SBPE –
Issues and Reform Options

BACEN
February 22, 2007
Brasilia

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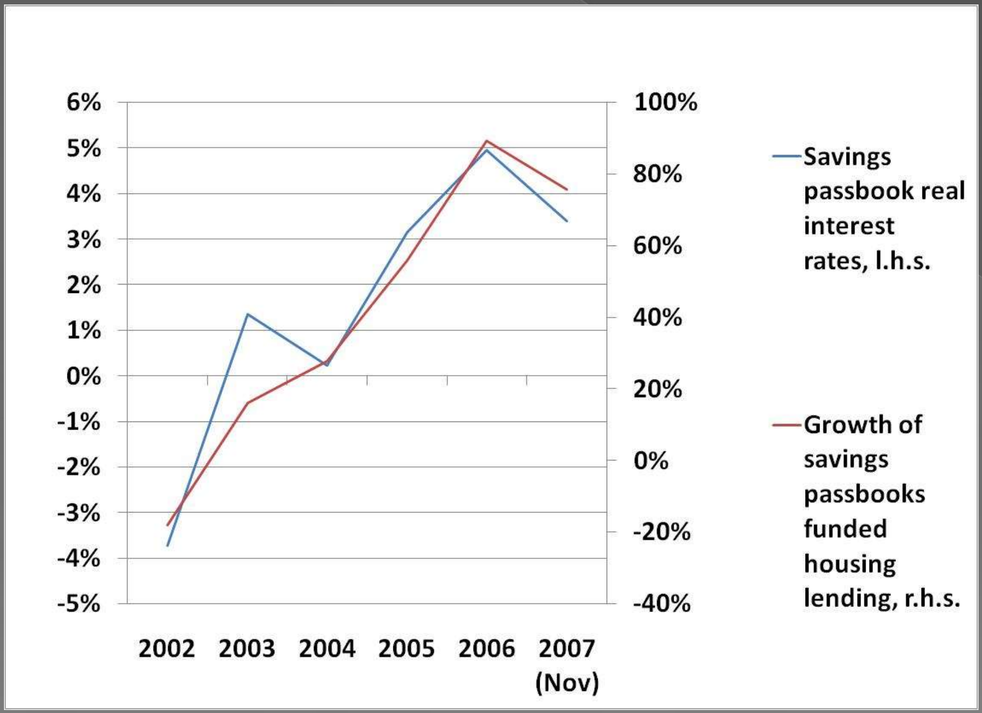
Reasons for recent deposit growth

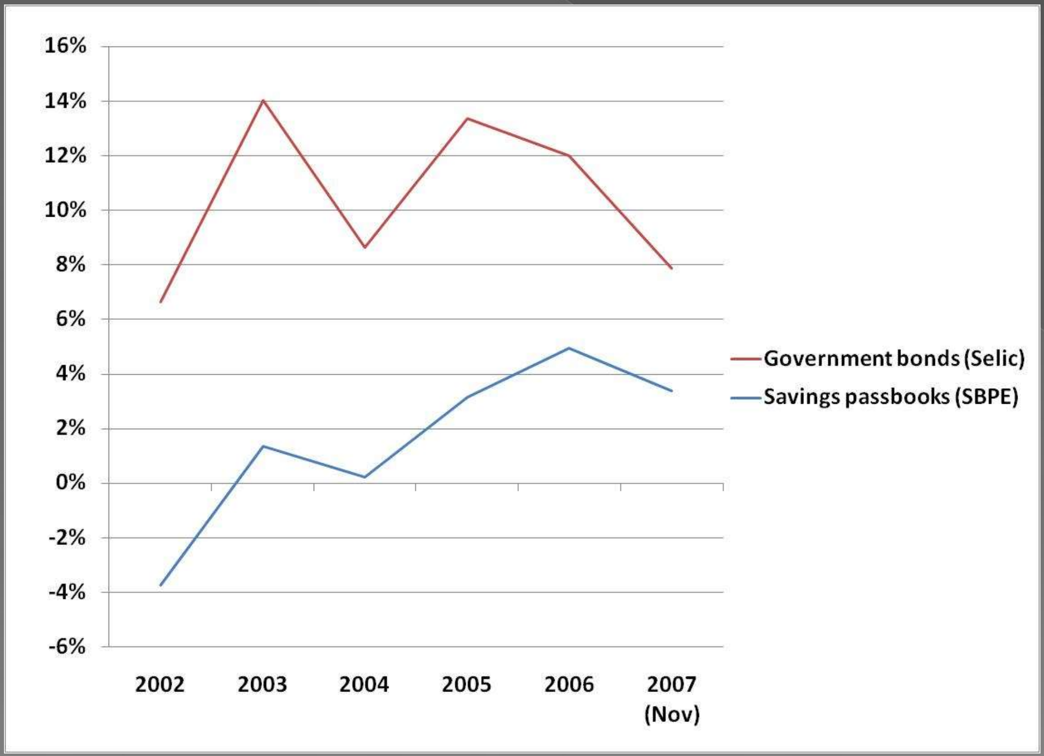
Real interest level and growth of savings passbook-funded housing loans



- FCVS bondholding reduction frees balance sheet
  - still only ca R$ 50/170 billion in mortgages
- Closing of gap to SELIC and positive real interest rates drive demand.

Mismatch issue I: relative returns of funding instruments

Real returns of Selic-based CDs and SBPE passbooks



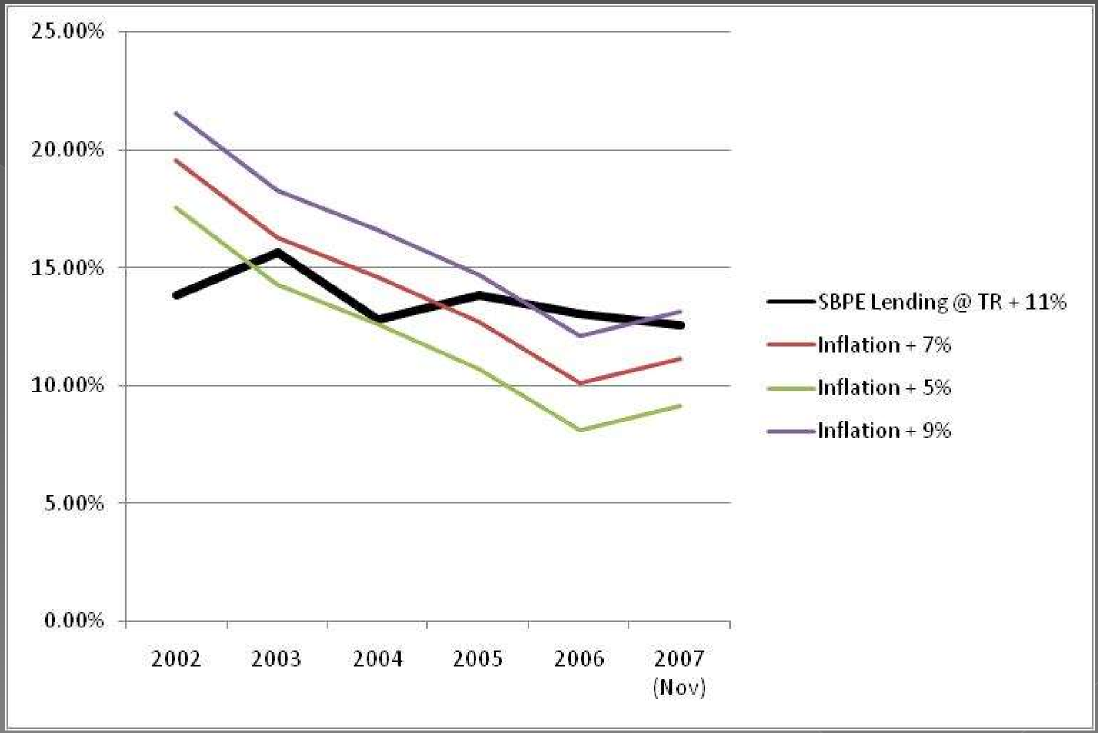
- Narrowing is the result of economic coincidence!!
- Yield gap can rearise at any moment.

→ Continued volatility of loanable funds, liquidity risk

Mismatch issue II: SBPE lending conditions increasingly uncompetitive/low margin

- Margins are squeezed
- Cannot finance prepayment risk/extension risk + credit risk + decent return on equity.
- Wildcare forex lending (Mexico 1994 ca 20% of mortgage funding), open forex positions.

SBPE and IPCA-based lending rates



SBPE margins and market rate scenarios

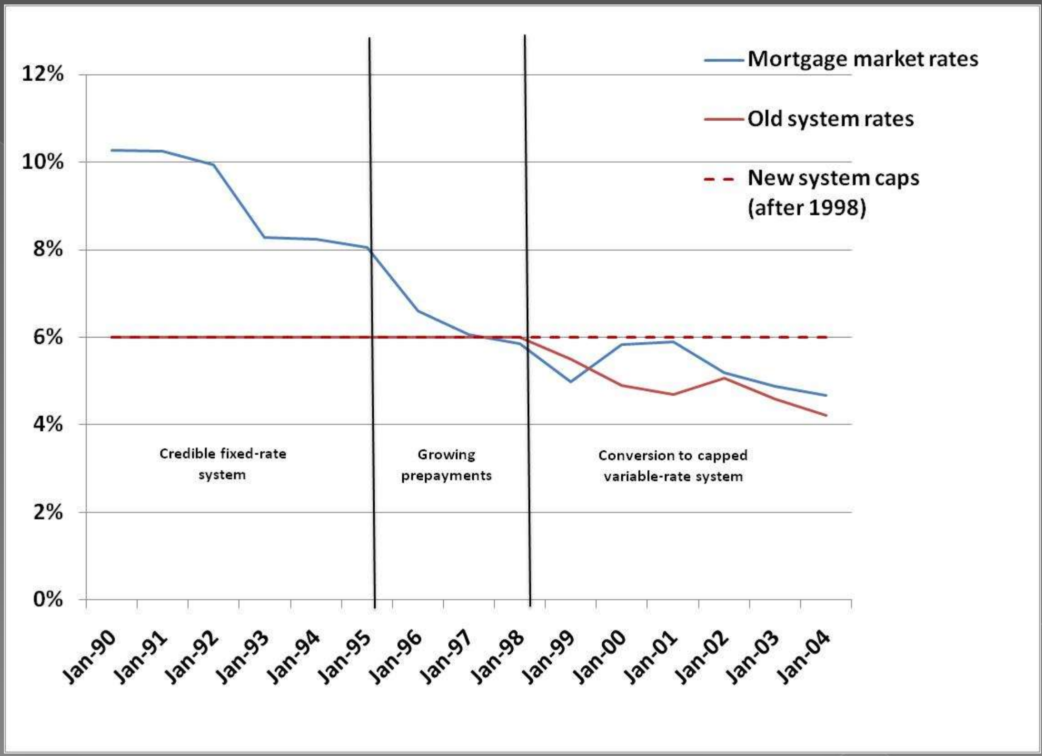
A	Taxa de Juros do Financiamento (nominal aa)	12%	11%	10%	9%	8%	7%	6%
B	Custo Financeiro da Poupança	6%						
C	Custo Operacional	2%						
D	Margem Bruta = Base de Cálculo dos Impostos A – (B+C)	4%	3%	2%	1%	0%	-1%	-2%
E	Impostos (35% x D)	1,40%	1,05%	0,70%	0,35%	0,0%	-0,35%	-0,70%
F	Margem Líquida após Impostos (D – E)	2,60%	1,95%	1,30%	0,65%	0, 0%	-0,65%	-1,30%
G	VIABILIDADE	VIÁVEL			INVIÁVEL (*)			

Source: Iorio/Lark.

Fixed-rate system breakdown because of mismatch – the Austrian case of 1998

- Fixed savings and loan rates worked under high inflation
- Maastricht process rate compression →market rates dropped under lending rate
- Competitors motivated borrowers to prepay
- System had to be converted to ARM with caps.

Market and system loan rates pre and post-reform



Which index, or deindexation ?

- TR underperforming inflation systematically (also inflationary expectations due to rigid discounts)
- Under prevailing PLAM TR means both lower initial affordability AND lower payment shock risk than IPCA, IGPM.

→ Consequence: TR carries higher default risk for low-income borrowers, IPCA has higher general default risk (yet Brazilian LTVs sufficiently conservative)

- Nominal rate system preferable once market rates drop below ca 10%. Coexistence (as in the market). Problems in low-income finance.

Mismatch issue III: Liquidity risk, interest rate risk

- Average mortgage loan life in Brazil ca 4-5 years, i.e. portfolio loan life ca 2-3 years.
- Passbooks are monthly callable (daily against penalties)

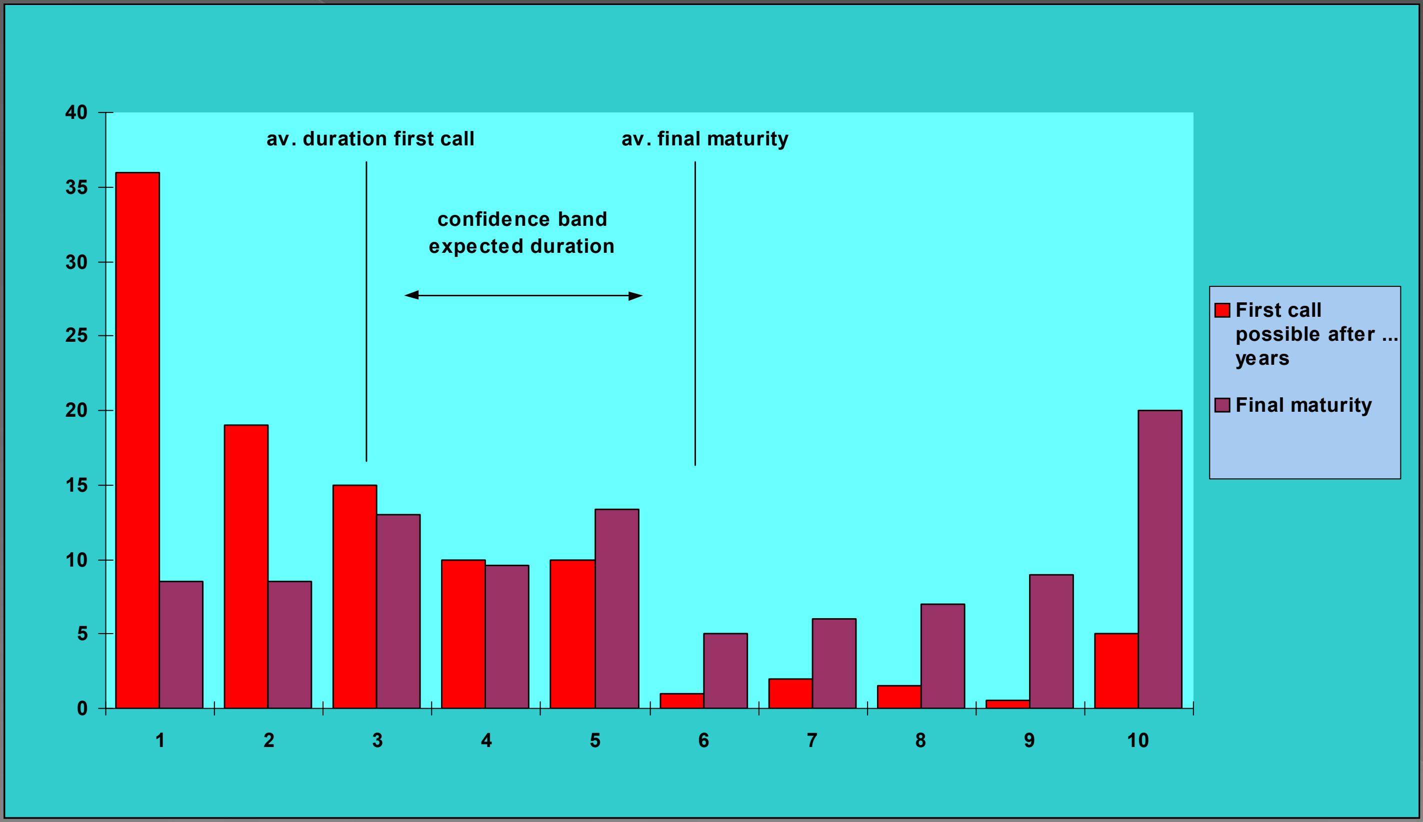
→ Duration gap in the range of 2-3 years min.

→ Interest rate increase creates extension risk (duration gap rises), at already thin margins threatens negative spreads →US S&L crisis.

→ Interest rate decline realizes prepayment risk → durations fall (e.g. to 1-2 years on portfolio basis →1 year deposit maturity already would considerably close duration gap.→US GSE funding strategies in the presence of prepayment risk = liquidity corridors.

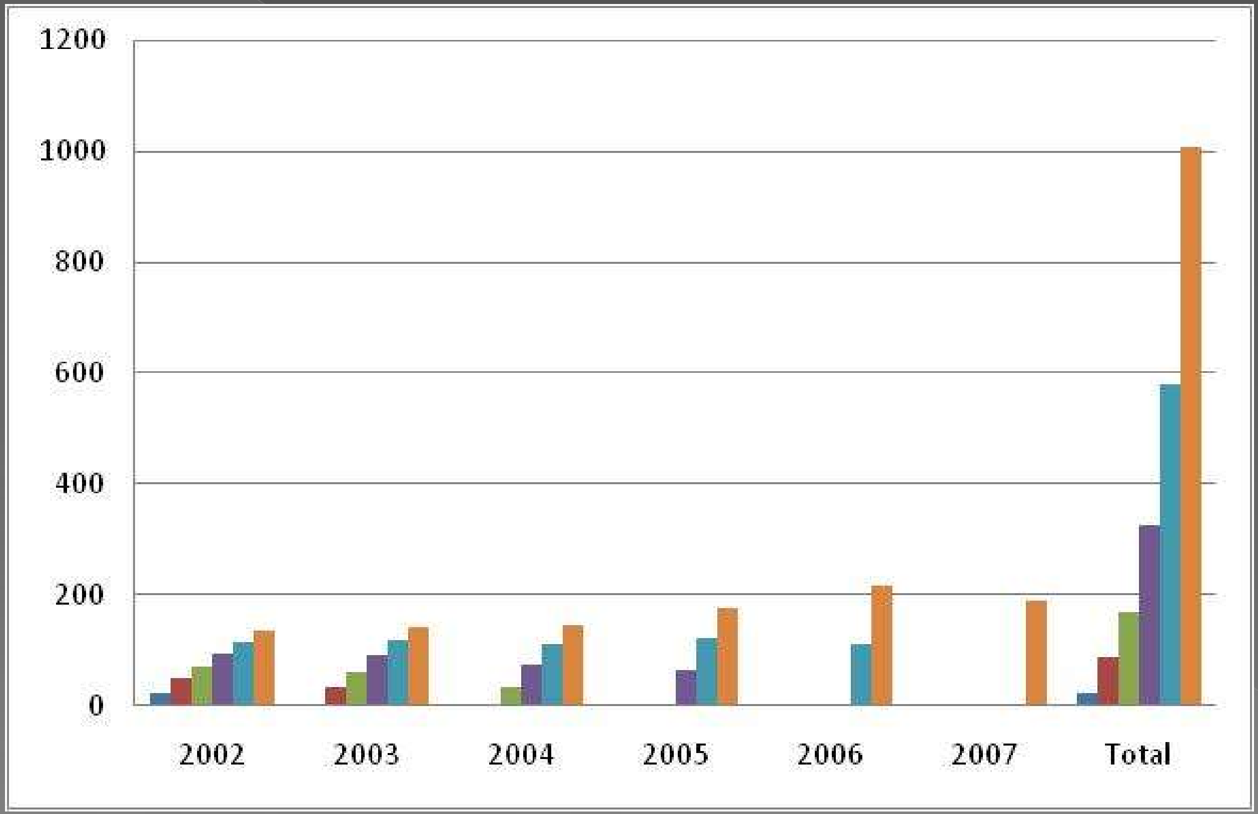
→ Why is tax support used to support very short-term deposits?

Liquidity/interest rate risk management by US GSEs (Freddie Mac) in the presence of prepayment risk



Fiscal costs of the tax exemption

Cohortwise costs p.a. at 15% tax rate, no interest on interest



Mismatch issue IV: Housing investment floors and loan demand

- History of investment floor arbitrage.
- Cements mismatch problem, if floor is linked to short-term deposit tax incentives.
- Distorts against CRI/letras (covered bond) market, which are consequently recycled into SBPE system.
- In combination with fixed rate policy, squeezes margins and drives up origination fees (excess demand for loans).
- Crowds out other private sector lending.
- Point system, floor formulation relatively inflexible.
- Hardly any product innovation.
- Still, current rise in loanable fund supply for housing desirable, after long draught

→ strategic dilemma speaking in favor of phased reform approach.

Reform priorities - discussion

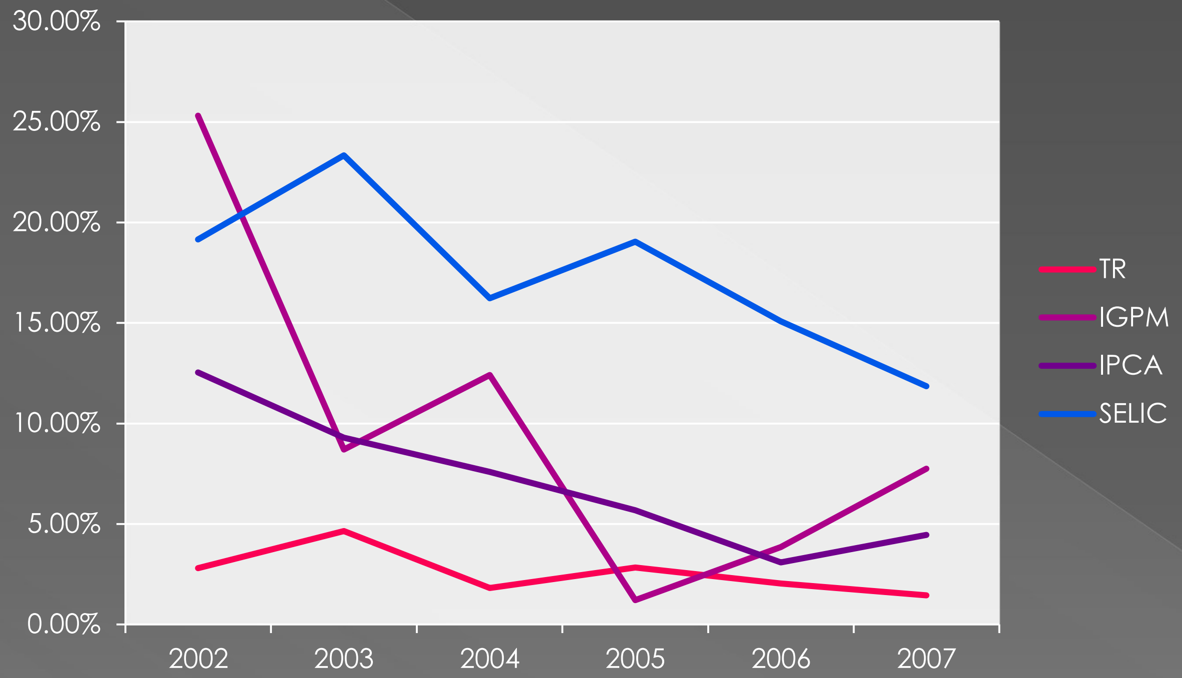
Pro asset side **(removing housing finance directed credit rules)**	**Pro liabilities side** **(restructuring savings passbook conditions)**
Reduce asset tenor to better mach passbook tenor.	Increase passbook tenor to better match mortgage asset tenor.
Promote illiquid assets to be held by long-term capital market investors.	Considerable liquidity risk of pure wholesale funding approaches (US, UK crisis) speaks in favor of securing access to deposits. Deposit markets are not less liquid than bond markets (esp. if public deposit insurance).
Shift interest rate risk of mortgages to capital market investors.	Capital market investors may reject prepayment / interest rate risk (requires intermediation). Also, with universal prepayment in Brazil, shorter-term interest rate fixing may be the most appropriate pricing strategy.
Keep deposit rates constant but free SBPE lenders from margin squeeze in mortgages by offering alternative investment options.	Constant (real) deposit rates mismatch with market conditions, means higher risk investment once directed credit to housing is lifted
Keep tax incentives to stem crowding out of all other credit purposes than government finance.	Crowding out likely a declining problem. The main issue is illiquidity of assets, which may be addressed by focusing tax incentives on longer-term liabilities.

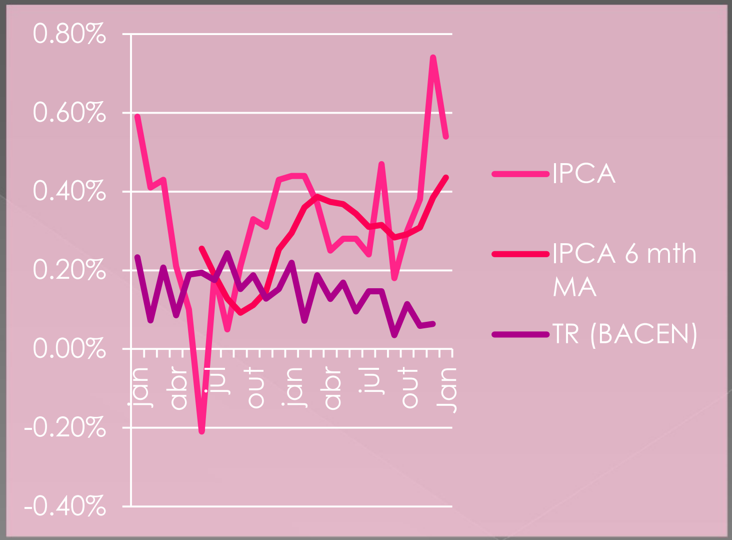
Proposed reform initiative I

Short-term – realignment with market conditions

- Support realignment of currency, interest rates with market conditions in order to **stabilize liquidity**.
- **Improve matching** of liquidity and interest rate risk profiles of assets and liabilities, **address distortions** compared to the mortgage-related securities market, and **reduce fiscal costs**, by shifting fiscal support to *long-term* deposits.
- Modify credit direction system to achieve **greater flexibility**.

Currency questions





Proposed reform initiative I

Short-term – individual measures

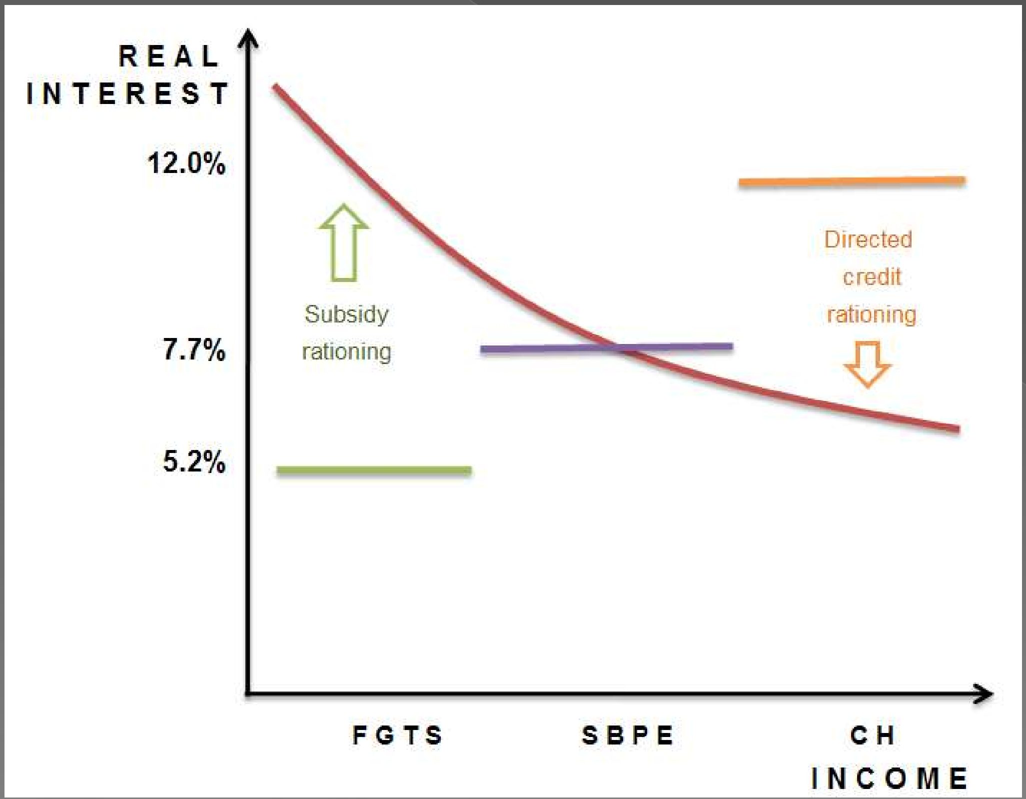
- **Lower deposit floors**, raise band (e.g. IPCA+2 – IPCA+10, TR+4 – TR +12)
- **Change currency** or allow matched dual systems (TR, IPCA, Nominal). Allow adjustable-rate lending with caps.
- **Refocus tax subsidy on term deposits** (>=1 year)
- Keep **simplified credit direction** for term deposits (temporary, extended point system instead of SFH limit)
- **Remove** credit direction **for short-term deposits**
- With partial liberalization, **strengthen deposit insurance oversight, risk management standards** (capital requirements).

Proposed reform initiative II

Mid-term – removal of directed credit system

- **Reform and diversify the mortgage-related securities menu**, including issuance cost reductions for CRI and the creation of 'straight' on-balance sheet bond instruments that could replace long-term deposits on the balance sheet of lenders.
- **Eliminate tax support and credit direction** for savings passbooks together with tax support and deposit insurance for mortgage-related securities.
- Enhance **back-stopping and other liquidity management options** for mortgage-related securities in case of liquidity crisis.

Future housing finance system – transition to market prices



- Remove rationing (=market rate funds)
- Reformulate subsidies (=grants or buy-downs for low-income)
- Enhance stability (=tax regime, encourage savings)

END

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