Central Bank for more analysis

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