RHUDO/LISBON

HOUSING FINANCE, CAPITAL MARKET DEVELOPMENT, AND THE INSTITUTO NACIONAL DE HABITAÇÃO

Final Report

July 31, 1991

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1801 K Street, N.W.
Washington, DC 20006

Telephone 202 296 0800

Price Waterhouse

July 31, 1991

Mr. David Painter
RHUDO/Lisbon
c/o American Embassy, Lisbon
Portugal

Dear Mr. Painter

Re: Financial Sector Development Project
Contract Number PDC-2206-Z-00-8191-00
RHUDO/Lisbon - Capital Market Development and Housing Finance
PIO/T No. 90002

Attached please find fifteen copies of our Final Report, ten for the INH and five for RHUDO/Lisbon, on Housing Finance, Capital Market Development, and the Instituto Nacional de Habitação as prepared by Price Waterhouse, Prime Contractor under FSDP.

We greatly appreciate the opportunity to be of service on this interesting and very important assignment, and look forward to the possibility of further collaboration with you in the future.

Sincerely,

J. Richard Breen
Project Director, FSDP

cc. Mr. José Trindade, RHUDO/Lisbon
Mr. Peter Kimm, APRE/H
Ms. Sandra Frydman, APRE/EM

RHUDO/LISBON - HOUSING FINANCE, CAPITAL MARKET DEVELOPMENT, AND THE INSTITUTO NACIONAL DE HABITAÇÃO

TABLE OF CONTENTS

APPENDICES

EXECUTIVE SUMMARY

I. INTRODUCTION AND BACKGROUND

Through its program of assistance to the Instituto Nacional de Habitação (INH), RHUDO/Lisbon contracted a team of consultants from APRE's Financial Sector Development Project to review the structure of housing finance in Portugal in the context of the country's evolving financial markets and to assess strategic alternatives for the INH. The project team was asked to review trends in the evolution of Portuguese financial markets, assess strategic alternatives for the INH, and evaluate the feasibility of new capital market instruments related to financing the construction and acquisition of housing, particularly in the area of social housing.

During the course of this assignment, the Portuguese Council of Ministers proposed a Decree-Law which, if adopted, will have substantial implications for the future structure and operations of the INH. The most important change which will result from the implementation of the Decree-Law will be that new potential sources of capital will be made available to the INH. The INH currently relies on government capital investment and subsidies and "take-out" financing by the state-owned savings bank to fund its operations. Under the draft Decree-Law, the INH will be authorized to issue mortgage bonds to fund its lending programs and will have its capital open for investment by public and private investors. The draft Decree-Law requires that the majority interest in the INH be retained by the government and government-owned entities. But, ownership by government-owned and private profit motivated enterprises will have a significant impact on the INH's management, policies and operations. The INH's governing board will be expanded to include representatives of the new investors who presumably will have different incentives than the current government-appointed board. Because the INH will be required to generate sufficient income to pay investors a satisfactory return on their investment, management may have to be more concerned with financial performance than meeting social goals.

The draft Decree-Law resolved many of the issues which were the initial focus of the project assignment and set out a strategic course for the INH. Therefore, many of the strategic alternatives for the INH proposed for evaluation by the consulting team were no longer feasible options. As a result, the recommendations contained in this report focus on preparing the INH to adapt to the changes with which it will soon be faced and to assume a new role in the private and public financial markets. Specifically, the recommendations address the management of the INH in the context of its changing capital structure, opportunities the organization may have for leveraging its relationship with its new shareholders, and possibilities for taking advantage of its newly granted authority to issue mortgage bonds.

The body of this report addresses two major areas: the structure of the Portuguese financial markets including housing and construction finance, and future prospects for the INH. In this regard, it addresses in detail the feasibility of creating a secondary mortgage market facility within the INH. The intention of this report is to help prepare the INH for its upcoming negotiations with the Government and capital contributors regarding its new capital structure and lines of activities.

II. THE MACROECONOMIC ENVIRONMENT AND THE HOUSING FINANCE SYSTEM

The driving force behind the Government of Portugal's macroeconomic policies is the need to bring Portugal into conformance with the rest of the European Community prior to the country's full integration in 1994. In the financial sector, Portugal's principal problems are high inflation, excess liquidity and interest rates well above European and world market levels. Until recently the Government and the Bank of Portugal sought to manage the economy through direct controls to limit the supply and cost of credit. The banking system was utilized primarily to finance the government's massive financial requirements and the role of the Bank of Portugal was to facilitate government finance. Inflation was controlled by freezing money at the Bank of Portugal. In the last two years the Bank of Portugal has shifted to a system of indirect monetary controls more in line with European Community members.

An integral part of the modernization of the Portuguese economy is the modernization of its financial system. The Portuguese financial system is undergoing rapid and comprehensive change. Reprivatization of the banking system, the opening of new banking and nonbanking financial institutions, and the development of new financial instruments are increasing the depth and diversity of the Portuguese financial markets. The stock markets are increasing in importance and the public and private bond markets have become major sources of capital for financing both government and industry. Emerging financial institutions function not only as financial intermediaries, but also provide a market for capital instruments.

The impact of the structural changes in the Portuguese financial system has not yet been felt in the housing finance sector, although housing credit represents the largest credit sector in the financial system. As of the end of 1989 housing credit outstanding totalled almost 1 billion contos but over 81 percent of that credit was granted by three specialized credit institutions. Of these three, the most important is the government-owned Caixa Geral de Depositos (CGD), which alone accounted for 62 percent of all housing credit outstanding. The CGD not only is the largest housing credit institution in Portugal, it is the largest credit institution of any class and at over $21 billion in assets, ranks 205th in the world. The CGD holds a mortgage portfolio of over 608 million contos ($4.1 billion) in over 290,000 loans. Housing credit represents almost 51 percent of all credit extended by the CGD. The CGD is the principal source of subsidized and preferential housing credit, which represents over 65 percent of all housing credit in

Portugal. The CGD funds its lending activities through deposits and is the primary depository institution for Portuguese household savings.

The existing mortgage subsidy system is complex, costly to administer and of limited profitability. As a result, most commercial banks find subsidized housing loans an unattractive investment. The increasingly competitive banking environment will squeeze margins even further, and make it even more unlikely that any institutions other than the Specialized Credit Institutions will provide subsidized housing credit. Given that one of the Specialized Credit Institutions, the Credito Predial Portugues, is scheduled for privatization, the CGD may actually have to take on more subsidized lending than it did in the past. In the future, the private banks will limit their housing credit activities to the high end of the market. This would leave the lower and middle income, subsidized borrower to the Specialized Credit Institutions.

In the future, the banking system will need new sources of liquidity for housing loans, as well as to remove existing housing credits from their balance sheets. The development of a secondary mortgage market would offer investment opportunities for insurance and pension management companies, which have a substantial appetite for high-quality financial instruments. A secondary mortgage market would enhance the efficiency of the housing finance system. The problem at hand is to find the right instrument at a price acceptable to investors.

In April 1990 a mortgage bond law was passed which authorized the issuance of bonds that are supported by the cash flows of a pool of mortgages. The team's conclusion is that such a bond could not be sold without the guarantee of either the government or a well known, financially sound institution. It is believed that such an instrument would sell to investors at an estimated 75-150 basis points over government bonds. However, existing government subsidized mortgages do not conform to the requirements of the decree-law establishing the mortgage bonds. In most cases the loan-to-value ratios (85-90%) are higher than permitted by the new mortgage bond law. More critical, the cash flow of these credits is affected by interest capitalization features, which may change from year to year. The lack of standardization forces the prospective investor to examine each and every loan contract as a unique risk. As long as this system is in place, the mortgage markets cannot develop the levels of efficiency, homogeneity and stability necessary to effectively access the capital markets.

III. THE ROLE AND PERFORMANCE OF INH

INH promotes the construction of low and moderate cost housing with subsidized construction loans. Borrowers include cooperatives, municipalities, and private developers who develop housing projects eligible for subsidy under the government's program for controlled cost housing. Housing units financed by the INH are generally purchased by families earning approximately two to three times the national minimum wage. The INH is virtually the only source of subsidized construction loans in the country since it not only grants subsidized housing credits directly, but controls the flow of subsidies to other institutions which extend subsidized construction loans. INH also is unique in that it gives substantial technical assistance to its borrowers, thus enabling cooperatives to manage construction costs and maintain quality control. The INH also has other programs for housing rehabilitation, rental housing for municipalities, and relocation of slum dwellers, as well as land acquisition.

The INH's volume of credit activity has increased at impressive rates. A recent program review documented that between 1987 and 1989, the INH increased the volume of credit approved years by 67%, 103%, and 186% respectively. At year end 1990, there were over 14,500 units under construction, the highest year end balance in its history. During 1990 INH financed units faster than they were able to be financed by the CGD. The result was a severe cash flow deficiency.

Assuming that a more effective relationship can be worked out with the CGD, that AID provides the additional $30 million HG loan, and that the Government of Portugal continues to pay the subsidies due to the Institute, INH appears to be sufficiently well-capitalized to continue its programs at about the 7,000-10,000 units per year. INH's capital is not sufficient for it to make long-term loans as well as shorter-term construction loans. In this regard, the program of long term loans to the municipalities, while an important program, is not financially viable.

IV. FUTURE STRATEGIC DIRECTION OF THE INH

As required by the Scope of Work, the team examined several alternative directions for the future evolution of the INH. Specific reference was made to INH becoming a mortgage bank or an S&L. For several reasons the team did not believe these were feasible directions for the INH. As an organization, the INH lacks experience as a banking institution. Moreover, there did not appear to be a lack of primary lenders in the market. Indeed, the CGD alone, with 400 branches, represents such a formidable force that it is difficult to believe that there are real gains to made by building a parallel structure. Moreover, in order to convert INH into a banking institution, a large capital investment would be required to finance the physical, administrative and human resource infrastructure. It is doubtful, at best, that the expenditure of funds to build a new state-owned retail housing bank would be a priority use of funds to address the problems of the housing sector, or the lower income home buyer.

The Government of Portugal's recent decisions to convert the INH from an arm of government to a quasi-governmental institution and to authorize the INH to issue housing bonds give a clear signal that while the Government intends the INH to continue to fulfill its mission to finance controlled-cost housing construction, it is seeking ways to reduce its direct financial commitment to the institution. Government cannot be relied upon as a permanent source of direct funding and the emerging private capital markets provide opportunities to channel investment capital into the housing market and particularly, the controlled-cost market served by the INH.

The team recommends that the original and basic mission of the INH be preserved. The INH performs a unique function in the market which private sector firms are not likely to provide and which state-owned institutions would prefer not to be required to offer as they struggle to assume their role as full fledged members of the European financial community. Financing controlled-cost housing will continue to require government intervention and in the seven years since its creation, the INH has developed a significant level of expertise to serve the low and moderate-income housing market. The team believes that the issue is not whether the INH should continue to exist, but how to leverage the INH's capabilities and its new legal status to maximize its effectiveness in meeting the housing needs of the country.

The proposed changes in the INH's statutory authority and the anticipated capital investment in the INH by the CGD create some new possibilities for the future role of the INH in the housing finance system of Portugal. One possibility is that the INH will become an affiliate of the CGD through the CGD's investment in the capital of the institution. As a "captive" construction lender, the INH would provide the construction financing for houses for which the CGD would provide the permanent mortgages. This option is not recommended because it would not serve to increase participation in the housing finance market and would make the market even more monopolistic than it is today. A better approach would be to create strong linkages with the CGD and at the same time undertake programs designed to provide incentives to other banks and financial institutions to participate in financing programs for low and moderate income housing. However, because of the CGD's dominance of in the housing finance market, any meaningful program will require CGD's support and active participation.

Another possibility is for the INH to serve as a mortgage conduit for the CGD and other mortgage lenders. The CGD could sell pools of high quality performing mortgages from its portfolio to the INH which would, in turn, finance the purchase of these assets by issuing mortgage bonds. The INH would purchase loans originated and serviced by the CGD and other mortgage originators, packaging the loans and issuing securities secured by these loans. The payments on the mortgages in the pools would meet the bond debt service requirements. These bonds would be marketable in the Portuguese capital markets if they carry the guarantee of the CGD, a AAA rated credit. The benefits of such an arrangement to the CGD and other participating mortgage lenders are apparent. The originating bank would have a new source of liquidity to finance its mortgage and other lending activity, making the institution less dependent on household deposits. By originating and selling assets, the mortgage lender could expand its lending activity and restructure its balance sheet to concentrate on more profitable shorter-term lending without the need for additional capitalization.

Initially, the INH would receive little direct benefit from such an arrangement with the CGD and could be exposed to additional risk if the program is not structured properly. However, over time the INH would develop a reputation in the capital markets which could provide the institution with a base to develop capital market instruments issued on its own credit. In addition, a program linking the INH with the CGD could improve the working relationship between the two institutions and potentially reduce the lag between the completion of INH construction and the CGD's granting of permanent mortgages on the units constructed which has caused such a financial drag on the INH.

While the team is not necessarily recommending that a mortgage conduit program be initiated, it is one possibility which could be explored to tap new sources of capital for housing, and to develop the institutional capability within the INH to broaden its activities. In order to expand the level and scope of its financing the INH must develop new sources of funding. Government is not going to supply these resources and the recapitalization of the INH by the CGD and other institutions will not provide a long-term source of funds to expand the INH's programs. To assure its permanent viability, this additional capital should be leveraged through debt financing in the capital markets. However, at the present time the INH does not have the record of sound financial operation which is the prerequisite for going directly to the market for financing. Until it establishes a credible reputation in the market, the INH will have to rely on other credit institutions, and the CGD in particular, to provide the credit enhancement for successful issuance of capital market instruments.

V. RECOMMENDATIONS

1. The INH should continue to promote controlled cost housing construction.

   a. The mission is unique in the Portuguese housing finance market. No other institution actively promotes the building of controlled-cost housing, and provides technical assistance to assist the cooperatives and municipalities to implement these projects.

   b. The volume of housing units financed in the past three years has represented a significant percentage of total units constructed, reaching as much as 14% of the market in a single year.

   c. INH has the human resource capacity to continue serving this role and will be limited only by its financial resources, and its ability to manage its funds with maximum efficiency.

2. The INH should take specific steps to improve the management of its financial resources. In the past, INH had surplus liquidity. In the future, greater attention will have to be paid to the efficiency with which financial resources are used.

a. The staffs of the INH and the Caixa Geral de Depositos should organize formal mechanisms to coordinate the construction financing program of INH with the permanent financing program of the CGD. The aim of this coordination should be to adjust the pace of the construction program to the likely availability of permanent financing as agreed to by the CGD. Without such a mechanism, the INH is likely to repeat the experience of 1990 and build new units which remain unoccupied for significant periods of time due to a lack of permanent financing.

b. The INH should seek to engage the Government and the municipalities in a dialogue to determine how the long-term municipal programs will be funded. INH should demonstrate how this type of lending absorbs its liquidity and could lead toward bankruptcy, an outcome which the government certainly would not like to repeat. The existing financial structure does not permit the INH to make long term loans and to carry on the existing program of low cost housing construction loans at the same time. The average maturity of the INH portfolio has climbed to 6.1 years primarily because of the influence of this type of loan.

c. INH should adopt policies to conserve cash during the construction period, We suggest that the INH end its practice of capitalizing interest due over the construction period. This practice increases the cost of the unit to the ultimate buyer, and partially undermines the original rationale of subsidized construction lending.

3. The INH should consider options to leverage its resources. Two options are worthy of serious consideration:

a. Guarantee Fund: This fund could be used to guarantee that percentage of a qualifying controlled cost housing construction loan that exceeds a bank's normal commercial loan-to-value ratio. Commercial banking practice limits construction loans to 65% of the total value of the project. This fund could guarantee an extension of that loan to say 85% or 90% of the value. If the INH were able to make these arrangement with the CGD or other banks, the effect would be to leverage its capital and increase the production of controlled cost housing.

b. Senior subordinated financing scheme: Under this scheme, the INH would finance a part of a construction project together with a senior construction lender. The senior lender would be paid first, then the INH, from the proceeds of the permanent take out. A senior subordinated financing scheme would allow the INH to increase the production of controlled cost housing with only a minimal investment of its own capital.

4. <u>The Government of Portugal should encourage the development of a secondary mortgage market to mobilize new sources of funds for the housing sector. At the same time, the INH should inform the government of the inherent risks involved if it were to issue mortgage bonds.</u>

   a. The INH should take great care to insure that it does not purchase substandard housing credits from the CGD, the CPP or any other credit institution which could expose the INH to what could prove to be catastrophic losses.

   b. Issuing mortgage bonds could divert the INH's managerial resources from their principal function of promoting controlled cost housing. To undertake any volume of transactions, the INH would need to make substantial investments in staff and equipment which may not be fully funded by the spread on mortgage securities.

   c. The INH would not be able to issue mortgage bonds acceptable to the market without either a government guarantee, or the guarantee of a highly regarded institution. Nevertheless, under certain conditions, mortgage bonds could be acceptable to investors.

   d. By issuing mortgage bonds, the INH would begin the process of building up its market reputation. This may allow it to issue bonds on its own in the future at a financially viable rate of interest.

5. <u>The principal parties interested in developing a secondary mortgage market should jointly study and implement changes to develop mortgages more acceptable to investors in the capital markets.</u>

   a. A working committee should be established, including the principal mortgage lending institutions and interested capital market institutions, to develop a standard mortgage loan contract acceptable to Portuguese capital markets.

   b. A study should be performed on the feasibility of a mortgage insurance system in order to provide the credit enhancement necessary to facilitate the securitization of mortgage loans.

6. <u>A study of alternatives to the current system of subsidy should be undertaken.</u>

   a. Although outside the scope of work of this study, we would like to supplement this report with a final recommendation. We recommend that alternatives to the current system of subsidies for low income borrowers be explored. One possibility would be for the government to directly subsidize the home buyer with no involvement of the mortgage lender. One means of delivering this subsidy would be through the income tax system. The aim of this method would be to allow the banks to structure their mortgage lending business towards all levels of income on a commercial basis.

b. We suggest that a study be performed on the impact that tax preference treatment of housing bonds, which could be issued to finance low-income housing, would have on the cost and marketability of those instruments as well as the affordability of housing finance.

I. INTRODUCTION AND BACKGROUND

Following the closing of the Fundo de Fomento da Habitação (FFH) due to financial difficulties, the Government of Portugal established the Instituto Nacional de Habitação (INH) to continue its support for housing programs for low-income families. The INH was to be an instrument of housing policy and a conduit of financing and subsidies. Unlike the FFH, the INH would not undertake any construction directly, rather it would ensure that construction projects were financially viable and up to government standards, and that construction costs would be controlled so that the housing units would be affordable to low-income families. The INH would have its construction loans "taken-out" by the Specialized Credit Institutions of the Government, principally the Caixa Geral de Depositos.

In order to reduce the fiscal burden of supporting INH programs, it was to draw on domestic and international sources of funds to supplement the Government's initial capital contribution. The INH had access to proceeds from a nearly $50 million National Westminster Bank loan that was contracted by the short-lived and immediate successor to the FFH. In addition, it borrowed $75 million from A.I.D.'s housing guarantee funds, and may still draw down an additional $30 million. The INH has had less success in the domestic market. It borrowed nearly $20 million from the Caixa Geral at a rate that exceeds the INH's lending rate.

The economic and financial environment in which the INH was created has changed dramatically. The financial system is being brought up to European Community standards in anticipation of Portugal's full adoption of EC standards and directives in the early to mid-1990s. Banks are preparing themselves for European-quality competition by strengthening the quality of their assets, mobilizing additional resources, and enhancing their capital. As a result, the willingness of even the Specialized Credit Institutions, one of which is up for privatization, to engage in less profitable lending, is waning.

A. USAID's Low-Cost Housing Program

In 1984, USAID launched a Housing Guarantee Program in the context of an evolving Government of Portugal approach to support for low-income housing. It sought to support the Government of Portugal in its efforts to transfer responsibility for production of low-cost housing to the construction sector. The Government's role would be limited to the promotion of housing at controlled costs.

The Housing Guarantee (HG) program set out to "...support...GOP initiatives by helping INH and municipalities address the problems of subsidies, affordability, norms and standards, revision of rental laws, and production of new types of housing."[1] The goal of the Housing Guarantee Program was to increase the supply of housing affordable to low-income families without increasing subsidies. During the course of this assignment, a Program Review Team was in the field to review progress made toward those objectives.

Beginning in 1985, A.I.D. extended four tranches of HG loans for a total of $75 million as of the first quarter of 1991 and in 1989 approved another $55 million, $25 million of which has been drawn down. $30 million will be drawn down in 1991-1992. This is likely to be the last extension of a HG loan to Portugal. As of July 1991, there is no longer a RHUDO in Lisbon. Therefore, the need of the INH to know how to mobilize additional resources in the financial markets has taken on some urgency. However, since the INH is currently undergoing a change in capital structure that will likely result in a capital injection from the government and specialized credit institutions, the need for new resources is not immediate.

B. PROJECT DESCRIPTION AND SCOPE

RHUDO/Lisbon contracted a team of consultants from APRE's Financial Sector Development Project to review the structure of housing finance in Portugal in the context of evolving financial markets and to assess the strategic alternatives for the INH. The project team was asked to review trends in the evolution of Portuguese financial markets, assess strategic alternatives for the INH, and identify conditions for new capital market instruments related to financing the construction and acquisition of housing, particularly in the area of social housing. The team addressed two broad areas: the structure of the Portuguese financial markets, including housing and construction finance, and future prospects for the INH. In this regard, it addresses in detail the feasibility of creating a secondary mortgage market facility within the INH. The Scope of Work is attached as Appendix C.

During the course of the assignment, the Portuguese Council of Ministers drafted a decree-law which has substantial implications for the INH. The most important changes which will result from the enactment of this decree-law are that the INH will no longer be an instrument of the Portuguese Government, the institution's equity capital may be

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[1] A Review of Portugal 150-HG-III Low Income Housing Program. US Agency for International Development. December 18, 1989. p.1, as quoted from the "Portugal Low-cost Housing Project: 150-HG-003." Project Paper, September 1984.

held by entities other than Government, the INH will have to pay a market rate of return to investors in its capital instruments, and the INH will be authorized to issue mortgage bonds under the 1990 mortgage bond authorization Decree-law. The proposed statutory changes in the INH's legal status and authority have determined a strategic course for the INH and settle many of the issues which were to be the focus of this assignment. Many of the strategic alternatives proposed for consideration by the consulting team are no longer realistic options.

As a result, the team focused its recommendations on preparing the INH for the changes it is about to face. The intention is to help prepare the INH for its upcoming negotiations with the Government and potential investors regarding the INH's new capital structure and lines of activities. Specifically, the team addressed the financial management of the INH in the context of its changing capital structure, opportunities it may have for leveraging its relationship with its new share-holders, and possibilities for it to expand its activities by issuing mortgage bonds.

The Scope of Work also called for an assessment of the current and potential market for municipal debt finance. During the course of its assignment, the team learned that, although municipalities are beginning to take responsibility for certain tasks that were traditionally the domain of the central government, they as of yet have little revenue-raising authority. Until they have a revenue stream, they will not be able to issue bonds of any type. The question of whether they ought to have more authority in this regard is political, and therefore beyond the scope of this assignment. Additionally, the credit record of municipalities is questionable at best. Until they build up their creditworthiness, there is very little prospect of municipalities attracting investors at rates they could afford to offer. Concurrent with this assignment, another consulting team contracted by RHUDO/Lisbon was in Portugal conducting a Program Review.

C. PROJECT STAFFING AND METHODOLOGY

This study was conducted by a team of FSDP consultants consisting of: J. Richard Breen, Team Leader; Elaine Weis, Housing Finance Specialist; Barbara Cassidy, Capital Markets Specialist; and Jill Minneman, Technical Support. Assistance was also provided by Ricardo F. Pinheiro of Price Waterhouse/Lisbon. The study took place over a three-week period in May 1991.

Information for the study was obtained from interviews and a broad range of written documents. Team members conducted interviews in Lisbon with both public and private sector representatives (see Appendix B for a list of persons contacted). In Lisbon, the team met with government officials of the Bank of Portugal and the Ministry of Finance. Meetings also were held with public specialized credit institutions, private commercial banks, and nonmonetary financial firms such as insurance companies, pension funds, investment companies, rating agencies, real estate developers, government advisers, and other participants in the financial markets. Written sources used for this project include annual reports and research studies of Portuguese financial institutions, official publications of the Bank of Portugal, journals, internal documents and audited financial statements of the INH. The team also relied upon documents of Portuguese trade associations.

II. THE FINANCIAL SYSTEM IN PORTUGAL

A. The Economic and Financial Environment

Since joining the European Community in January, 1986, Portugal has experienced five years of rapid economic growth, with annual growth rates averaging over 4 percent, well above the EC average. Portugal's economic growth has been fueled by strong domestic demand and capital inflows from other EC countries and Brazil. While these factors have generated robust economic expansion, they have contributed to a persistent rate of inflation well above that of Portugal's EC partners. Portugal's efforts to modernize and privatize its economy has also been at the expense of extensive government debt. Concerns about the impact of market integration and competition within the EC have given rise to concerns about the ability of Portuguese enterprises to compete in a unified European market. As a result, Portugal has received reprieves from the EC which will allow some policies to be phased in over a two to three year period. Among these policies are those affecting trade, agriculture and capital inflows.

While Portugal has undergone much recent financial deregulation, it has not yet reached the point where it can be brought into the Exchange Rate Mechanism (ERM) of the European Monetary System without disruption of the domestic monetary system. Portuguese authorities believe that a transition period is required and Portugal has been granted a three year reprieve from further liberalization of short term capital flows. Greece and Portugal are the only two members of the EC currently outside the ERM. It is uncertain when Portugal will join the ERM since bringing the country in line with the rest of the members could result in a recession, unemployment and a devaluation of the escudo which would have negative political ramifications for the Government.

The most serious problem facing the Portuguese economy is high inflation, which has remained above 13 percent despite stringent credit controls and restrictive monetary policy. Recent economic data indicate that inflation in Portugal peaked in the fourth quarter of 1990 and has ebbed somewhat since. The Government has announced that bringing inflation under control has the highest priority and is attempting to dampen inflationary expectations by sending strong signals to the capital markets that it would like to see interest rates decline as soon as inflation allows. There are some signs that the Portuguese inflation rate may abate to some extent, but there is a high degree of skepticism among private forecasters that the government will be able to achieve its goal of single digit inflation by the end of 1991. Less sanguine forecasters expect inflation to ease only slightly to a 10 percent range by 1992 and to remain at that level for the next several years.

The persistence of inflationary expectations has impeded the development of a long term capital market in Portugal and has led lenders and investors to demand a high inflation premium. Issuers and investors simply are not willing to gamble on the Government's ability to manage the economy. As a result, there are few government or corporate bonds with maturities of more than five to seven years and bank loans usually have maturities of one year of less.

Interest rates on bank credit and government and corporate bonds reflect the uncertainty about the future of the Portuguese economy and monetary policy with real interest rates of over 6 percent. As of the end of May, 1991, the rate on short-term government debt was above 19 percent. The Association of Portuguese Banks (APB) 90-day interest rate indicator, the Portuguese prime rate, rose from 20.4 percent at the beginning of 1990 to 24 percent as of the end of May, 1991. The best corporations could raise debt in the capital market at 22-23 percent, including up-front fees while weaker corporations would have to pay 27 percent or more. The small construction companies so essential to the housing market would be required to pay over 30 percent.

Nonsubsidized housing credit is extended by the mortgage lending institutions at a 24 to 26 percent rate and interest rates on consumer credit other than housing are even higher. Consumers are required to pay a 7 percent government tax above the basic or prime rate, which in May, 1991 would result in a 31 percent interest rate on automobile loans and a 33 percent rate on other types of consumer credit. Credit cards typically carry a rate 10 percent above the regular consumer credit interest rate, or about 40 to 41 percent as of the end of May, 1991. Government officials and financial executives recognize that interest rates at these levels cannot be sustained in a more competitive market environment.

A well functioning financial system will be crucial to the successful integration of Portugal into the European Community. While the key to building an efficient financial system will be the maintenance of price stability, another principal objective is to fashion a competitive, diversified financial system capable of financing Portugal's economic growth and development and competing with financial institutions from other EC countries. Both good policy and good institutions will be required to accomplish these objectives.

The Government of Portugal (GOP) has taken steps to support the development of the financial sector. The Bank of Portugal has been granted some independence to implement monetary policy. The principal tools of monetary policy have shifted from direct credit allocation and controls to a system of indirect controls through reserve requirements, open market operations and interest rate policy. Laws and regulations have been adopted which authorize the establishment of private banks, insurance companies, pension funds, investment companies and a broad range of other financial services providers. The stock exchanges have experienced substantial growth and trading is active. The GOP has begun the process of re-privatizing most of the large, state-owned banks and insurance companies that were nationalized in 1975, and intends to divest itself of most government-owned institutions within the next several years.

B. The Structure of the Financial Sector

After the revolution of 1974, the Portuguese banking system was nationalized and, until 1983, the Portuguese constitution prohibited private ownership of banks. Beginning in 1983 steps were taken to liberalize the banking system and return the ownership of most public institutions to private hands. The principal legislation establishing the legal and regulatory framework for a private banking system was adopted in 1986. Since that time the Portuguese financial system has been undergoing a rapid transformation as the financial institutions nationalized by the government in the 1970's are returned to private hands and new bank and nonbank financial organizations are established offering a wide range of financial products and services. Private sector institutions are growing rapidly and the largest private sector bank, the Banco Commercial Portuguese, ranks among the five largest banks in the country. Just four years ago it was the fifteenth. However, most financial institutions in Portugal remain public, and most prominent among them is the Caixa Geral de Depositos, a state-owned savings bank that will remain in government hands. Public sector institutions still hold the majority of banking resources.

The Portuguese financial system is on the road to increasing liberalization and deregulation. This has given rise to competition, internationalization and disintermediation, and has led to the development of new ways to mobilizing savings and allocate resources. Recent changes in the system have resulted in new institutions, products and services.

There are three main groups of institutions within the financial system:

a) Monetary Financial Institutions: these include the monetary authority -- the Bank of Portugal and commercial, savings and investment banks;

b) Nonmonetary Financial Institutions: these can grant credit but cannot take deposits. They are consequently blocked from creating money;

c) Other Nonmonetary Institutions: these cannot grant credit, but mobilize savings for investment in financial assets.

The following chart gives the general structure of the Portuguese financial system[2].

Monetary Financial Institutions	Monetary Authorities	Ministry of Finance Bank of Portugal
	Others	Commercial Banks Savings Banks Investment Banks
Nonmonetary Fin'l Institutions	Portuguese Finance Companies Investment Companies Leasing Companies Venture Capital Companies Regional Development Companies Factoring Companies Other Parabanks	
Other Nonmonetary Fin'l Inst.	Insurance Companies Investment Management Companies Pension Management Companies Stock Exchange Money Market Intermediary Companies	

Competition among financial companies is intensifying as existing institutions strive to gain market share and structure themselves to survive and prosper in the post-1992 European financial environment and as new institutions enter the market. As shown in Table 1, the number of financial institutions in Portugal increased from approximately 326 as of December 31, 1985 to about 551 as of the end of 1990. Most of the growth took place in the nonbanking financial sector, principally in subsidiaries or affiliates of banks. Strategic alliances and affiliations are being formed among banks, insurance companies and other financial companies to enable Portuguese-owned and operated financial services conglomerates to withstand the anticipated competition from larger,

[2]The discussions of the structure and important trends of the Portuguese financial system draws heavily upon a Banco de Fomento e Exterior study entitled, "O Sistema Bancário Portugues face a Criação do Mercado Único Comunitário," by José Gabriel P. Calixto, 1990.

Table 1

COMPOSITION OF THE FINANCIAL SYSTEM

	Number of Institutions In Operation			Total Assets (millions of contos)	
	31/12/85	31/12/89	31/12/90	31/12/87	31/12/89
Total Commercial, Investment & Savings Banks	25	29	33	7172	10145
Commercial Banks & Branches of Foreign Banks	20	24	26	4596	6640
Long-Term Investment Banks	2	2	4	369	476
Savings Banks (CGD, CPP, CEL/MG)	3	3	3	2207	3028
Caixas Economicas (excl. CEL)	16	11	11		59
Agricultural Mutual Credit Coops. (including Caixa Central)	195	218	224		360
Investment Companies	6	18	16		222
Leasing Companies	7	16	21		355
Factoring Companies	2	4	5		23
Hire Purchase Finance Companies		1	9		0.6
Regional Development Companies		1	1		0.5
Other Financial Institutions					
Real Estate & Securities Investment Management Companies		18	23		5
Assets Portfolio Mgmt. Companies		8	11		0.4
Money and Exch. Market Intermediaries		6	5		0.4
Mortgage Lending Intermediaries					
Dealer Firms		1	6		1.7
Brokerage Firms		6	8		2.1
Administration Companies (SACEGrupo) (excluding those in liquidation)		26	25		58
Venture Capital Companies		25	25		
Entrepreneurial Development Companies		3			
Pension Fund Management Companies		12			2.9
Real Estate Mgmt. and Investment Companies			42		87.3
Others (excluding those in liquidation)	7	6	6		38
Insurance Companies	50	65			470
Pension Funds		178			108
Representation Offices of Credit Institutions	18	17	20		
Investment Funds		31	60		245

* Source: Mr. Jose da Silva Lopes, Financial Consultant to Bank of Portugal

** All figures are approximate

more sophisticated European institutions when Portugal becomes fully integrated into the EC by 1994.

Increasing competition in the financial sector has resulted in three significant changes: (1) a proliferation of institutions operating in the market, with the opening of the system to new private institutions, Portuguese and foreign; (2) enormous development of parabanking activities: investment funds, venture capital companies, money market intermediaries, leasing companies, factoring companies, and regional development companies; and (3) prospect of growth in commercial activity, brought about by European integration.

Along with the increase in the number of institutions, there also has been diversification in the range of products and services offered by the system and by each institution. This transformation is particularly notable in the area of new investment instruments. While two or three years ago there were only term deposits, currently there an array of alternative investments such as Treasury Bills, participation units in investment funds, participation securities, stock, various types of bonds, certificates of deposit, and other special forms of deposits.

Another critical element of the transition of the Portuguese financial sector to a market system has been the transformation of government financing. Until the mid-1980s, Government financed itself through the state-owned banks. In 1985 a decree law authorized the issuance of Treasury bills. Since that time, Government has utilized Treasury bills and an increasing variety of market instruments including TRMs (one- to seven-day certificates), TIMs (six-month certificates), FIPS (medium-term floating rate notes), CLIPS (medium-term revolving floating rate notes repriced every six months) and OCAs (medium-term capital appreciation bonds).

Important progress has been made toward liberalizing interest rates. In June 1984, there were only 12 interest rates, all of them administratively determined. Starting in March 1987, the Bank of Portugal determined only two rates: on term deposits between 181 days and one year, and the maximum lending rates for certain credit operations.

Since 1985, capital markets have been reactivated after a lull in activity. Exchange of shares in 1983 was valued at 44,000 contos, compared to 198,734 contos in 1987. This increase in activity is attributed to an improvement in the economic environment particularly in the area of inflation, a desire on the part of credit institutions to reduce the term of their liabilities, and fiscal incentives. The increase in capital market transactions has been accompanied by some banking disintermediation. While 60% of financing in 1985 came from bank credit, in 1988 only 30% was from this source.[3]

Paradoxically, Portugal is experiencing increasing diversification of financial services and products at the same time that financial resources and power are being concentrated in a few large holding companies. Competitive market factors are the driving force behind the business strategies of the largest Portuguese financial companies to gain and solidify market share across the spectrum of the financial services sector. For example, the largest bank in the country, the publicly owned Caixa Geral de Depositos, is the lead organization of the Caixa Geral de Depositos Group. The Group includes the Banco National Ultramarino and the third largest insurance company in the country, FIDELIDADE, as well as leasing, real estate and investment company subsidiaries. Caixa now has international ties, having recently purchased the Spanish retail network of Chase. The private Banco Commercial Portuguese is a holding company for insurance, leasing, real estate, asset management, merchant banking, brokerage and factoring subsidiaries. The partially privatized Banco Portugues do Atlantico is the lead organization in a group consisting of over 60 financial and nonfinancial enterprises. The Espirito Santo Group, which is affiliated with the largest bank in Europe, Credit Agricole, owns the fourth largest Portuguese insurance company, Tranquilidade, and has banking interests in Europe and the United States. The Espirito Santo Group is expected to win the bid for the Banco Espirito Santo e Comercial de Lisboa, a publicly owned bank that was owned by the Espirito Santo family prior to nationalization.

The financial sector regulatory structure also has undergone significant changes: Administered ceilings for bank credit were eliminated in early 1991; the required reserve base was expanded to include government securities as well as sterile reserves at the Bank of Portugal; the EC Banking Directives on risk-based capital and solvency ratios were adopted; strict requirements for establishing adequate loan loss reserves were imposed; restrictions were placed on externally financed credit to control the inflow of foreign capital; high barriers to market entry and expansion of banks were established; laws authorizing the issuance of mortgage bonds and other financial instruments were adopted and a new comprehensive law establishing the framework for prudential regulation of the securities market has been issued.

[3] The Portuguese Debt Markets. Finantia. August 1990. p.5.

C. The Portuguese Banking System

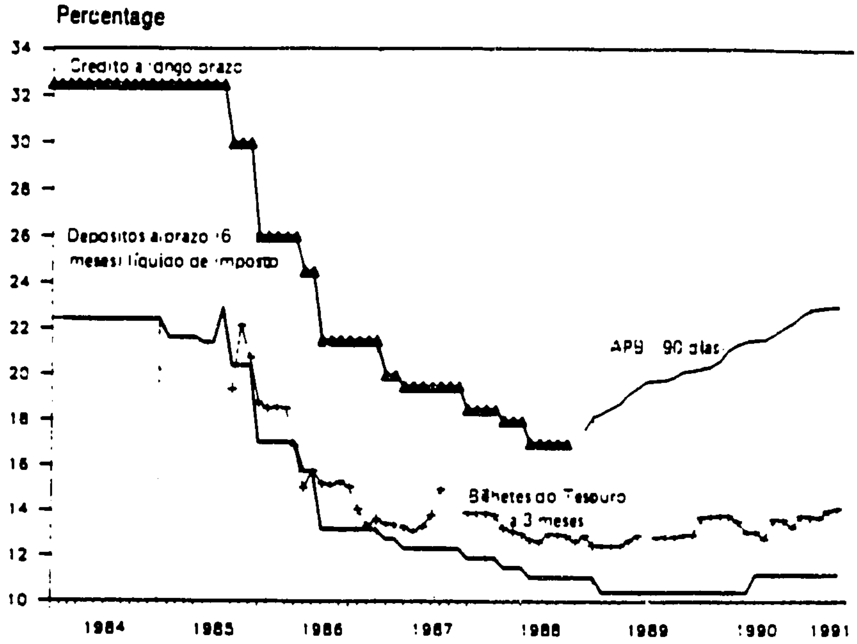
The Portuguese banking system consists of public and private commercial banks and savings banks and publicly-owned investment banks. As of December 31, 1990, there were 33 commercial banks, including foreign banks licensed in Portugal, three savings banks and four investment banks. Commercial banks have broad credit and investment authority including granting credit for agricultural, commercial, industrial and consumer purposes, investing in government securities, and investing in debt and equity securities of financial and nonfinancial enterprises. Until 1975 commercial banks could not grant credits for a term of more than one year and it was not until 1986 that the commercial banks were authorized to accept term deposits with maturities of one year or more. Despite the liberalization of these maturity restrictions, both credits and deposits at commercial banks are highly concentrated in maturities of less than one year. Bank lending also is concentrated in the manufacturing and wholesale and retail trade sectors, with over half of all commercial bank credit outstanding in these two sectors.

Savings banks have a somewhat more limited franchise but can still offer a broad range of banking services and products. Investment banks were created to offer medium and long-term credit for economic development, particularly in export financing. The largest savings banks--the Caixa Geral de Depositos (CGD), Credito Predial Portugues (CPP) and Caixa Economica de Lisboa/Montepio Geral (CEL/MG)--are categorized as specialized credit institutions, and historically have concentrated their credit activities in the housing sector. Over 80 percent of all credit granted to individuals for home purchase was held in the savings banks as of the end of 1989. This class of credit accounted for 43 percent of total loans held by savings banks.

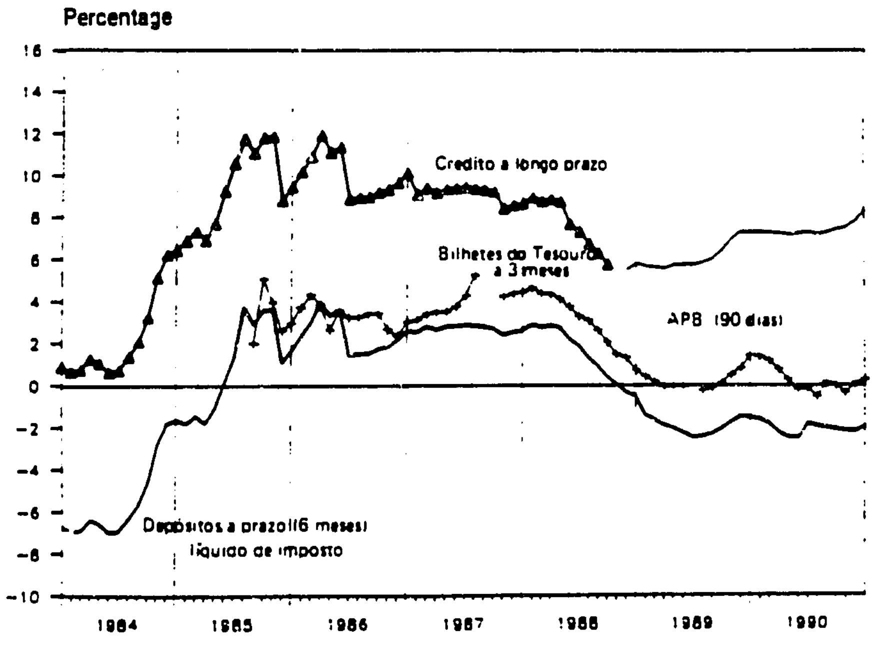
Due to their specialization in long-term housing credits and the fact that savings and investment banks were never subjected to statutory maximums on the maturity of their loans, it is not surprising that the term structure of savings and investment bank credits is significantly longer than that of the commercial banks. As shown in Charts 1 & 2 of Appendix A, as of December 31, 1989, 68.7 percent of credit outstanding in savings and investment banks had a maturity of more than five years. However, the term structure of their deposits does not match the term structure of the loan portfolio. As of September, 30, 1989, only 25.9 percent of savings and investment banks deposits had maturities of more than one year. Therefore, the savings and investment banks are vulnerable to the risks of an asset/liability mismatch. Any significant outflow of deposits could severely strain their liquidity. If increasing competition from commercial banks and the capital markets results in a drain of funds from the savings banks, these institutions will be forced to curtail new lending, particularly in the long-term mortgage sector, and to restructure their portfolios to shift available resources to shorter-term commercial and industrial credits. There is some evidence that the three savings banks have already

Table 2

NOMINAL INTEREST RATES



INFLATION-ADJUSTED INTEREST RATES



* Credito a longo prazo = Long-Term Credit

Depositos a prazo (6 meses) liquido de imposto = 6 Month Term Deposits (net of taxes)

APB (90 dias) = Portuguese Bankers Association, 90 day Reference Lending Rate

Bilhetes do Tesouro a 3 meses = 3 Month Treasury Bills

** Source: Bank of Portugal, Monthly Summary, March, 1991, p.60

begun restructuring their loan portfolios. Interviews with all three institutions revealed that they are channelling financial resources away from their traditional housing credit into more profitable, shorter term loans and investments.

The savings banks have not faced a liquidity crisis because there have been surplus funds in the banking system. This is due partially to restrictive credit ceilings until recently imposed by the Bank of Portugal. However, these institutions cannot rely on excess liquidity to protect them in the future. New sources of funds may have to be developed, including debt financing and asset sales and securitization.

Deposits provide most of the financial resources in the banking system although some banks have begun issuing debt securities through the stock exchanges or the over the counter markets. Debt financing is not attractive to banks in the current interest rate environment because of the relatively high cost of borrowed money relative to the cost of deposits. As shown in Table 2, term deposit rates average from 14 to 15 percent while the rate the market demands on even the best quality credits is 20 to 21 percent. In addition, banks with well established branch systems have no difficulty attracting deposits. Portugal has one of the highest savings rates in Europe at 24% of GDP and most domestic savings are held in the form of bank deposits. In fact, most of the financial resources in Portugal are held as deposits in the banking system, a situation which poses problems to the Bank of Portugal in its efforts to control inflation.

As shown in chart 1 of Appendix A, as of September 30, 1989, deposits held in the banking system totalled 6.7 billion contos (approximately $47 billion at the current exchange rate). Sixty-three percent of total deposits were held in the commercial banks and 36 percent in savings and investment banks. As shown in chart 3 of Appendix A, credit outstanding in the banking system totalled 3.6 billion contos as of December 31, 1989, with commercial banks holding 1.7 billion contos (48%) and savings and investment banks holding 1.9 billion contos (52%).

Despite the rapid growth of the nonbank financial sector, commercial and savings banks can be expected to continue to be the dominant force in the Portuguese financial system. This is largely due to the linkages between the large banks and the emerging nonbanks. Therefore, resources are more highly concentrated in the banking sector than might be expected. The Portuguese banking system is highly concentrated, with the CGD alone accounting for almost 30 percent of all deposits and credit outstanding in the banking system as of the end of 1989. The CGD's dominance of the private deposit market is a result of its historical role as the state savings bank and as the successor to the postal savings system and the institution's well developed national branch network. As of the end of 1989, the CGD had over 400 domestic branches.

As the emerging private and re-privatized banks begin to capture a larger share of the private credit and deposit markets, the CGD's share of the private deposit market can be expected to erode. However, the CGD's competitive advantage in terms of its market penetration and distribution network will limit the inroads the private banks and the re-privatized commercial banks can make. The development of the new private banking sector will be further constrained by the need for substantial infusions of capital to support future growth, and the barriers which the Bank of Portugal has erected to slow branch expansion. These banks may be forced to offer higher interest rates to compete effectively for deposits. Price competition will squeeze bank profit margins and further weaken the government-owned banks struggling to work out nonperforming and troubled credits to state-owned enterprises. As a result, the GOP may have difficulty privatizing these institutions without a significant level of assistance.

There are few independent nonbank financial institutions other than insurance companies and pension funds. Those which do exist deal in the institutional or wholesale markets. These companies do not have the institutional capability to develop a broad retail base. If the current trends in the Portuguese financial sector continue, the resulting structure will be several large systems of diverse financial institutions centered around a lead bank. The related companies will have common ownership or cross shareholdings and will develop their markets through cross marketing with their parent or affiliated banks. This is the pattern of development throughout the EC and there is no reason to expect the Portuguese financial sector to evolve along different lines.

The entry of European banks into Portugal is another factor which will influence the development of the Portuguese financial system. As Portugal moves closer to full integration into the European Monetary System (EMS), concern has increased about the ability of Portuguese institutions to compete with larger European banks. Representative offices of large European banks have operated in Portugal for some time and have not gained a significant share of the market. This is largely due to restrictions placed on their activities. However, by 1994, the GOP will no longer be able to give preferential treatment to domestic institutions.

While attention has been focused on direct entry by European banks, substantial investment by European banks in Portuguese institutions may have a greater impact. Spanish, French, German, Swiss, Scottish and Italian banks already have made substantial direct and indirect investments in Portuguese financial institutions and represent one of the most important sources of capital to finance the growth of the Portuguese banking sector. Portuguese institutions also are entering into joint ventures with foreign institutions to offer new products and services in the Portuguese market. While there may be substantial potential for financing through these joint venture banks, they are likely to concentrate on the lucrative high end of the market -- in commercial lending and resort real estate financing -- and are unlikely to target the consumer and housing credit market.

D. Insurance Companies and Pension Funds

Insurance companies and pension funds are emerging sources of intermediate-term and long-term finance. As of the end of 1989, there were sixty-five licensed insurance companies in Portugal (See Table 3). Currently, insurance companies are directly or indirectly owned and controlled by the government. However, the privatization process has begun. Until May 1991, only one Portuguese insurance company, Tranquilidade, was in private hands, held by the Grupo Espirito Santo. In mid-May a second company, Aliança, was privatized. In the future a domestic life insurance industry can be expected to emerge as a major participant in the Portuguese financial markets. Studies of the life insurance industry in Portugal have shown that the market for life insurance products is underdeveloped in the country. The growth potential for the life industry is substantial.

Similar growth is anticipated in the pension fund industry. Laws passed in 1989 required companies to fund their pension liabilities or establish a pension fund for their employees. Many companies elected to establish a pension fund and by the end of 1989 178 pension funds had been established with 108 million contos of assets under management (See Table 5). In response to these market developments insurance companies established pension fund management subsidiaries and pension fund management companies were organized. As of the end of 1989, twenty-three companies offered pension management services, of which ten were life insurance companies and thirteen pension managers. Many of the pension management companies are affiliated with an insurance company or a credit institution. Life insurance companies managed 85 pension funds with 37 million contos of assets and pension fund management companies managed 93 funds with 71 million contos in assets.

The life insurance and pension fund markets offer the greatest potential for tapping new resources for the housing sector because of the long term of their investment horizon, the statutory and regulatory restrictions on life insurance and pension fund investments, and the exemption of interest and dividends earned by life insurance companies and pension funds from income tax withholding (See Tables 4 & 6). Under current regulations, the government has established minimum and maximum percentages for investment by life insurance companies and pension funds. Maximum investment limits are imposed to assure portfolio diversification and prudential management of assets. Minimum investment limits appear to have been imposed to create a market for government securities and listed and OTC capital instruments.

As life insurance companies and pension funds grow they may have some difficulty staying fully invested under the current regulatory regime because of a scarcity of capital instruments in the market. Discussions with a pension fund manager indicated that competition for the limited supply of high quality corporate debt instruments was bidding up the market price. As the Portuguese capital markets mature and expand, the supply of capital instruments should catch up with the demand, but the current environment appears to be very positive for issuing new debt securities.

Table 3

THE PORTUGUESE INSURANCE INDUSTRY
As of December 31, 1989

	Number of Companies	Premiums (millions of contontos)	Percent of Market
Type of Company			
Public Enterprise	4	76.20	32.77%
Stock Company	23	113.91	51.69%
Mutual Company	4	1.70	0.77%
Branches	34	32.55	14.77%
Total	65	224.35	100.00%
Structure of the Industry			
Imperio		26.55	11.83%
Mundial Confianca		24.11	10.75%
Fidelidade		22.82	10.17%
Tranquilidade		21.05	9.38%
Bonanca		20.06	8.94%
Alianca		16.68	7.43%
Europeia		8.39	3.74%
O Trabalho		6.96	3.10%
Portugal Previdente		6.23	2.78%
Metropole		5.76	2.57%
Sociedade Portuguesa de Seguros		4.82	2.15%
Garantia		4.74	2.11%
UAP - VIE		4.69	2.09%
Social		4.34	1.94%
GAN - VIE		3.47	1.55%
All Others (50)		43.68	19.47%

* Source: O Sistema Financeiro Portugues, Banco Portugues do Atlantico, 1990

Table 4

INSURANCE COMPANIES

TECHNICAL RESERVES REQUIREMENTS

TYPE OF ASSETS	MINIMUM %	MAXIMUM %
Securities of the Government of Portugal (except treasury bills or CLIP's)*	40	90
Bonds of Portuguese Entities	---	50
Shares of Portuguese Companies that are traded on the stock exchange	10	12.5
Particpation Certificates and/or "cosigned funds" that are traded on the stock exchange	---	5
Real Estate Located in Portugal	---	45
Loans on Real Estate Located in Portugal	---	5
Shares in Investment Funds of Securities and/or Real Estate	---	10
Treasury Bills or CLIP's*	---	10
Term Deposits or Certificates of Deposit	---	5
Other Assets, including stock of Portuguese companies that is not traded on the stock exchange, and/or foreign securities traded on the stock exchange from member nations of the EEC	---	5

Note: The securities issued by any one firm cannot, in any case, represent more than 5% of the technical reserves of an insurer.

* CLIPS are Credito em Leilao ao Investimento Publico (Auctioned Public Debt Instruments).

** Source: O Sistema Financeiro Portugues, Banco Portugues do Atlantico, 1990

Table 5

THE PORTUGUESE PENSION FUND INDUSTRY
As of December 31, 1989

	Number of Companies	Funds Managed: No.	Funds Managed: Percent of Market	Assets Under Management: Amount (millions of contos)	Assets Under Management: Percent of Market
Type of Company					
Insurance Companies	10	85	47.8%	36.96	34.2%
Pension Fund Management Companies	13	93	52.2%	71.07	65.8%
Total	23	178	100.0%	108.03	100.0%
Structure of the Industry					
Tranquilidade (I)		27	15.2%	22.60	20.9%
Vanguarda (SGFP)		10	5.6%	16.28	15.1%
Previsao (SGFP)		2	1.1%	15.61	14.5%
Praemium (SGFP)		27	15.2%	12.05	11.2%
Futuro (SGFP)		10	5.6%	10.05	9.3%
SGFP Banco de Portugal (SGFP)		1	0.6%	7.01	6.5%
Fungest (SGFP)		13	7.3%	5.49	5.1%
Imperio (I)		4	2.2%	5.18	4.8%
American Life (I)		33	18.5%	4.34	4.0%
GAN - VIE (I)		6	3.4%	2.71	2.5%
SGF (SGFP)		11	6.2%	2.36	2.2%
Unipensao (SGFP)		10	5.6%	1.49	1.4%
Ocidental - Vida (I)		3	1.7%	1.14	1.1%
All Others		21	11.8%	1.73	1.6%
Total		178	100.0%	108.03	100.0%

* Source: O Sistema Financeiro Portugues, Banco Portugues do Atlantico, 1990

Table 6

PENSION FUND MANAGEMENT COMPANIES

TECHNICAL RESERVES REQUIREMENTS PER FUND

TYPE OF ASSETS	MINIMUM %	MAXIMUM %
Demand Deposits, Treasury Bills, CLIP's*, and Investments in the Inter-bank Money Market	3	---
Securities of the Government of Portugal, excluding Treasury Bills and CLIP's*	30	---
Stock of Portuguese Companies	5, increasing by 1 per year up to	10
Bonds of Portuguese Entities, Participation Certificates, or other Negotiable Debt Instruments, including cash, cash bonds, not traded on the stock exchange and/or foreign securities traded on the stock exchanges of Member Nations of the EC	---	20
Real Estate	---	35
Participation Certificates Issued by the Same Investment Fund	---	20

Note: The securities issued by any one firm cannot, in any case, represent more than 10% of the technical reserves of a pension fund.

* CLIPS are Credito em Leilao ao Investimento Publico (Auctioned Public Debt Instruments).

*' Source: O Sistema Financeiro Portugues, Banco Portugues do Atlantico, 1990

III. THE HOUSING FINANCE SYSTEM

A. Mortgage Lending

Mortgage credit outstanding represent the largest single category of bank credit in Portugal. From 1987 to 1989, housing credit increased both in absolute terms and as a percentage of total credit in the Portuguese banking system. As of December, 1987, credit to individuals for house purchase was 20.8 percent of total credit outstanding and by the end of 1989, housing's share of the total credit market had risen to 27.3 percent. Housing credit outstanding totalled almost 1 billion contos as of the end of 1989 and represented the largest credit sector in the financial market (See Chart 3 in Appendix A).

The increase in the outstanding balance of housing credit can be attributed more to the capitalization of interest on loans in portfolio than to a flow of funds into the housing sector. New housing credit granted fell steadily from 1987 to 1989. In 1987, 210.5 million contos of new credit for home purchase was granted while in 1989, the volume of new credit had dropped to less than 174.7 million contos, a decline of 17 percent. The savings banks experienced a 15 percent drop in the volume of new housing credit granted during the two year period. The decline in new extensions of housing credit was more pronounced among the commercial banks, with new loan volume falling by 33 percent from 1987 to 1989. However, although the volume of new mortgage credit extended has diminished, activity in this sector of the capital markets still exceeded the aggregate value of all new debt securities issued by private enterprises.

Commitments for housing credit have shown a similar pattern of decline since 1987. Based on statistics compiled by a Portuguese Civil Engineering Association, AECOPS, only 33,253 housing credits totalling 128.1 million contos were contracted in 1990 compared with 56,359 contracts valued at 164.8 million contos in 1987. During the same time period, housing costs were escalating rapidly and the value per housing credit contract reflected this price escalation. In 1987 the average housing credit was 2,924 contos and by 1990 the average value had increased to 3,853 contos. In January of 1991, 2,978 housing credits were contracted totalling 12.4 million contos with an average value per contract of 4,154 contos. Therefore, while the total number of new homes financed through the banking system has fallen, it appears that the average cost per unit has increased, making housing less affordable to lower and moderate income families.

According to the Caixa Geral, 1989 was characterized by a strong reduction in the demand for housing, a trend that began after 1986.

The following chart shows the decline in the number of mortgage applications at the CGD:

1986	1987	1988	1989
58,286	48,347	37,320	26,493

The decline in applications, according to the CGD, has been due to the increase in the price of housing units, the lack of adjustment of the conditions regarding eligibility for subsidized housing loans, and the reduction in the percentage of interest which can be capitalized under the mortgage subsidy scheme.

High mortgage interest rates also have had a depressing effect on the housing finance market. In an effort to reduce and rationalize government subsidies, the Government of Portugal removed the ceiling on mortgage interest rates in March 1989 and established a mortgage subsidy system which directs subsidies towards the lower-income target groups. After deregulation, mortgage rates increased from their previous ceiling of 17.5 percent to the current interest rates of 20.5 to 22.5 percent for subsidized housing credit and 24 to 26 percent in the general housing finance market. The interest rate to which the government subsidy factor is applied was capped at 17.5 percent, with the borrower paying the full difference between the maximum subsidy rate and the market. Therefore, even families eligible to receive the greatest subsidy now pay a positive real interest rate on mortgage loans. In addition, subsidies are phased out over a maximum of seven years or sooner, if family income increases above the maximum for eligibility. For example, the lowest income family could receive a 40 percent subsidy. This percentage is applied to the 17.5 percent maximum, not the market interest rate. Therefore, if the market rate is 22.5 percent, the interest rate actually paid would be 15.5 percent after the subsidy (22.5% - (.4 x 17.5%) = 15.5%). Assuming a 13 percent inflation rate, a 15.5 percent mortgage rate represents a 250 basis point real interest rate. If family income increases to the level at which the borrower is entitled to receive only a 30 percent subsidy, the mortgage interest rate paid would rise to 17.25 percent, or a 425 basis point real interest rate. With even the most highly subsidized interest rates at this level, housing is not affordable for many lower income families.

For the last fifteen years housing credit in Portugal has been highly regimented, with government establishing the financial structure of mortgage loans, the maximum interest rate and the maximum loan-to-value ratios for both subsidized and unsubsidized loans. Since 1986 the government has taken steps to deregulate the mortgage market and rationalize housing subsidies by eliminating the interest rate ceilings for all housing credit except for emigrant housing savings plans by establishing a stratified housing subsidy system based on family income, and, most recently, by eliminating the maximum house cost for subsidized mortgages. However, the Portuguese housing finance system must still function within fairly rigid parameters, particularly in the subsidized housing scheme. Subsidized and other preferential housing credit plans like the emigrant and young persons housing savings plans accounted for over 87 percent of total housing credit outstanding at the end of 1989. Because of the predominance of subsidized housing credit in the system, the subsidy scheme is probably the most critical factor influencing the housing finance market.

While the stratified housing subsidy structure currently in use is effective in targeting scarce resources to the lowest income group; its complexity makes housing finance less attractive to credit institutions, even the specialized institutions whose primary purpose is to finance housing. As long as a highly structured subsidy system is in place, the mortgage markets cannot develop the levels of efficiency, homogeneity and stability necessary to effectively access the capital markets. Political considerations may make it difficult for government to overhaul the housing subsidy system. However, but if its objective is to tap the capital markets as a source of funds for housing, government will have to deal with the problems created by the system it mandates for subsidized housing finance. Concern for maintaining housing affordability without increasing government expenditures will have to be balanced with the need for financially viable instruments with predictable cash flows as collateral for mortgage-related instruments.

1. Housing Finance Institutions

Housing finance in Portugal is provided primarily through the state owned CGD, the CPP and the CEL/MG. Of the 986.4 million contos in credit to individuals for house purchase outstanding at the end of 1989, 18.5 percent was through commercial banks and 81.5 percent was in the three specialized credit institutions. Mortgage credit accounted for only 10.5 percent of all credit granted by commercial banks compared with almost 43 percent of total credit granted by the specialized institutions. Commercial banks have concentrated on the upper income and second home segments of the housing market and also extend mortgage credit as an accommodation to their good customers. Based on discussions with representatives from the banking sector, there is no dominant housing lender among the commercial banks. Commercial banks finance house purchases for their good customers in the normal course of business. Only one commercial bank, the BCP, and a newly licensed mortgage bank have targeted the housing finance market as a sector for business development.

Among the specialized credit institutions, Caixa Geral de Depositos held almost 62 percent of total housing credit outstanding and over 75 percent of housing credit at savings banks. The second largest savings bank, the Credito Predial Portugues, held 13 percent of total housing credit and 16 percent of housing credit at savings banks. The Caixa Economica de Lisboa/Montepio Geral held the balance of housing credit at savings banks. Based on these statistics, it is apparent that the CGD is the housing finance system in Portugal and any actions to improve the operations and efficiency of the housing finance system must necessarily be implemented at the CGD.

As a state-owned institution, the CGD has a mandate to serve a social purpose as well as maintain a sound financial condition. Its central function has been to provide long term mortgage credit, particularly to the subsidized housing sector. As the largest credit institution in Portugal and the primary depository institution for household savings, the CGD has been able to support the housing sector at its historical levels of operation. As of the end of 1989, the outstanding balance of housing credit at the CGD totalled 608.3 million contos (about US$4.1 billion) in approximately 290,000 loans, for an average mortgage balance of 2,079 contos. The rate of growth in housing credit at the CGD slowed in 1989 and the trend continued in 1990. However, housing credit remains the largest class of loan in the CGD's portfolio, representing 50.8 percent of total credits outstanding.

The CGD is Portugal's principal source of subsidized mortgage credit. Subsidized loans, "crédito bonificado," represented over 65 percent of total housing credits in Portugal as of the end of 1989.

The following chart shows the share of subsidized housing lending in CGD's total lending for housing:

	1987	1988	1989
New Credit Granted	91%	84%	73%
End of Year Balances	91%	62%	65%

Subsidized housing credits are at lower interest rates than general housing credits and the high percent of subsidized loans in the CGD's portfolio has had a dampening effect on their profitability. Until 1990 the government established the maximum interest rate mortgage lenders could charge on subsidized mortgage loans. Since that time, lenders have been able to adjust the mortgage rates in response to changes in market interest rates, but the CGD and the other mortgage lenders have not increased the interest rate on subsidized loans to market levels. The CGD's interest rate on subsidized housing credit as of the middle of 1991 was 21.5 percent, compared to a 24 to 26 percent rate on unsubsidized credits.

At the CGD and other housing finance institutions, housing credit is funded largely through short term deposits, a situation which, despite adjustable interest rates, exposes housing finance institutions to substantial risk. As the deposit market share of the traditional housing lenders erodes, the supply of funds to long term housing credit can be expected to decrease.

The anticipated privatization of the Crédito Predial Portugues may also serve to reduce the supply of housing credit to the economy. According to its 1989 annual report, about half of CPP's loan portfolio is in housing, and 86% of that housing loan portfolio is subject to the administratively fixed maximum interest rate of 17.5%, well below the current lending rate for housing. CPP's strategy is to decrease the percentage of subsidized loans in its housing loan portfolio. In 1988, these accounted for 64% of housing loans granted, in 1989 it was reduced to 54% and, according to an interview with CPP, the plan for 1990/1991 is the reduce it to just 46%. Moreover, of CPP's portfolio of subsidized housing loans made in 1989, 67% were held by borrowers in subsidy class I, those that receive the maximum subsidy of 40%. Unless the government requires that the CPP's new owners commit a certain portion of the CPP's lending to housing, it is probable that the CPP will further reduce its activity in the sector. Under private ownership, more profitable lines of business will be pursued.

Privatization is not the only factor which will put pressure on the housing finance sector. The CGD and the CEL/MG are diversifying their loan portfolios to reduce their concentration in relatively low yielding long term housing credit, particularly in subsidized housing finance. One factor which could have a positive impact on the mortgage market is Portugal's adoption of the Bank for International Settlement (BIS) risk-based capital standards. The BIS Commission risk-based capital requirements give preferential treatment to housing credit by assessing a risk weighting of 50 percent rather than the 100 percent weighting assigned to commercial and consumer credit. Many Portuguese banks are experiencing pressure on their capital due to rapid growth and/or charge-offs and provisioning of substandard and nonperforming loans. Therefore, allocation of a larger portion of their credit portfolio to housing credit would reduce the bank's capital requirement, increase its leverage and provide the opportunity for enhanced profitability. Housing credits are also some of the least risky loans with delinquency rates below 10 percent and default rates below 2 percent.

2. General and Subsidized Mortgage Lending Systems

Because of the dominant role of the specialized credit institutions in housing finance, they have developed specialized expertise in housing credit which does not exist in other institutions. This expertise and the institutional infrastructure which supports a housing finance system is particularly important in Portugal because of the complex subsidy system which has been adopted (See Table 7). Housing subsidies are stratified by household income into four classes, with further delineation by number of persons per household. The lowest income group, Class I, receives a subsidy of 40 percent; Class II receives a 30 percent subsidy, Class II receives a 20 percent subsidy; and Class I, a 10 percent subsidy. These percentages are not applied to the actual interest rate charged by the lender, but to an administered "reference rate" currently set at 17.5 percent. Therefore, the subsidy is a fixed amount of interest on the outstanding balance and as interest rates on housing credit move up or down, the mortgagor pays the full difference. In addition, subsidies are phased out over a seven year period. As the mortgagor's income rises or falls, he may move to a different subsidy class.

The subsidy formula is further complicated by the use of the so-called "z-factor" which requires the capitalization of interest on a statutorily established percent of mortgage interest charged. The z-factor, currently set at 60 percent, is the percent of the interest which is not capitalized. The remaining 40 percent of interest is capitalized and added to the loan balance, resulting in a higher mortgage payment and an escalating loan balance.

The system has been made even more complex by the recent introduction of a fixed payment option for subsidized housing credit. Borrowers can elect to have either a level payment or a graduated payment mortgage and, presumably, can change from one structure to the other during the life of the loan. About two-thirds of credit granted after the introduction of the level payment option utilizes the graduated payment structure and one-third, the level payment scheme. Conversely, about two-thirds of nonsubsidized credit is on the level payment system. Mortgagors are also permitted to make partial repayments of principal at any time, changing the base on which interest and the monthly payment is computed.

In April 1991, a decree law was published that now allows borrowers to negotiate the schedule for payment of principal and interest that is more in line with the borrower's cash flow. It also established a new form of payment that is a hybrid of the level and graduated payment systems. It is designed to start off with a higher payment than the level payment loans but increase less dramatically than graduated payment loans. It also eliminated the subsidy eligibility requirement that is based on price of the house and the region where the house is located. In addition, it allows all the commercial banks to grant subsidized housing credit, taking away the exclusive rights of the specialized credit institutions to receive these subsidy payments. This additional flexibility compounds the difficulty of administering subsidized and general market housing credit.

Table 7

CRÉDITO À HABITAÇÃO – REGIME JOVEM BONIFICADO, BONIFICADO E GERAL

(Dec. Lei 328 B/86 Portarias 362/87 e 229 B/89 Desp. 24/04/90)

PRESTAÇÕES MENSAIS EM ESCUDOS A CARGO DO MUTUÁRIO POR CADA 1000 CONTOS

Juros não capitalizados 60% Taxa 20.5%

REGIME DE PRESTAÇÕES CRESCENTES (valor a deduzido das bonificações)

ANOS	Classe I		Classe II		Classe III		Classe IV		REGIME GERAL
	Jovem bonificado	Bonificado	Jovem bonificado	Bonificado	Jovem Bonificado	Bonificado	Jovem bonificado	Bonificado	
1	7 319$	7 319$	8 672$	8 672$	10 025$	10 025$	11 378$	11 378$	12 731$
2	7 744$	7 744$	9 149$	9 149$	10 554$	10 554$	11 959$	11 959$	13 364
3	8 189$	8 334$	9 645$	9 791$	11 101$	11 247$	12 557$	12 703$	14 014$
4	8 655$	8 957$	10 162$	10 463$	11 668$	11 970$	13 175$	13 476$	14 682$
5	9 298$	9 610$	10 854$	11 165$	12 409$	12 720$	13 965$	14 276$	15 365$
6	9 974$	10 295$	11 577$	11 897$	13 179$	13 499$	14 781$	15 101$	16 063$
7	10 843$	11 173$	12 490$	12 819$	14 136$	14 465$	15 782$	16 111$	16 770$
8	11 751$	12 088$	13 438$	13 775$	15 124$	15 462$	16 811$	17 148$	17 486$
9	12 694$	13 038$	14 417$	14 761$	16 139$	16 484$	17 862$	18 207$	18 207$
10	13 667$	14 018$	15 421$	15 771$	17 174$	17 525$	18 928$	18 928$	18 928$
11	14 669$	15 025$	16 447$	16 802$	18 224$	18 580$	19 647$	19 647$	19 647$
12	15 690$	16 049$	17 484$	17 843$	19 278$	19 637$	20 355$	20 355$	20 355$
13	16 724$	17 084$	18 525$	18 886$	20 327$	20 687$	21 048$	21 048$	21 048$
14	17 761$	18 121$	19 559$	19 919$	21 357$	21 717$	21 717$	21 717$	21 717$
15	18 792$	19 148$	20 574$	20 930$	22 356$	22 356$	22 356$	22 356$	22 356$
16	19 800$	20 150$	21 551$	21 902$	22 953$	22 953$	22 953$	22 953$	22 953$
17	20 770$	21 111$	22 474$	22 815$	23 497$	23 497$	23 497$	23 497$	23 497$
18	21 683$	22 011$	23 321$	23 648$	23 976$	23 976$	23 976$	23 976$	23 976$
19	22 518$	22 827$	24 066$	24 376$	24 376$	24 376$	24 376$	24 376$	24 376$
20	23 245$	23 531$	24 679$	24 679$	24 679$	24 679$	24 679$	24 679$	24 679$
21	23 834$	24 092$	24 867$	24 867$	24 867$	24 867$	24 867$	24 867$	24 867$
22	24 246$	24 469$	24 915$	24 915$	24 915$	24 915$	24 915$	24 915$	24 915$
23	24 435$	24 615$	24 796$	24 796$	24 796$	24 796$	24 796$	24 796$	24 796$
24	24 338$	24 468$	24 468$	24 468$	24 468$	24 468$	24 468$	24 468$	24 468$
25	23 669$	23 669$	23 669$	23 669$	23 669$	23 669$	23 669$	23 669$	23 669$

	REGIME GERAL
Regime de prestações constantes – Aquisição	15 811$
Regime de prestações constantes – Construção (270 prestações)	15 901$

a) CLASSE DE BONIFICAÇÃO: Nos termos legais a bonificação é uma percentagem da taxa fixada para o efeito (actualmente 17.5%) correspondendo à CLASSE I 40%, à CLASSE II 30%, à CLASSE III 20% e à CLASSE IV 10%.
b) A taxa de juro contratual é actualmente 20.5% [illegible] a taxa básica de referência definida e praticada pela Caixa que em cada momento vigorará para este tipo de operações. Os juros não capitalizáveis são 60%.
c) A percentagem máxima do empréstimo é de 90% [illegible] do valor da avaliação ou da **aquisição se este tiver sido inferior àquele**. No crédito Jovem a percentagem é de 100%.
d) Nos financiamentos à construção de habitação os juros são calculados dia a dia e cobrados trimestral e postecipadamente durante o período de construção.
e) A taxa de esforço máxima que condiciona o montante dos empréstimos a conceder é, em relação ao encargo da prestação inicial de 1/3 ou 1/2 do duodécimo do rendimento líquido anual, consoante as prestações sejam crescentes ou constantes respectivamente.
f) Para valores superiores consultar tabela específica.

Concelhos de LISBOA e PORTO. Concelhos sede de Distrito. Concelhos da grande LISBOA (Almada, Amadora, Barreiro, Cascais, Loures, Moita, Montijo, Oeiras, Seixal, Sintra, V.F. de Xira) e do grande PORTO (Gondomar, Maia, Matosinhos, Valongo, V. do Conde, V.N. de Gaia, Póvoa de Varzim).
Concelhos de Abrantes, Albufeira, Alenquer, Caldas da Rainha, Chaves, Covilhã, Elvas, Entroncamento, Espinho, Estremoz, F. da Foz, Guimarães, Ílhavo, Lagos, Loulé, Olhão, Palmela, Peniche, P. da Régua, Portimão, Santiago do Cacém, S. João da Madeira, Sesimbra, Silves, Sines, Tomar, Torres Novas, Torres Vedras, V.R. Santo António.
Restantes Concelhos do Continente.

21e

The administrative cost and burden is further increased by the government's policy of "grandfathering" existing loans whenever the laws and regulations governing subsidized housing credit changes. For example, the current regime was adopted in 1986 but by 1989 the CGD still had over two-thirds of its loans under earlier subsidy structures. This system results in a subsidy computation which is adjusted annually based on the mortgagors' income. Adjustments will also be made whenever the mortgage lender changes the interest rate, the government changes the z-factor, or the family circumstances of the mortgagor change.

3. Prospects for Housing Lending in the Future

The high cost of administering subsidized housing credits is a strong disincentive to participation in the subsidized housing market. Only the existing housing credit institutions have the systems and the personnel in place to administer subsidized housing credit and it is highly unlikely that commercial banks will commit resources to a sector which promises a below-market return on investment. There are a number of other reasons why existing housing finance institutions other than the CGD will decrease their involvement in housing finance and why other institutions are unlikely to venture into the mortgage market. Interestingly, high delinquency and default rates, even on subsidized housing credits, are not cited as reasons for a lack of interest in the sector. The three housing credit institutions report similar default rates of 1 to 2 percent and delinquency running at 6 to 8 percent. Mortgage credits are generally regarded as a higher quality, if less profitable, credit than commercial and industrial loans.

The principal deterrents to greater involvement by credit institutions in the housing finance sector are the illiquidity of the loans, the lower spreads on mortgages and the administrative cost of managing a mortgage portfolio. Regarding particular institutions, the CPP is being prepared for privatization and its large exposure in subsidized housing loans makes the institution less attractive to prospective investors. The CEL/MG indicated that while it will continue to serve its customers by providing mortgage financing, it is not seeking to expand this line of business and, due to its negative experience with subsidized credit, will reduce its involvement in the subsidized mortgage sector.

Commercial banks do not have long-term funding sources, and lack the expertise to underwrite and service mortgage loans. To serve the financial needs of the private business sector, both public and re-privatized commercial banks will require several years of portfolio restructuring. New private banks are seeking the most profitable lending opportunities and are devoting the majority of their resources to building market share among the more affluent segments of the market. Most are probably years away from expanding into the housing sector and even if they do enter the market, they will participate at the higher income end of the housing spectrum.

Life insurance companies and pension funds will not enter the primary mortgage market. However, they would invest in mortgage related financial instruments and programs in which the insurance company provides mortgage payoff coverage and mortgage life insurance on mortgages collateralizing bonds issued by a mortgage lender. Because of the close affiliations between many of the larger life insurance companies and credit institutions, insurance companies would direct mortgage business to their bank affiliate rather than entering the mortgage market directly.

The current high interest rates and the practice of capitalizing interest in excess of the borrowers' ability to pay are further disincentives to bank involvement in the housing finance market. The negative cash flow burden of capitalizing interest compounds the problem of "borrowing short and lending long." Due to all of these factors, for the near and intermediate term future, the CGD can be expected to continue to be the principal source of long term mortgage loans and may eventually be the only source of subsidized housing credit.

B. Construction Financing

Residential construction financing is provided by both commercial banks and the specialized credit institutions. Data provided by AECOPS indicate that residential construction, after a sustained period of growth from 1984 to 1988, declined in 1989 and 1990 and is projected to experience an even sharper decline in 1991. AECOPS has estimated that total residential construction financing dropped by 2 percent in 1989 and 1990 and will decline by 3.5% in 1991. One reason for the sluggishness of the residential construction sector is the increasing level of activity in the commercial and public works construction sectors. Contractors and subcontractors who might otherwise be engaged in residential construction may be diverted into more profitable and less risky nonresidential construction. These large construction projects are being financed by the EC and domestic and private investors. High interest rates, tight monetary policies and rapidly escalating construction costs have also contributed to the decline in residential construction.

Residential construction is somewhat less risky in Portugal than in many other countries because of the strong demand for housing in the country. The risks of construction financing are associated with the ability and integrity of the developer and contractors and with the location of the project. Residential construction financing is granted to

Table 8

TRENDS IN RESIDENTIAL CONSTRUCTION
(millions of escudos)

Year		Total Value of Housing Construction	INH	INH as % of Total Construction
1984		122,150	5,632	4.61%
1985		134,515	10,528	7.83%
1986		146,867	10,592	7.21%
1987		189,306	14,468	7.64%
1988	(est. for total)	208,537	15,594	7.48%
1989	(est. for total)	204,072	22,459	11.01%
1990	(est. for total)	199,980	28,425	14.21%

* Source: AECOPS, INH and RHUDO/Lisbon.

private developers and to cooperatives, with the cooperatives accounting for the majority of subsidized housing production. In some cases cooperatives are organized for the sole purpose of building a multi-family residential building and are then dissolved or transformed into a form of homeowners association. In other cases, cooperatives are in the business of housing construction and function much like a private developer, except that the cooperative maintains a role after the housing units are sold. For other cooperatives housing construction is a service to their members who have a "common bond" of employment or other affiliation. One cooperative, CHESMAS, works frequently with the INH to build housing for its members. As of 1990, it had 636 members and had provided housing for 369. Among CHESMAS' member services is substantial assistance it provides in preparing the necessary documentation to obtain mortgage loans. In order to reduce delays, CHESMAS requires its members to gather the necessary information and has its staff and volunteers prepare the forms. CHESMAS not only contracts developers, it also plans for day care, has a boy scout troop, athletic teams, and a theater group. Monthly fees pay for maintenance and gardening. CHESMAS even has a lawyer on retainer and has a voice in the municipal government. The cooperative headquarters sports a party room, shack bar, and mini-mall complete with a video club.

As might be expected, the CGD is the largest residential construction lender in Portugal. In 1989, it financed almost 77 percent of all residential construction financing provided by the specialized credit institutions. The CGD grants construction credits to private developers and cooperatives which are customers of the institution. While the CGD grants loans for up to 65 percent of the cost of construction, it does not finance land acquisition and development. The CPP and the CEL/MG also provide construction financing on terms similar to the CGD.

All three housing lenders have had a mixed experience in financing construction by cooperatives. Well managed, broad-based cooperatives which are customers of the bank represent good credit risks. Many cooperatives consist of middle- and upper middle-income members. There is also little, if any, risk of unsold housing units in cooperative construction because the cooperatives maintain a list of qualified purchasers ready and able to purchase the dwelling units constructed. Cooperative-constructed housing presents no speculative risk. On the other hand, the specialized credit institutions have had negative experiences with cooperatives which are poorly managed and which lack the skill and expertise to retain and monitor qualified contractors to perform the construction. Significantly, CHESMAS has formed alliances with smaller, less-experienced cooperatives to assist them in organizing, arranging financing from the INH, choosing and working with construction firms, and training members in developing the preparing the required mortgage loan documentation.

Banks are reluctant to finance "spec" construction loans to private developers unless the developer has a proven track record and the housing project is located in an established market. Even with an established developer, most units are presold and deposits made to reserve the units.

Construction lending institutions expressed some concern about overbuilding in the second home and luxury home markets and with housing projects built in locations remote from the urban centers. They prefer to finance housing in Lisbon and Oporto where there will be no question about market absorption.

IV. THE INSTITUTO NACIONAL DE HABITAÇÃO: FINDINGS AND RECOMMENDATIONS

A. Background of the INH

The enabling legislation which created the INH sets forth the stated goals of the organization. These are:

- o to conduct research on housing and develop sound housing policy;
- o to prepare and report on a national housing plan; to coordinate financial policy for the housing sector;
- o to finance social housing programs; and
- o to supervise the execution of housing policy.

As the recipient of USAID Housing Guaranty loans, the INH is further subject to the policy objectives stipulated in the loan agreements. The program objectives of the Housing Guaranty program are to promote:

- o improved living conditions in existing and low-income neighborhoods;
- o increased production by local developers of new housing affordable for ownership by low-income families; and
- o increased supply of land and services suitable for low-cost housing.

The goals and objectives set for INH are far-reaching and exceed the financial and managerial resources of the organization. Since its creation, INH has focused its efforts on financing increased production of low cost housing units. There has been some activity in other areas, but INH has not evolved into the housing and housing finance policy arm of the government which may have been envisioned when the organization was created. The goals set for the INH may have been too ambitious for a small organization with limited resources. After more than five years of full operations, perhaps it is an appropriate time to evaluate what the role, purpose and function of the INH should be in the future economic, financial, and institutional environment in Portugal.

The framework for INH credit programs is established by law and regulation. The general regulation of the INH's low cost housing program was established by Portaria no. 828/88 December 29th which defined the limits on the size and price of units eligible for subsidy. In 1989 regulations were issued authorizing subsidized financing for land acquisition and infrastructure development for all developers. The INH also is authorized to extend loans to municipalities for the construction of low cost owner and rental housing.

The INH received its initial funding from the government and has financed most of its construction loans with funds provided by USAID Housing Guaranty loans. In 1991 the INH will draw down the last $30 million of Housing Guaranty funds and must consider what its future role will be in the housing finance sector and what resources it is capable of mobilizing. There appears to be a need for the INH and the institution does serve a segment of the market which other credit institutions would not be willing to finance. If the INH ceased to exist, the government of Portugal would create a new agency to replace the INH. Therefore, the Government and the INH should examine alternative strategies that focus on making the INH a stronger, more financially viable entity.

B. The Role of the INH in the Construction Sector

As shown in the following table, the Instituto Nacional de Habitação (INH) has been a significant factor in the residential construction sector since its creation in 1984. Based on the AECOPS estimates for total housing construction, INH's participation reached a peak of over 14 percent in 1990 and, despite a projected reduction in new lending in 1991, is still expected to account for over 9 percent of the value of residential construction for the year.

INH serves a segment of the market which other credit institutions would not finance in its absence. All of the institutions contacted in conjunction with this study indicated that the INH serves an important purpose and makes a contribution to the sector. The consensus of opinion was that the INH should continue to promote the construction of controlled cost housing. The credit institutions would not extend credit to many of INH's customers and if credit were granted it would be on more restrictive terms.

Until April 1991, the INH and the specialized credit institutions were the only entities authorized to offer subsidized construction financing. On April 22, 1991, Decree-Law 150-A/91 authorized all other credit institutions to grant subsidized financial support to controlled cost housing programs. This decree law also assigns to the INH the responsibility of allocating subsidies as well as determining the amount of subsidies that can be allocated based on the finances available in the fiscal budget. It also charges the INH with verifying that all controlled cost housing projects are financed in conformity with the legal conditions regarding construction and financing. Although credit institutions are responsible for supervising the development of the projects, they may request the INH to provide technical support. For its services, the INH can charge a fee to the institutions. Under current market conditions, it is unlikely that any institution that is not currently participating in the controlled cost housing construction program will participate.

The INH has several credit programs to serve its unique market segment. The INH finances each phase of housing development with a separate loan and does not provide acquisition, development and construction (ADC) financing in a single financing package. A mortgage on the subject property is taken for each loan. Land acquisition loans are granted for up to 80 percent of the appraised value of the land. Legal and regulatory restrictions require that the value of the land cannot exceed 7 percent of the total project cost. Land acquisition and development loans are made to cooperatives and private developers.

The INH extends construction loans to municipalities, cooperatives and private developers. The terms of loans to municipalities are more liberal than those applied to cooperatives and developers and the municipalities are the only entities to whom the INH extends long-term credit. Until 1989, loans to cooperatives were advantaged under the applicable regulations, but since that time, cooperatives and private developers have operated under the same regulatory regime. The INH extends construction financing to these entities for subsidized housing and for community facilities. There are regulatory restrictions on builder profit for private developers, but the tax benefits the builders receive give developers an after-tax profit about equal to what they would earn in the open market.

INH provides 100% construction loans to municipalities, 100% construction loans to cooperatives (although in practice it finances 85-90%) and 80% construction loans to private developers. These represent loan-to-value ratios far higher than credit institutions would offer. The regulations require interest during the construction period to be paid current, but interest capitalization during construction is negotiated on a case-by-case basis in the loan agreement.

A key element of the INH's construction financing program is the technical assistance and training provided to cooperatives with little experience in housing construction. The INH gives monthly seminars on topics such as supervision of controlled cost construction and quality control.

These services are offered at no charge to the borrowers, raising the cost of loan administration and reducing the profitability of construction financing. The interest rate the INH charges on construction loans is indexed to the weighted average interest rate charged by the three specialized credit institutions. The dominance of the CGD in this group means that the INH's rate is closely tied to the rate charged by the CGD. In May, 1991, INH's interest rate on construction loans was 22.5 percent. Like mortgage loans, the subsidy on construction loans is a fixed one-third of the 17.5 percent reference rate. Therefore, the financing component of construction costs will increase or decrease as market interest rates change, but the subsidy element will remain the same unless the government changes the reference rate.

INH's comparative advantage in the low cost construction financing market lies primarily in its more liberal financing terms and in the technical assistance it provides. There is no cost advantage to the borrower. Cooperatives and private developers utilize the INH's credit facility because they receive personal service, free technical assistance, and a quicker turnaround on their loan approvals than they could obtain at the CGD or other credit institutions. The INH's clients, particularly the cooperatives, may be poorer credit risks than the entities financed by credit institutions due to their lack of experience in housing construction.

The INH occupies a unique position in the financial sector and other credit institutions are not likely to serve the INH's clients. However, the INH does not have to remain a separate government agency to perform its function. It could be just as effective, if not more effective, as a subsidiary or affiliate of the CGD.

C. Future Alternatives for the INH

Several alternatives have been considered in the last year, including converting the INH to a credit institution or a mortgage bank. These options were rejected by the government and in May, the Council of Ministers agreed to transform the INH from a government institution to a "sociedade anonima" whose capital stock would be jointly owned by the Treasury, public or private financial institutions, and others, provided that the majority of INH capital is held by public entities. It is expected that the CGD and the CPP will invest in the capital of the INH, but due to the INH's poor reputation in the market and questionable financial prospects, few, if any, other institutions are likely to invest unless required to do so by the government. The form of capital instrument which will be issued is the "título de participação," or participation certificate but, as of the date of this report, the government has not yet determined the amount of securities which will be issued. Títulos de participação are long-term capital instruments guaranteeing a fixed return and a percentage of the issuing entity's net profits. Titulos de participação have been issued by other entities in which the government retains an interest. For example, both the Banco Portugues do Atlantico and the Credito Predial Portugues have issued these instruments.

The issuance of titulos de participação will provide new capital to the INH to finance its operations, but will also result in a substantial reduction in the INH's retained earnings. INH will be required to place all of its profits in a reserve for payment of fixed interest and profit participation and these funds will not be available to pay operating expenses and to fund new loans. The government has not yet set the terms on the titulos de participação, but they can be expected to pay a rate of interest at least equal to the rate paid on government securities. Assuming that the titulos de participação will carry an interest rate of at least 17.5 percent, the INH's cost of capital will increase significantly. In 1990 the INH earned only a 13.4 percent return on equity, a rate of return insufficient to support a 17.5 percent cost on its capital if the entire 15 million contos of existing capital is converted to titulos de participação. If the INH's existing capital is retained as equity capital without a stated return, the INH's 1990 profits could support a maximum issuance of approximately 11 million contos in titulos de participação at a 17.5 percent fixed rate without any profit participation.

It is apparent that if the INH is to take advantage of this new source of capital it must seek ways to enhance its revenue and increase the turnover of its loan portfolio. The INH has not set up sufficient liquidity reserves to fund its cash needs because of the demands placed on the organization to increase loan production. In the past, financial management has not been the primary concern of the INH because it has had surplus liquidity. The measure of the INH's performance has been the number of units produced. However, after 1991 the institution will be fully invested and will have additional demands placed on its cash flow to pay its obligations on the new capital instruments. Financial concerns will have to take precedence over production goals if the INH is to remain a fiscally sound entity. Some of the objectives of the INH's programs may have to be reconsidered if they are not funded directly by the government. For example, the objective of creating a housing research and technical service center within the INH may not be feasible if the cost of such an endeavor must be funded out of the INH's operations. There is simply not enough profitability to support any extensive new non-revenue generating activities.

The INH does not have control over many of the variables which have an impact on its financial condition. The terms of the Housing Guaranty loans are set and the interest rates and exchange rate risk on the various loans will depend on U.S. and international market conditions. INH can only try to anticipate these changes and establish reserves to protect itself from adverse movements.

In some months the INH has not been able to fund its commitments and has had to defer disbursements on construction loans until funds were available. Some relief has been granted in 1991 by the agreement between the INH and the CGD and CPP under which the CGD will finance the construction of 18 million contos of INH approved projects and CPP will finance 6 million contos. As of May, 1991, the CGD had approved applications for projects of 10-12 million contos. However, CGD credit management regards INH loans as poorer credit risks than CGD's own loans because of the higher loan-to-value ratio and is reluctant to increase this support of the INH.

The INH's resources also have been strained by the government's failure to pay the subsidy due in 1989 and tardiness in government payments of reimbursements. Since 1989, government has paid the subsidies due to the INH, but has not always paid them promptly. The CGD, CPP and CEL/MG, however, do not report similar delays in subsidy payment because settlement is made in these institutions' accounts at the Bank of Portugal. Payments of subsidies due could be expedited if INH were permitted to establish a settlement account at the Bank of Portugal. However, government may not perceive a real need to pay INH in a timely fashion. The change in INH's legal status may also alter the government's relationship with the agency and result in more prompt payment.

Nonrecurring charges also have taken their toll on the INH. In early 1991 the INH was required to pay a portion of the exchange rate loss on a loan from National Westminster Bank. The INH had established a reserve for exchange rate risk, but the payment negatively impacted its cash position. In 1990, the Caixa Económica Açoreana, SA, a bank in which the INH had a 2.6 million contos deposit, failed and was reorganized. The INH's liquid deposit was converted to an equity position which was subsequently written down to 2 million contos. INH receives no dividend income from this investment and it would have great difficulty selling its interest. If the reorganization is not successful in returning the bank to profitable operation, further charge-offs will be required and the investment may prove worthless. Even if the reorganization is successful, the investment will remain very illiquid.

Increased lending activity under the INH's municipal finance program component has exacerbated the INH's cash flow problems. The INH extends 100%, 25-year loans to municipalities to finance low income rental housing. Security for these loans could be either a mortgage or a claim against the municipality's budget allocation from the central government. Payments are made directly by the municipalities. As of the end of 1990, the INH had 5.6 million contos in long term loans outstanding to municipalities. These long term loans reduce the INH's reflows and lengthen the maturity of its loan portfolio. The INH has contracted for additional long term loans to municipalities which will strain its resources. In 1991, the INH expects to disburse 4.4 million contos in long-term loans to municipalities.

Increasing long-term financing of municipalities will weaken the INH's financial position and will make it necessary to secure new sources of financing to maintain even its current level of construction financing. However, financing of municipal housing is one of the program goals of the INH and a failure to fulfill this objective will have a negative impact on the housing sector. Government will have to determine its policy objectives on the issue of municipal finance and establish priorities for INH participation. The INH cannot tie up its funds in long-term loans to municipalities and at the same time meet its construction lending objectives.

The INH is totally dependent on the CGD for permanent take-out financing and delays in processing mortgage loans to purchasers of INH financed houses has created severe pressure on the INH's liquidity. The INH should be able to maintain a level of construction loan production consistent with its recent performance if mortgage loan processing at the CGD can be expedited. Mortgage loans on INH financed units have required 12 months or more for processing. This excessive delay not only ties up the INH's resources, it increases the cost of the units to the low income beneficiaries due to capitalization of construction interest. The legal requirements for registering a mortgage and releasing the INH's interest impose a limit to the efficiencies which could be realized even under the best of circumstances. Table 9 shows the deeds and registration requirements for the different stages of housing development. Senior credit officers at the CGD and the other mortgage lending institutions indicated that the average time for processing a mortgage loan is four to six months. If mortgages on INH properties could be processed in the average time, this would be a great improvement.

The CGD has been criticized for not giving INH mortgage applicants priority in loan processing. It is not surprising that the CGD would give buyers of houses on which it held the construction loan priority over those referred from the INH. It would also be anticipated that the CGD will give preference to mortgage loans to take-out the 18 million of INH approved constructions loans which it has committed to finance. The issue is how INH can motivate CGD to expedite the processing of INH funded projects. Some improvement in CGD loan processing has been evident in recent months and CGD's investment in the capital of INH should provide an incentive to improve INH's financial position.

The INH should begin to operate more like a private sector entity by taking a more active role in the mortgage loan approval process. At a minimum, the INH and its clients should establish an agreed upon schedule for mortgage approval the INH should

Table 9

Table of the main deeds & registration.

<table>
<tr><td></td><td colspan="4">Developers</td></tr>
<tr><td colspan="2"></td><td>Cooperat.</td><td>Private</td><td>Local gov.</td></tr>
<tr><td></td><td>Real estate registration</td><td colspan="3">Deeds</td></tr>
<tr><td>1. Land</td><td colspan="4"></td></tr>
<tr><td>Acquisition</td><td>1</td><td>1</td><td>1</td><td>1</td></tr>
<tr><td>Loan</td><td>-</td><td rowspan="2">1</td><td rowspan="2">1</td><td>1</td></tr>
<tr><td>Mortgage</td><td>1</td><td>-</td></tr>
<tr><td>2. Construction</td><td colspan="4"></td></tr>
<tr><td>Loan</td><td>-</td><td rowspan="2">1</td><td rowspan="2">1</td><td>1</td></tr>
<tr><td>Mortgage</td><td>1</td><td>-</td></tr>
<tr><td></td><td colspan="4">Purchasers</td></tr>
<tr><td>3. Units</td><td></td><td colspan="3"></td></tr>
<tr><td>Acquisition</td><td>1</td><td colspan="3">1</td></tr>
<tr><td>Loan</td><td></td><td colspan="3" rowspan="2">1</td></tr>
<tr><td>Mortgage</td><td>1</td></tr>
</table>

monitor compliance with the schedule and intervene whenever the client does not meet the timetable. An interview with a private housing developer disclosed that his company is actively involved in mortgage loan processing, initiating the contact with the mortgage lender, assisting the buyer in preparing applications and other documentation, monitoring the credit approval process at the lender and even the conservatorio where mortgages are registered. In construction financing, time truly is money and delays impose unnecessary costs on both the home buyer and the construction lender. If the INH expects the CGD to expedite mortgages on its projects, it should initiate contacts with the CGD and attempt to negotiate an understanding of the actions the INH can take to improve the situation.

The INH should implement other improvements in its financial and cash management in other areas over which management does have at least some control. One area is improved coordination between cash budgeting and construction loan disbursement. Currently, the INH plans for even monthly disbursements, while the technical department disburses on the basis of vouchers for work completed. Since construction expenses are not incurred at a constant rate over the life of the project, it is not useful to budget as if they were. If possible, INH should disburse less frequently. Less frequent disbursement would conserve the INH's cash and could also reduce the financing cost component of a project if construction financing is utilized later in the construction process. For example, if a client determines it will need 2 million escudos in three months to pay costs incurred during that period, it would be more cost effective to draw the full amount at the end of three months rather than draw one-third each month. The borrower will save on the interest cost to carry the earlier disbursements. If a borrower is so financially weak that it has no other financial resources but the construction disbursement, it is not a good credit risk and probably should not be financed at all.

The INH also should evaluate its policy of capitalizing interest on construction loans. If no interest is paid during the construction period, interest is compounded on the interest capitalized, increasing the ultimate cost of the houses to the low income buyers, so there really is no benefit to construction period interest capitalization. At a minimum, some portion of the interest should be paid current and the balance capitalized. The INH could adopt the formula established for mortgage loans of capitalizing 40 percent of the interest and requiring that 60 percent be paid when due. Cooperatives can and already do assess members for the cash needed to pay the interest and this practice could be standardized for all cooperative financing. Private developers may have more difficulty paying interest current. Developers in a weak financial condition may not be able to meet more stringent requirements. Municipalities may not be able to meet the cash demands of paying construction interest and it may be advisable for the INH to adopt a different policy for construction loans to municipalities.

It should be recognized that if the INH adopts tighter financial and cash management policies, it may not be able to finance weak and marginal borrowers. It also may have to limit its long term financing to municipalities for low income rental housing. The INH may not be in a position to initiate other programs to conduct research and provide technical assistance and other services to the housing sector unless these activities generate sufficient revenue to cover their cost. As a result, the INH will not be able to achieve the full scope of the mission set for it by legislation. With the change in the INH's organizational status from a government agency to a sociedade anonima, <u>government should reconsider the INH's role and function in the housing sector and set achievable goals.</u> The INH cannot be all things to all segments of the sector and still maintain fiscal integrity. Choices will have to be made.

1. Resource Mobilization

The INH should continue to be Portugal's major source of financing for acquisition of land, and promotion of construction of controlled-cost housing. Much of its construction financing activity can be funded with reflows from earlier loans. <u>The INH should take all reasonable actions to improve its earnings on construction financing, including charging origination or processing fees to its clients.</u> If fee income could be generated to cover at least part of the cost of loan origination, the INH could increase its profit margin to support additional borrowing or issuance of capital instruments.

<u>The INH will not be able to increase its lending volume without mobilizing new financial resources.</u> The anticipated capital investment by the CGD and other institutions will provide additional resources for lending. <u>However, the INH should consider options which leverage its limited resources rather than using its capital to fund loans directly. One possibility would be to utilize capital to guarantee a portion of construction loans made by other institutions.</u> In the current environment credit institutions have sufficient funds to increase their credit granting activities. High quality loans with adequate security can always be financed and the INH could be used to enhance the quality of credit granted for affordable housing construction. A loan guarantee program would be a natural expansion of the loan agreement the INH has with the CGD and could provide the incentive needed to involve the CGD and other credit institutions in financing the construction of affordable housing.

There are numerous structures which could be considered. The INH could set up a guarantee fund equal to 20 to 25 percent of a construction loan financed by another institution. The INH would charge a guarantee fee of perhaps 1 percent to the borrower and would invest the money in the guarantee reserve in market rate short term financial instruments like government securities. Since other institutions do not grant loans with as high a loan to value ratio as offered by the INH, the guarantee fund could cover the difference between a, say 85 percent loan-to-value ratio, and the institution's own credit limit. For example, the CGD makes 65 percent construction loans under its own credit policies. The INH could guarantee an additional 20 percent to bring the loan up to 85 percent. If an INH guarantee fund backed 25 or 30 percent of a loan, the CGD would have even greater protection and might find low cost housing loans more attractive.

The benefit to the INH and the housing sector is better utilization of financial resources. One million contos used to make construction loans directly can support only an equivalent amount of financing, but if that same million contos is used to fund a guarantee fund covering 25 percent of a pool of construction loans funded by a third party institutions, the financing which can be provided is increased 400 percent.

The INH also should consider the option of a senior-subordinated financing scheme. In a senior-subordinated structure, the INH would finance a portion of the cost of construction and its interest would be subordinated to the loan granted by a third- party institution. The senior lender would be repaid first out of reimbursements from take-out financing and the INH would be repaid second. For example, the INH could finance the acquisition and development of the land and subordinate its interest in the mortgage to the construction lender. Although this scheme would have to be reviewed under Portuguese law, it is a viable means of leveraging the INH's resources and should be considered. Using a simple example, if land and infrastructure costs are 50,000 contos and construction costs are 500,000 contos the INH could finance the land and infrastructure cost and execute and register a subordination agreement, which would position it behind the construction lender who would advance the 500,000 contos construction loan. Therefore, for an investment of 50,000, the INH would support the financing of 550,000 contos of output. Alternatively, the INH could purchase a participation in a construction loan granted by a credit institution, or a third party institution could purchase a participation in an INH construction loan and the INH would subordinate its participation interest to the other lender.

The INH could sell participations in its loans without subordinating its interest to that of the investor. The risk would be the same for the INH and the investor and reflows would be distributed on a pro rata basis. The CGD and other potential investors may not be willing to have INH as the lead lender because of the INH's limited experience in construction financing.

There are other credit enhancement and participation structures which the INH could explore, but the objective of any program should be to maximize the efficiency and productivity of the financial resources available to the INH. Direct lending is the least efficient use of INH funds and other alternatives should be considered.

The INH also should explore the possibility of borrowing in the capital markets to finance its construction lending activities. The recent amendment to the INH statute authorizes the INH to issue mortgage bonds under the mortgage bond law, Decree Law no. 125/90. Mortgage bonds can be issued on the security of a mortgage collateralizing a construction loan. There are some provisions of the mortgage bond law which limit its applicability to construction loan financing. The three year minimum maturity permitted under the law is not as appropriate for construction loan financing as for longer term mortgage finance. The 80 percent loan to value maximum stipulated in the law would require the INH to make its credit criteria more stringent.

There is a strong demand for short term debt instruments in the market and high quality bonds can be sold easily and quickly. However, the INH is not recognized as a high quality credit and bonds issued on its credit would not be marketable without a government guarantee or the guarantee of the CGD. The CGD is the only AAA rated bank credit in the Portuguese market and INH paper with CGD backing would be marketable. The government may not be willing to give INH a guarantee and presumably CGD would charge a guarantee fee which could make the financing infeasible.

The periodic disbursements of construction financing do not lend themselves readily to bond types of financing unless the issuing institution can earn a positive spread on unutilized funds. This would not be the case in Portugal. Based on discussions with investment managers, the INH would probably have to offer an interest rate of 20 to 20.5 percent on any bonds it could issue, even with a government or CGD guarantee. If the INH invested the bond proceeds in government securities, it would earn a 17 to 18 percent rate of interest, a rate lower than the bond rate. Unless the INH could charge a higher interest rate on the construction loan, it would lose money on a bond financing.

The capitalization of interest during construction would make it difficult to structure a straight bond, i.e. a bond with periodic interest payments and repayment of principal at maturity. Interest capitalization bonds could be issued instead of traditional bonds. Interest capitalization bonds are issued in the Portuguese capital market in limited amounts and may be suitable investments for life insurance companies and pension funds.

In all of these alternative schemes, the INH would probably have to raise its credit standards, eliminating some of the weak and marginal cooperatives and developers who are currently financed by direct INH loans. The INH could still provide direct financing for clients and projects which do not meet the credit standards of the CGD and other credit institutions. The guarantee or participation program could fund higher quality credits with the resources of other lenders, enabling INH to target lower income projects and new developers who have not yet established a track record.

V. ANALYSIS OF THE FEASIBILITY OF CREATING A SECONDARY MORTGAGE MARKET FACILITY WITHIN INH

A. Benefits of a Secondary Mortgage Market

The alternative strategies discussed earlier in this report have addressed options available to the INH for funding its current program of controlled cost housing construction lending and improving the efficiency of utilization of funds available to the INH for its own programs. They do not address the broader issue of whether the INH should play a more important role in the housing finance and capital markets. One strategic alternative which should be considered is to utilize the INH as a mortgage liquidity facility for the CGD and other mortgage lenders. If the INH issued housing bonds under its recently granted statutory authority and used the proceeds to purchase mortgages from long-term mortgage lenders, the INH could have a profound influence not only on the housing and housing finance markets, but on the development of broader and deeper Portuguese capital markets.

The development of a secondary mortgage market, even if it is limited in scope compared to the secondary mortgage market in the United States, is a natural evolution of the housing finance sector. The specialized credit institutions which have traditionally provided mortgage finance in Portugal are facing new competition for deposit and other resources and more stringent international capital and accounting standards which may make mortgages less attractive for investment. As the Portuguese financial sector moves towards a true market environment, government support for the specialized housing lenders can be expected to decrease. In a market environment, the housing sector will be assured of a reliable flow of funds only if institutions and instruments can be developed which enable housing to compete successfully for capital.

There appears to be general agreement in Portugal that the development of a secondary mortgage market would enhance the efficiency of the housing finance system, increase the flow of funds to the housing sector, and create needed financial instruments in the capital market. As stated in the preamble to the Mortgage Securities Act:

> Credit institutions and parabanks will now have a new way of mobilizing resources by using the reflow from the mortgage loans that they have made. The investors will have access to a financial product of considerably reduced risk. The real estate sector, particularly the housing segment, will benefit from the new dynamism that the system will produce.

The benefits of an efficient secondary mortgage market are widely recognized. The flow of funds into the housing sector is increased, mortgage lenders reduce their risk and increase fee income through origination of mortgages for sale rather than for portfolio, mortgage securitization leads to standardization of underwriting, documentation and credit terms and conditions. An efficient secondary mortgage market reduces the cost of housing credit to the home buyer by pricing housing credit at capital market rates and increased competition in the housing finance sector. A properly functioning secondary mortgage market creates a circular flow of funds through the financial system so that institutions can increase the turnover of their own funds, earning fee income with each turnover. This process optimizes the efficiency of the financial sector and eliminates the constraint on the aggregate proportion of resources financial institutions will commit to housing credit.

B. The Role of a Secondary Mortgage Market in the Portuguese Housing Finance System

The Portuguese banking system has had excess liquidity for several years and has not felt the liquidity pressures banks in other countries have experienced from time to time. The illiquidity of mortgage finance is a concern primarily of the specialized credit institutions. Since the two largest housing credit institutions, the CGD and the CPP, are government owned, the problems of housing finance have been largely problems of government finance. However, with the implementation of the European Community banking directives and the BIS Commission capital requirements, the government's and the market's interest in asset securitization has increased.

What role does a secondary mortgage market play in an economy with a high savings rate and a history of excess liquidity? Due to the inherent problems of funding long term assets with short term deposits, prudent bankers will lend only a relatively small percentage of their total resources for long term mortgages. The Portuguese savings banks are in the process of restructuring their asset portfolios to reduce their concentration in housing credit in order to increase profitability and reduce their asset/liability risk. Even where total financial resources are expanding, only a portion of that growth will be utilized for new housing credit. As long as financial institutions must hold the housing credits they originate in their portfolios until they are paid, the availability of financial resources for housing will be constrained and the housing finance system will operate at a less than optimal level of efficiency.

In Portugal's rapidly evolving financial market, the constraint on mortgage financing is that the credit institutions which extend housing credit have reached or are very close to the aggregate level of mortgages they can prudently hold in their portfolios. In the absence of a functioning secondary mortgage market, public and private credit institutions can only increase their asset size or limit new extensions of housing credit to some portion of the amount of reflow on their existing housing credits to maintain the desired allocation to mortgage credit in their portfolios. The development of a secondary mortgage market would mobilize new sources of funds for the housing sector and create new capital market instruments attractive to the emerging non-bank financial sector. The question is whether the INH is the appropriate entity to develop the secondary mortgage function.

C. The INH and the Secondary Mortgage Market

The recently issued draft Decree-Law has laid the legal foundation for the INH to develop a secondary mortgage market operation. The INH could play a crucial role in increasing the flow of capital to the housing sector by using its authority to issue housing bonds not only to fund its own operations but also to offer a mortgage liquidity facility to Portuguese mortgage lenders. The INH already has relationships with the principal mortgage lenders in Portugal and may soon be directly affiliated with at least the CGD if the CGD and other institutions invest in the equity capital of the INH. As a quasi-governmental corporation, the INH would have a structure similar to the government sponsored mortgage enterprises in other countries.

As was discussed earlier in this report, INH-issued securities would not find ready acceptance in the capital market because the INH does not have a record of strength and sound financial performance. The transformation of the INH to a quasi-governmental entity will create even greater uncertainty about the status of the INH. In addition, mortgage backed securities would be a new instrument in the Portuguese capital market. Investors will have some reluctance to buy an instrument which may be highly illiquid.

In every country in which a secondary mortgage market has been created, the market has been initiated through the government or an instrumentality of the government because, until the market matures, direct or indirect government guarantees of secondary mortgage market instruments have been necessary to provide investors with a homogeneous, creditworthy investment. Market acceptance of a new class of security depends on the market's evaluation of the credit risk inherent in the instrument, the timely payment of interest and principal and the ability of the investor to sell the security quickly without loss.

A new security with an uncertain market, issued by an organization like the INH which lacks credibility in the market, would be difficult to sell without some type of explicit or implicit government backing. This would be true even if INH housing bonds were overcollateralized with seasoned performing mortgages because investors would not be interested in a security which required them to analyze the underlying mortgages to determine the creditworthiness of the instrument. The investor will look to the creditworthiness of the issuer or a third-party guarantor for the timely payment of interest and principal, not the underlying pool of mortgages which could include mortgages with different terms, maturities, repayment streams and collateral values. It should be recognized that a secondary mortgage market will not evolve based solely on the security of the underlying mortgages and that a guarantee either by the government or a creditworthy government enterprise like the CGD will be necessary.

D. Secondary Mortgage Market Instruments

The secondary mortgage market is an institutional market, not a retail market. While the individual investor can purchase some types of mortgage related securities, the instruments are designed to meet the needs of institutional investors like life insurance companies, pension funds, investment companies, mutual funds, and banks. Since the investment needs of the different types of institutional investors vary, different financing structures have been created to appeal to particular segments of the investor community. The structure of mortgage securities ranges from the traditional pass-through security in which the monthly payments of interest and amortization, net of loan servicing fees, are passed through to the investor, to highly complex collateralized mortgage obligations which reconstitute the cash flows of the underlying pool of mortgages into a series of "tranches" with different maturities and payment streams.

Advances in technology have enabled underwriters and issuers to design very sophisticated financing structures which rearrange the cash flows from the underlying pool of mortgages into the payment stream which the investor requires. This restructuring is comparable to process engineering in which given inputs are processed to produce the desired output. Today, an issuer can create a wide range of different financial structures from the payment stream generated by a pool of mortgages. The constraints are the financial feasibility of the structure, the marketability of the instrument, the costs of administering the structure and the risks inherent in the model. However, in a new capital market where mortgage related instruments are unknown, the initial securities should be uniform and structured along the lines of other debt instruments which have already gained market acceptance. Private placements can be customized to the needs of the specific investor, but public issues should use a standardized bond structure.

E. Prerequisites for the Development of a Secondary Mortgage Market

1. Legal and Regulatory Structure

In order to assure the orderly functioning of a secondary mortgage market, an appropriate legal and regulatory framework must be established. The 1990 Portuguese law authorizing the issuance of mortgage securities appears to have established such a framework, although there has been criticism that the provisions of the law are too rigid and restrictive. The principal provisions of the law are:

a. Empowers credit institutions and parabanks legally authorized to grant loans guaranteed by mortgages to issue bonds secured by mortgages. The recent amendments to the INH statutes expand this authority to the INH. Bank and parabank issuers should provide financing for the construction of acquisition of real estate and have "own funds" available of at least 1,500,000 contos.

b. Requires the prior authorization of the Minister of Finance, with the advice of the Bank of Portugal, to issue mortgage securities.

c. Limits the maximum loan-to-value for mortgages pledged as security for mortgage bonds to 80 percent and the maximum leverage on the mortgage pool to 80 percent for a 125 percent coverage ratio.

d. Requires that the mortgages used as collateral be valid first mortgages on real property in Portugal, that the mortgage loans not be subject to any existing assignment or pledge and be free and clear of all encumbrances and that the owner of the mortgages has good title and is authorized to assign, transfer, or pass title to the mortgages.

e. Requires that the securities be guaranteed by the issuing institution or a third party guarantor.

f. Amends the Civil Code to give holders of mortgage securities priority of claim against the mortgages held as security. Therefore, the holders of mortgage securities enjoy a special preference over all other creditors relating to the mortgage loans securing the bonds. The underlying mortgage loans can be liquidated to repay the principal and interest on the bonds.

g. Establishes a minimum term to maturity for mortgage securities of at least three years.

h. Requires that the mortgaged property be insured against all hazards.

2. Credible and Creditworthy Issuer

The successful development of a mortgage securities market, like any other market, will depend to a large extent on the market's perception of the financial and managerial integrity of the institutions which issue the securities. Investors must have confidence in the administrative and financial competence of the institution and in the guarantee for the timely payment of principal and interest to investors. Based on the interviews conducted during the course of this project, the <u>INH does not have the requisite reputation and acceptance to be a credible issuer on its own credit</u>. The <u>CGD does have credibility in the market and CGD issued securities would be readily accepted</u>. CGD or Government guaranteed bonds also would be easy to place at 75 to 100 basis points over government securities of comparable maturities. The market will not accept bonds secured solely by a pool of mortgages, even if the mortgages are well seasoned and performing.

3. Collateral

The underlying pool of credits is the primary source of payment of interest and repayment of principal for any asset-backed security. However, no investor is going to analyze the credit of each individual loan in the collateral pool. The composition of the underlying pool of credits will be critical to the financial soundness of the security both to the issuer, the investor and the third party guarantor(s). Mortgages outside the subsidy scheme should be relatively easy to aggregate into collateral pools even though there is no standardization of mortgage instruments in the Portuguese housing finance market. Nonsubsidized housing credits are predominantly level payment adjustable rate loans with 20 to 25 year original maturities, 80 percent or lower initial loan-to-value ratios and interest rates 300 to 400 basis points above the average bond rate. Mortgagors tend to pay down their housing credits on an accelerated schedule by making periodic payments to reduction of principal, so the duration of nonsubsidized housing credits is significantly shorter than the contract maturity. Lump sum prepayments are less frequent, but do represent prepayment risk to the issuer and/or the investor, depending on the structure of the financing.

While Portuguese mortgage delinquency and default rates have been relatively low, the INH is not in a position to assume the credit risk of mortgages which it did not underwrite and which it is not servicing. The INH does not have the financial resources to cover shortfalls in mortgage cash flows when mortgage bond interest and principal payments come due. The INH can protect itself through overcollateralization and through recourse provisions. Any credit institution selling the mortgage to the INH should agree that the INH would have recourse to sell the mortgage back during the remaining life of the mortgage should the mortgage become delinquent for three months or more or default.

Discussions of mortgage securities focus on the permanent mortgage as collateral for the security. However, any credit can be securitized, including the INH's construction loans. Construction loan pools are not widely used except in the form of loan participations or syndications because of the greater risk inherent in construction financing, the reliance on construction loan monitoring and supervision by the construction lender, the uncertainty of the cash flows during construction and the quality of the construction mortgage as collateral. Since the construction loan is secured by a mortgage on land and improvements on the land and the improvements are not in place, the value of the collateral in the event of default on the bond is highly uncertain. Bonds secured by a pool of construction loans probably would not be "bankable" without a government or CGD guarantee.

Another difficulty with construction loan securitization is the cash flow of construction financing. Construction loans are disbursed over the period of construction, usually 12 to 15 months, in increments based on the progress of construction and expenses incurred. Construction period interest may not be paid current, with some portion capitalized and repaid when the permanent mortgage is taken out by the buyer.

4. Servicing of Mortgages

The INH does not have the expertise, experience, staff and infrastructure to service the mortgages it may purchase. The credit institution currently holding the mortgage should continue to service the loan and receive a servicing fee as compensation. In the United States the servicing fee is 3/8 of 1 percent of the outstanding principal balance of the mortgage being serviced. In other countries, the servicing fee is computed as a percent of the amount collected.

5. Market Demand for Mortgage Securities

The debt securities market in Portugal has had a very short term investment horizon, with issues of five years or less predominating. Today it would be difficult to place an issue with a maturity longer than 7 years. Although the maturities of the underlying pool of mortgages for a mortgage security will average more than five years, an issuer will have to issue bonds with a maturity shorter than the underlying mortgages. This maturity mismatch increases the risk to the issuer who may have to refinance maturing bonds in order to pay off the bonds.

Commercial banks invest primarily in short-term debt instruments because of the short term of their liabilities. However, the BIS risk-based capital standards may make investment in mortgage securities somewhat more attractive to Portuguese banks. The BIS capital requirements assess different risk weightings for different classes of bank investment. Riskier investments like commercial loans and corporate bonds carry a 100 percent weighting, which means that a bank will have to have $8 in capital to support every $100 of commercial loans or corporate bonds on its books. Mortgage backed securities are assessed only a 20 percent risk weighting, so the bank which purchases a mortgage-backed security would have to maintain only $1.60 for each $100 invested. The increased leverage a bank has by investing in mortgage-backed securities makes such investments more profitable than commercial lending and investment in corporate bonds.

The growth of life insurance companies and pension funds, traditional intermediate and long-term investors, has created a demand for high-quality, medium-term credit instruments. The increase in life company and pension fund assets under management has outpaced the expansion of the securities market and has created a very favorable environment for issuers. Since the interest earned on securities is tax exempt for life companies and pension funds, the INH should be able to obtain a favorable interest rate on bonds placed with these institutions.

The regulations governing investment by life companies and pension funds have directed investment towards particular segments of the securities market by establishing minimum as well as maximum levels of investment. Under the mortgage securities law, mortgage securities are classified as "obligations of Portuguese entities" subject to a maximum investment limit of 50 percent for life companies and 20 percent for pension funds.

Interviews with investment managers and representatives of underwriters and issuers indicated that if the INH issues securities with the guarantee of the government or a highly regarded private company, it would have no difficulty selling into the market. However, there was no interest in INH paper without credit enhancement. The INH would have to establish a reputation in the market for sound management and profitable operations before investors would be willing to accept their paper.

E. Structure of Mortgage Pools

There are a number of factors which must be taken into consideration in constructing a mortgage pool which underlies mortgage securities.

1. Size of the Pool - The mortgage pool must be sized in a principal amount that will: 1) meet the statutory 125 percent coverage rule; 2) provide a sufficiently wide range of individual maturities; and 3) not be too large for the market to absorb quickly. An initial issue of 10 million contos could be placed easily and quickly under current market conditions.

2. Term Structure of the Pool - Mortgages included in the pool, at least for initial issues, should consist of "seasoned" performing mortgages originated at least two years prior to their inclusion in the pool. Limiting mortgages to those which have demonstrated successful performance will reduce the risks of the pool. The term structure of the pool should be diversified and provide sufficient amortization to repay the bonds in accordance with the schedule established. If the maturities of the underlying mortgages are too short, the issuer is exposed to reinvestment risk if, as would be the case in Portugal today, he could not reinvest the proceeds from mortgage amortization at a rate at least equal to the bond rate. Conversely, if the maturity of the mortgages is too long, amortization of the mortgages will not generate sufficient funds to repay the mortgage security when due and the issuer will be forced to refinance the securities.

3. Credit Enhancement - The creditworthiness of the mortgage pool will be evaluated based on the sufficiency of the mortgage cash flow to pay interest and principal on the bonds, the quality of the mortgage loans in the pool, overcollateralization on the pool and a

guarantee by a third party guarantor of the timely payment of interest and principal on the bonds. A convenient mechanism must be set up so that under the third party guarantee, the INH has immediate access to the funds needed to pay debt service on the bonds should there be a shortfall on a payment date. This could be accomplished by having a line of credit at the Bank of Portugal to advance any funds needed under the guarantee. The guarantor's account would be charged with the amount of any advance under the credit line and repaid by the INH when funds are collected on the mortgage pool. Another alternative is to increase the size of the bond issue to include a debt service reserve equal to one or two interest payments. The inclusion of a Debt Service Reserve increases the cost of the bonds since the interest rate earned on the reserve will be lower than the interest rate on the bonds.

G. Alternative Financing Structures

There are numerous financing structures for mortgage securities. However, since mortgage securities are a new instrument in Portugal, initial issues should employ a structure comparable to existing debt instruments in the market. These include a traditional bond structure with semi-annual payment of interest and repayment at maturity, a modified pass-through structure with semi-annual repayment of principal and the balance due at maturity, and serialized securities with tranches of bonds repaid at different maturity dates. These structures provide the best match between the cash flows on the underlying mortgages and the payments required on the securities issued.

Since mortgage securities are a new instrument in Portugal, initial issues can be expected to carry a risk premium over private debt instruments of comparable quality. The spread over the government interest rate may be as high as 125 basis points, but should decline over time as mortgage securities gain market acceptance. The critical issue is whether there is a sufficient spread between the interest rate on the underlying mortgages and the mortgage securities to cover all costs of issuance, servicing fees, administrative costs, guarantee fees and other administrative costs. It is highly unlikely that the spread between the rate on subsidized housing credits and the rate demanded by the market for mortgage securities will be sufficient to cover these costs. Therefore, the mortgage pool underlying the mortgage securities must consist of unsubsidized mortgages or a mix of unsubsidized and high quality subsidized mortgages.

In order to facilitate the creation of a mortgage securities market, the government passed a mortgage securities law in 1990 authorizing the issuance of mortgage backed securities by all banks and parabanks. The recent amendments to the INH statutes have also authorized INH to issue mortgage bonds. The law was subsequently amended in 1991 to give secured creditors clear priority of claim against the underlying mortgages under the civil code. Despite these initiatives, no mortgage backed securities or housing bonds have been issued. A senior official of the CGD indicated that his institution did not find issuance of mortgage bonds, under the restrictions of the existing statute and at the current market interest rates, a very attractive proposition. The interest rate which the market would demand on the bonds would be far higher than the institution's weighted average cost of funds. The CGD also is anxious to restructure its portfolio to decrease the concentration in mortgages. The issuance of mortgage bonds will not further that objective. Issuing mortgage bonds at a relatively high cost will increase the bank's assets and decrease its net interest margin, putting further pressure on its capital adequacy. However, as a result of its leadership position in the mortgage market, the government-owned CGD will float a small issue in the summer of 1991.

H. Problems of Securitization of Subsidized Mortgages

Under the mortgage securities law subsidized mortgages at the maximum legal loan to value ratio of 90 percent could not be utilized as collateral for mortgage securities. Seasoned subsidized mortgages, those where the property value has appreciated to the point where the loan to value ratio is less than or equal to the statutory 80 percent ceiling, could be utilized. However, using seasoned loans for mortgage pools would preclude the INH from purchasing the mortgage credits originated for the buyers of INH financed units. Therefore, there is little direct benefit to the INH of creating a secondary mortgage market facility.

Even if subsidized mortgage credits meet the requirements of the mortgage securities law, the complex mortgage subsidy regime in Portugal makes securitization of this class of mortgages difficult. There are too many variations of the mortgage subsidy structure. Also, mortgages can move from one subsidy level to another as the mortgagor's income increases or decreases from year to year. This problem is exacerbated by the government's frequent amendment of the subsidy structure. The interest rate on subsidized loans of 21 percent does not provide a sufficient spread over bond interest rates of 20 to 20.5 percent. Perhaps the most serious deterrent to securitization of subsidized mortgages is the capitalization of a mandated portion of mortgage interest, currently 40 percent. Interest capitalization mortgages under the current regime do not begin amortizing until the thirteenth or fourteenth year, well beyond the longest maturity bond which could be issued. The uncertainty of future cash flows from subsidized mortgages increases the risk to the bond issuer and the bond guarantor. Given these factors, it would be difficult to devise a financially feasible financing structure for mortgage securities in which the underlying mortgage pool consists entirely of subsidized mortgages. Subsidized mortgages are not securitizable. At best, they could be included as a relatively small portion of a diversified pool of mortgages consisting primarily of unsubsidized mortgage credits.

I. Risk to the INH

Creation of a secondary mortgage market facility within the INH involves additional risks to the organization unless mortgage securities are carefully structured to protect the INH from credit and liquidity risk. Great care should be taken to insure that the INH does not purchase substandard housing credits from the CGD, the CPP or any other credit institution which expose the INH to what could prove to be catastrophic losses. A default on even a single bond interest payment could destroy the credibility not only of the INH but the mortgage securities market as well. Investors are wary of new instruments which do not have an established history and it is imperative that the first mortgage securities issued in Portugal be of the highest quality. If problems arise in this emerging sector of the capital markets it will be difficult to regain credibility for the instrument.

J. Benefits to the CGD and Capital Markets

In discussions with the CGD, the CGD suggested that they could sell a pool of mortgages to INH. The purchase would be funded by INH issuing a mortgage security guaranteed by CGD. There are benefits to CGD and the capital markets from this program. CGD liquidates mortgages on its balance sheet, receiving cash which can be invested in more profitable lines of credit. The guarantee is a contingent liability which is "below the line" on the CGD's balance sheet. The capital markets benefit because CGD is a AAA rated credit whose guarantee on the mortgage securities will assure its marketability. The INH receives very little direct benefit other than a very narrow spread or limited fees. Managerial resources in the INH will be diverted from its principal function of promoting controlled-cost housing and if any volume of transactions is undertaken, the INH would be required to make additional investments in staff and equipment which may not be fully funded by the spread on the mortgage securities. The fundamental question is whether the development of a secondary mortgage market facility within the INH is consistent with the mission of the institution and the government's strategy for the housing finance sector.

Another impetus to greater consideration of the development of a mortgage-backed securities market has been the need to develop a broader and deeper domestic capital market. The Bank of Portugal strongly supports the creation of new debt instruments to absorb the excess liquidity in the system and "demonetize" national savings. The mortgage securities market could become one of the largest segments of the capital market.

K. Benefits to the INH

Although this scheme has little direct financial benefit to the INH and entails substantial risk, there are two potential indirect benefits. First, by issuing bonds, the INH may be able to develop a good reputation in the market over time. This may help the INH in the future to issue shorter term bonds in the market to help fund its own operations. According to INH estimates, the INH will need new sources of funds in the next 2-3 years. The experience gained by issuing mortgage bonds could result in an improved market perception of the INH and assist it in mobilizing resources in the future.

A second indirect benefit to the INH would be an improved relationship with the CGD. The CGD's financial interest in the INH, rooted in its probable future holding of INH títulos de participação, would be enhanced if the INH were to buy CGD mortgages and issue them as securities. This closer relationship could encourage the CGD to expedite the processing of mortgages which would take out INH construction loans more quickly. This would help considerably to ease the cash flow constraint of the INH.

APPENDIX A

Charts

Chart 1

TERM STRUCTURE OF DEPOSITS

	1985	% of total	1986	% of total	1987	% of total	1988	% of total	9/1989	% of total
Savings & Investment Banks										
Demand deposits	278,165	20.6	412,964	23.8	489,682	25.0	489,682	23.4	603,034	24.9
Time deposits	1,054,153	78.1	1,288,564	74.1	1,360,030	69.3	1,394,417	66.7	1,528,295	63.1
With Notification	3	0.0		0.0		0.0	1,610	0.1	2,360	0.1
30 to 90 days	9,022	0.7	12,860	0.7	13,456	0.7	8,674	0.4	10,876	0.4
91 to 180 days	23,313	1.7	15,630	0.9	17,582	0.9	12,530	0.6	27,682	1.1
181 days to 1 year	443,394	32.9	628,098	36.1	726,259	37.0	772,052	36.9	860,054	35.5
Over 1 year	578,421	42.9	631,976	36.3	602,733	30.7	599,551	28.7	627,323	25.9
Emigrants savings	17,234	1.3	25,709	1.5	43,651	2.2	64,503	3.1	87,473	3.6
Housing savings		0.0	2,618	0.2	4,222	0.2	4,979	0.2	6,623	0.3
Other Savings	176	0.0	8,871	0.5	64,987	3.3	137,166	6.6	195,418	8.1
Total	1,349,728	100.0	1,738,726	100.0	1,962,572	100.0	2,090,747	100.0	2,420,843	100.0
% of total deposits	32.7		35.4		35.6		33.6		36.1	
Commercial Banks										
Demand deposits	689,232	24.8	960,231	30.3	1,160,356	32.7	1,503,596	36.4	1,417,378	33.1
Time deposits	1,978,733	71.1	2,021,120	63.8	2,067,081	58.3	2,131,754	51.7	2,195,237	51.3
At notice	1,375	0.0	1,174	0.0	1,234	0.0	1,149	0.0	2,249	0.1
30 to 90 days	26,395	0.9	47,839	1.5	28,349	0.8	10,365	0.3	17,755	0.4
91 to 180 days	36,741	1.3	38,136	1.2	36,595	1.0	25,325	0.6	25,994	0.6
181 days to 1 year	1,376,272	49.4	1,373,333	43.4	1,468,455	41.4	1,506,761	36.5	1,463,643	34.2
Over 1 year	537,950	19.3	560,638	17.7	532,448	15.0	588,154	14.3	685,596	16.0
Emigrants savings	116,236	4.2	179,237	5.7	238,550	6.7	293,577	7.1	345,518	8.1
Housing savings		0.0	764	0.0	1,920	0.1	6,482	0.2	15,470	0.4
Other Savings		0.0	4,982	0.2	79,435	2.2	189,831	4.6	305,855	7.1
Total	2,784,201	100.0	3,166,334	100.0	3,547,342	100.0	4,125,240	100.0	4,279,458	100.0
% of total deposits	67.3		64.6		64.4		66.4		63.9	
TOTAL DEPOSITS	4,133,929		4,905,060		5,509,914		6,215,987		6,700,301	

* Source: Bank of Portugal, Quarterly Bulletin, December, 1990, pp. 66-67

Chart 2

TERM STRUCTURE OF LENDING--END OF YEAR BALANCES
(millions of escudos)

	1986	% of total	1987	% of total	1988	% of total	1989	% of total
Savings & Investment Banks								
Under 1 year	140,702	10.4	202,930	12.9	204,074	12.1	236,799	12.7
1 to 5 years	238,024	17.7	243,866	15.5	310,318	18.4	349,700	18.7
Over 5 years	968,977	71.9	1,123,849	71.6	1,176,864	69.6	1,285,068	68.7
Total	1,347,703	100.0	1,570,645	100.0	1,691,556	100.0	1,871,567	100.0
% of total loans	42.7		48.3		49.1		51.9	
Commercial Banks								
Under 1 year	1,044,930	57.7	957,934	57.0	1,064,262	60.8	1,065,050	61.3
1 to 5 years	423,623	23.4	358,878	21.4	328,302	18.7	329,425	19.0
Over 5 years	341,301	18.9	362,318	21.6	359,292	20.5	342,725	19.7
Total	1,809,854	100.0	1,679,130	100.0	1,751,856	100.0	1,737,200	100.0
% of total loans	57.3		51.7		50.9		48.1	
TOTAL LOANS	3,157,557		3,249,775		3,443,412		3,608,767	

* Source: Bank of Portugal, Quarterly Bulletin, December, 1990, pp. 49-51

53

Chart 3

DISTRIBUTION OF LENDING--END OF YEAR BALANCES
(millions of escudos)

	1986	% of total	1987	% of total	1988	% of total	1989	% of total
Savings & Investment Banks								
Agriculture, forestry, hunting								
and fishing	34,577	2.6	40,128	2.6	43,438	2.6	46,986	2.5
of which:								
Fishing	6,375	0.5	7,025	0.4	8,720	0.5	8,200	0.4
Extractive Industries	5,278	0.4	3,062	0.2	3,897	0.2	3,362	0.2
Manufacturing Industries	260,915	19.4	267,813	17.1	290,212	17.2	317,847	17.0
of which:								
Textiles, clothing and leather	26,140	1.9	32,512	2.1	38,464	2.3	46,176	2.5
Chemical and allied industries	57,261	4.2	55,191	3.5	51,683	3.1	44,024	2.4
Metal production machinery								
and transp. equipment	77,370	5.7	63,843	4.1	62,529	3.7	64,323	3.4
Electricity, gas & water	176,181	13.1	208,186	13.3	208,073	12.3	189,509	10.1
Construction & public works	216,977	16.1	212,440	13.5	166,395	9.8	183,400	9.8
Wholesale & retail trade,								
restaurants and hotels	56,479	4.2	47,546	3.0	52,336	3.1	72,166	3.9
Transport, warehousing &								
communications	62,093	4.6	54,694	3.5	49,626	2.9	50,607	2.7
Non-monetary financial institutions	20,152	1.5	26,123	1.7	42,815	2.5	47,885	2.6
Public sector	70,266	5.2	102,669	6.5	104,518	6.2	96,728	5.2
Other credits	444,785	33.0	607,984	38.7	730,246	43.2	863,077	46.1
of which:								
Credit to individuals for								
house purchase	400,620	29.7	555,878	35.4	682,435	40.3	803,302	42.9
Total	1,347,703	100.0	1,570,645	100.0	1,691,556	100.0	1,871,567	100.0

*Source: Bank of Portugal, Quarterly Bulletin, December, 1990, pp. 49-51

54

(CONTINUED)

DISTRIBUTION OF LENDING--END OF YEAR BALANCES
(millions of escudos)

	1986	% of total	1987	% of total	1988	% of total	1989	% of total
Commercial Banks								
Agriculture, forestry, hunting								
and fishing	94,011	5.2	79,685	4.7	63,760	3.6	64,985	3.7
of which:								
Fishing	15,412	0.9	12,402	0.7	10,970	0.6	12,037	0.7
Extractive Industries	11,985	0.7	8,498	0.5	10,260	0.6	10,004	0.6
Manufacturing Industries	631,989	34.9	566,667	33.7	603,726	34.5	595,037	34.3
of which:								
Textiles, clothing and leather	174,354	9.6	171,146	10.2	183,889	10.5	186,016	10.7
Chemical and allied industries	80,627	4.5	78,933	4.7	74,657	4.3	80,088	4.6
Metal production machinery								
and transp. equipment	110,992	6.1	94,532	5.6	98,552	5.6	93,011	5.4
Electricity, gas & water	111,992	6.2	121,563	7.2	134,658	7.7	125,049	7.2
Construction & public works	153,003	8.5	126,132	7.5	135,686	7.7	126,135	7.3
Wholesale & retail trade,								
restaurants and hotels	431,301	23.8	378,969	22.6	401,778	22.9	410,013	23.6
Transport, warehousing &								
communications	31,716	1.8	33,222	2.0	41,334	2.4	44,974	2.6
Non-monetary financial institutions	17,915	1.0	30,695	1.8	23,186	1.3	27,337	1.6
Public sector	27,321	1.5	32,061	1.9	21,849	1.2	17,974	1.0
Other credits	298,621	16.5	301,638	18.0	315,619	18.0	315,692	18.2
of which:								
Credit to individuals for								
house purchase	171,553	9.5	158,300	9.4	186,967	10.7	183,129	10.5
Total	1,809,854	100.0	1,679,130	100.0	1,751,856	100.0	1,737,200	100.0
TOTAL LOANS	3,157,557		3,249,775		3,443,412		3,608,767	

*Source: Bank of Portugal, Quarterly Bulletin, December, 1990, pp. 49-51

5

Chart 4

TERM STRUCTURE OF LENDING--NEW CREDIT GRANTED
(millions of escudos)

	1986	% of total	1987	% of total	1988	% of total	1989	% of total
Savings & Investment Banks								
Under 1 year	232,363	45.8	315,372	44.4	294,597	40.5	314,973	43.3
1 to 5 years	66,252	13.1	116,903	16.5	199,079	27.4	196,339	27.0
Over 5 years	208,681	41.1	277,983	39.1	233,030	32.1	216,336	29.7
Total	507,296	100.0	710,258	100.0	726,706	100.0	727,648	100.0
% of total loans	17.3		21.3		18.5		17.2	
Commercial Banks								
Under 1 year	2,042,959	84.2	2,260,355	85.9	2,862,063	89.4	3,129,982	89.4
1 to 5 years	245,587	10.1	214,523	8.2	227,219	7.1	251,167	7.2
Over 5 years	137,827	5.7	155,366	5.9	111,423	3.5	119,073	3.4
Total	2,426,373	100.0	2,630,244	100.0	3,200,705	100.0	3,500,222	100.0
% of total loans	82.7		78.7		81.5		82.8	
TOTAL LOANS	2,933,669		3,340,502		3,927,411		4,227,870	

* Source: Bank of Portugal, Quarterly Bulletin, December, 1990, pp. 52-54

Chart 5

DISTRIBUTION OF LENDING--NEW CREDIT GRANTED
(millions of escudos)

	1986	% of total	1987	% of total	1988	% of total	1989	% of total
Savings & Investment Banks								
Agriculture, forestry, hunting								
and fishing	20,520	4.0	20,435	2.9	28,838	4.0	29,796	4.1
of which:								
Fishing	3,483	0.7	2,455	0.3	4,055	0.6	3,633	0.5
Extractive Industries	2,229	0.4	3,965	0.6	2,512	0.3	1,429	0.2
Manufacturing Industries	132,739	26.2	168,581	23.7	199,499	27.5	191,744	26.4
of which:								
Textiles, clothing and leather	21,243	4.2	28,750	4.0	34,594	4.8	28,861	4.0
Chemical and allied industries	21,740	4.3	24,856	3.5	27,789	3.8	19,939	2.7
Metal production machinery								
and transp. equipment	23,344	4.6	35,413	5.0	36,594	5.0	42,232	5.8
Electricity, gas & water	65,734	13.0	76,175	10.7	28,334	3.9	13,891	1.9
Construction & public works	43,117	8.5	107,061	15.1	107,106	14.7	127,041	17.5
Wholesale & retail trade,								
restaurants and hotels	41,183	8.1	44,179	6.2	49,937	6.9	65,477	9.0
Transport, warehousing &								
communications	22,457	4.4	15,863	2.2	16,003	2.2	16,358	2.2
Non-monetary financial institutions	9,002	1.8	23,944	3.4	41,192	5.7	33,005	4.5
Public sector	33,647	6.6	41,836	5.9	64,921	8.9	60,392	8.3
Other credits	136,668	26.9	208,219	29.3	188,364	25.9	188,515	25.9
of which:								
Credit to individuals for								
house purchase	108,483	21.4	172,078	24.2	151,358	20.8	145,829	20.0
Total	507,296	100.0	710,258	100.0	726,706	100.0	727,648	100.0

* Source: Bank of Portugal, Quarterly Bulletin, December, 1990, pp.52-54

(CONTINUED)

DISTRIBUTION OF LENDING--NEW CREDIT GRANTED
(millions of escudos)

	1986	% of total	1987	% of total	1988	% of total	1989	% of total
Commercial Banks								
Agriculture, forestry, hunting								
and fishing	95,641	3.9	83,703	3.2	63,600	2.0	69,912	2.0
of which:								
Fishing	16,657	0.7	15,229	0.6	13,096	0.4	15,453	0.4
Extractive Industries	16,314	0.7	19,595	0.7	18,763	0.6	15,673	0.4
Manufacturing Industries	1,012,384	41.7	1,018,958	38.7	1,276,191	39.9	1,351,454	38.6
of which:								
Textiles, clothing and leather	305,197	12.6	324,349	12.3	392,891	12.3	429,799	12.3
Chemical and allied industries	132,244	5.5	131,385	5.0	154,373	4.8	155,116	4.4
Metal production machinery								
and transp. equipment	150,847	6.2	154,681	5.9	188,828	5.9	188,174	5.4
Electricity, gas & water	121,245	5.0	155,259	5.9	204,136	6.4	249,744	7.1
Construction & public works	141,727	5.8	136,696	5.2	180,149	5.6	190,582	5.4
Wholesale & retail trade,								
restaurants and hotels	641,162	26.4	691,214	26.3	889,986	27.8	975,621	27.9
Transport, warehousing &								
communications	47,268	1.9	56,708	2.2	78,044	2.4	107,791	3.1
Non-monetary financial institutions	38,159	1.6	74,703	2.8	80,811	2.5	100,138	2.9
Public sector	34,543	1.4	33,574	1.3	36,452	1.1	13,277	0.4
Other credits	277,930	11.5	359,834	13.7	372,573	11.6	426,030	12.2
of which:								
Credit to individuals for								
house purchase	43,414	1.8	38,426	1.5	35,448	1.1	28,917	0.8
Total	2,426,373	100.0	2,630,244	100.0	3,200,705	100.0	3,500,222	100.0
TOTAL LOANS	2,933,669		3,340,502		3,927,411		4,227,870	

*Source: Bank of Portugal, Quarterly Bulletin, December, 1990, pp. 52-54

APPENDIX B

List of People Contacted in Portugal

LIST OF PEOPLE CONTACTED IN PORTUGAL

U.S. GOVERNMENT AGENCIES

Richard LeBaron	US Embassy: First Secretary, Economics Section
Dave Leibson	RHUDO/Lisbon: Director
Jose Trindade	Consultant to RHUDO
Edward Robbins	Consultant to RHUDO

GOVERNMENT OF PORTUGAL

Antonio Silva Ferreira	Bank of Portugal: Deputy Director, Banking Supervision Department
Joaquim Gaspar Martins Perdigao	Ministry of Finance: Division Chief, External Affairs
Antonio Braz dos Santos	Ministry of Finance: Director General of Public Debt
Francisco Serras Catarino	Bank of Portugal: Economist, Department of Balance of Payments and External Finance
Antonio Borges	Bank of Portugal: Deputy Governor

BANKING SECTOR (COMMERCIAL, DEVELOPMENT, INVESTMENT & SPECIALIZED BANKS)

Bernardo Joao Carvalho Sousa Fialho	Banco Portugues do Atlantico: Commercial Division
Joao do Carmo Oliveira	World Bank, Economic Development Institute: Senior Economist
Antonio Maria Silva Freire	Caixa Geral de Depositos: Manager, Treasury and Securities

Jose Antonio Ferreira Gouveia Novais	Credito Predial Portugues: Subdirector, Housing & Construction Development
Jose P. Santos Rodrigues	Instituto Nacional de Habitacao: Department of Economic and Financial Studies
Nuno Manuel Oliveira Luz de Almeida	Instituto Nacional de Habitacao: Managing Director
Augusto Santos Ferreira	Instituto Nacional de Habitacao: Financial Controller
Hermano Manuel da Silveira Vicente	Instituto Nacional de Habitacao: Technical Director
Isabel Maria Martins Dias	Instituto Nacional de Habitacao: Legal Department
Jose Morgado	Banco Comercial Portugues: Director, Mortgage Finance
Pedro Rebelo Pinto	Banco Comercial Portugues: Mortgage Finance Department
Manuel Quelhas Gomes	Montepio Geral, Savings Bank: Adjunct Director
Joao Vieira Gomes de Abreu	Caixa Geral de Depositos: Director, Construction & Housing Credit
Nicholas L. Racich	Manufacturers Hanover-Portugal: Vice President

<u>OTHER</u>

Maria Julia Martins	Companhia de Seguros Tranquilidade: Director, Life & Pension
J. Miguel Pauperio	Companhia de Investimentos e Servicos Financeiros: Managing Director
Vasco Ribeiro Ferreira	Mar Finam, S.A.: Administrator
Jose Luis Almeida Pinheiro	INITIUM: Economist

Jose da Silva Lopes	Financial Consultant to Bank of Portugal
Jose Luis Oliveira da Silva	Sociedade Gestora de Fundos de Investimento Mobiliares: Administrator
Nuno Botelho	BCI Investimentos SGPS, S.A.
Helena Marques da Silva	Lisbon Stock Exchange: Jurist, Juridical Direction
John Scott Johnson	BCI Investimentos SGPS, S.A.
Joao Real Pereira	Companhia Portuguesa de Rating
J.C. Rodrigues da Costa	Bolsa de Valores de Lisboa: Marketing Manager
Luis Borges Nogueira	Finantia: Director
Ricardo Pinheiro	Price Waterhouse, Portugal
Charles Buchannan	Luso-American Development Foundation: Director
Chaves Lopes	CHESMAS Cooperative: President
Jose Cardoso da Silva	Buckingham Portugal, SGPS

APPENDIX C

Scope of Work

STATEMENT OF WORK

ARTICLE I - TITLE

An Analysis of Capital Market Development in Portugal with respect to Housing Finance and strategies of the National Housing Institute.

ARTICLE II - BACKGROUND AND OBJECTIVES

Since 1984, the Instituto Nacional de Habitação (INH) of Portugal has financed the construction of more than 38,000 units at sales prices averaging less than half the median of other housing generally available on the market. In so doing, the INH has shown that access to specialized credit for land development and construction of low cost housing projects encourages private developers, cooperatives, and municipal authorities to produce homes affordable to low income families. The financial resources of the INH, however, are limited as are the instruments it is currently authorized to use in local capital markets. Moreover, as it does not provide take out financing, its cash flow and medium term planning are precariously hinged on, and encumbered by, irregularity in the supply of long term financing from the mortgage banks.

At the same time, capital markets in Portugal have been changing rapidly and will continue to evolve in response to economic growth and restructuring imposed by Portugal's entry to the European Economic Community (EEC) as well as changes in European banking as it heads towards a single financial market. The Government of Portugal has encouraged this process, has begun the process of privatization of its banks and other financial instruments including mortgage baked bonds, real estate investment trusts and lease purchase financing of real estate investments.

Efforts to finance low income housing though are hampered by high interest rates, currently up to 23 percent. Inflation in 1990 was 13.4 percent, but monetary management aimed at bringing inflation down to EEC averages has kept credit in short supply and market interest rates high.

Now five years old, the INH has determined that it needs to re-examine its objectives, its relationships to other sectoral institutions and the financial structure of its programs.

The purpose of this analysis are to review the structure of housing finance in Portugal in the context of evolving financial markets and to assess strategic alternatives for the INH. Clients for this analysis are the Secretary of State for Treasury.

69

ARTICLE III - SCOPE OF WORK

A. Review Trends in the Evolution of Portuguese financial markets

Review and report on:

1) dimensions, structure and trends in the evolution of financial markets that may have or have had impacts on housing and municipal finance;

2) dimensions, structure and trends in housing finance and the relative place of construction of mortgage lending in financial markets;

3) dimensions, structure and trends in municipal financing and potential for municipal debt placement in financial markets;

4) changing sources of capital - types of institutions, companies and banks that are or could be induced to invest in housing developments, construction loans, mortgages, mortgage securities, municipal bonds or bonds of the INH and other sectoral institutions;

5) structure and trends in the development of financial instruments that could be adapted to finance low cost housing and municipal infrastructure; and

6) the impacts that monetary policy, regulation of financial markets and European integration may have on housing and municipal finance in Portugal.

B. Assess strategic alternatives for the INH

Assess and report on:

1) current financing and medium term plans of the INH;

2) strategic alternatives including:

a) a continuation of the current structure and existing lines of credit;

b) a turnover of construction financing for low income housing to mortgage banks and shift INH programming to new lines of credit, for example: land acquisition and development, municipal infrartructure, urban renewal, home improvements or building renovations;

c) an increase in capital resources of the INH including:

65

- issuance of stock;

- opening the statutory capital of the INH to the Caixa Geral de Depositos (alone or with other national institutions);

- institutionalization of mechanisms with the Caixa (alone or with others) for refinancing of INH activities either through sale of loan assets or issue of securities backed by mortgages on INH loans;

d) INH participation in or a restructuring of the INH (alone or with other national institutions) as:

- a mortgage bank;

- a retail banking institution but with a focus on housing and land development;

- a secondary market financial institution with attributes including capital market operations, the refinancing of mortgage backed securities and possibly municipal bonds;

- a regulator of Government interest rate and other incentives for low income housing and regulator of secondary market instruments designed to facilitate financing of low income housing and municipal programs.

  a "Savings and Loans" and "Building Sector" experience in either the U.S. or in Europe whether in terms of structure or its attraction in the markets for mortgage back bonds, specifically its operation procedures and as a source of funds. Potential for applying the model in Portugal.

C. <u>Identification of conditions for new capital market instruments</u>

Identify and report on:

1) types, design parameters and market potential for capital instruments to facilitate the financing of low income housing and municipal programs including bonds, mortgage backed securities, real estate investment trusts and leasing arrangements;

2) potential for secondary markets in such capital instruments and identify conditions that may be necessary including standardization of instruments, mortgage insurance and regulatory measures;

66

3) roles that the INH should play in development of new capital instruments and secondary markets.

D. Discuss finding with the Board of the INH

After delivery of a draft report, meet with the Board of Directors of the INH and with the Secretaries of State for Housing and the Treasury to discuss findings.

E. Discuss capital markets with senior staff of the INH

Give short talks on capital markets or housing finance followed by questions and discussion at a one-half-day meeting to be arranged by the INH of their senior staff and selected guests from other sectoral institutions. Talks could be on structure and trends in the U.S. capital markets, new market instruments, secondary mortgage markets, or other areas proposed by the consultants drawn without need for lengthy preparation from their specific experience or area of expertise.

ARTICLE IV - LEVEL OF EFFORT

A. Review of trends in Portuguese capital markets

The review and report on trends in Portuguese capital markets, Part A of the Scope of Work, are to be accomplished with senior staff, consultants, or staff from the Contractor's office in Lisbon (up to 20 person days including travel to Lisbon of a capital markets specialist).

B. Assessment of Strategic Alternatives and Identification of conditions for new capital market instruments

The assessment of strategic alternatives and identification of conditions for new capital market instruments, Parts B and C of the Scope of Work, are to be accomplished in a two week visit to Lisbon of a senior advisor/team leader on capital markets, a housing finance specialist, and a technical assistant. The team is to be supported by Contractor's office in Lisbon (total of up to 45 person days.)

C. Preparation of a draft report

A draft report is to be prepared by the advisors in the U.S. on completion of the Lisbon visit (total of up to 10 person days).

D. Discussions with INH board and senior staff

The two U.S. advisors are to return to Lisbon after delivery of their draft report to discuss their findings

67

with the Board of the INH, Part E of the Scope of Work. The discussion of capital markets with the senior staff of the INH, Part F of the Scope of Work can be scheduled either during their first visit or this return visit. The Contractor's report is to be finalized in Lisbon during the return visit based on comment from the INH and RHUDO/Lisbon (total of 15 person days).

ARTICLE V - REPORTS

A. A Draft Report including the reviews and assessments, Parts A-C of the Scope of Work, is to be delivered within two weeks of completion of the initial visit to Lisbon. Five copies will be submitted to the INH; three to RHUDO/Lisbon and two to APRE/H. The report will include and executive summary, not to exceed five pages, and a summary suitable for public briefings or press release, not to exceed one page.

B. The Final Report will be completed during the second visit to Lisbon. Within one week of the completion of that visit, Ten copies will be delivered to the INH; five to RHUDO/Lisbon; and five to APRE/H.

ARTICLE VI - TERM OF PERFORMANCE

All work is to be completed by June 30, 1991.

68