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THE SECURITIZATION OF ASSETS IN MEXICO

CARLOS AIZA HADDAD*

For the past few decades, asset securitization has been a common form of financing in developed countries. It has slowly become available as an alternative form of financing in emerging markets, such as Mexico. The concept of asset securitization involves converting banks' credits and other financial assets with low liquidity into liquid securities that will be placed in the financial system to be purchased and traded by other financial institutions and both sophisticated and unsophisticated investors.

The Securities and Exchange Commission of the United States has defined securitization as follows:

...securities that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.¹

On the investor's side, securitization offers access to financial assets such as mortgage and consumer loans, credit card and other types of receivables, consumer loans and other less common assets, such as employee loans and tax receivables that will mature at a given point in time in the future, and that would not otherwise be available to the common investor.

On the issuer's side (in particular when the issuer is a financial institution), beyond the benefits arising from a potentially efficient source of financing, securitization releases financial assets and, more importantly, capital requirements imposed on such financial assets from the books of the financial institution, thereby permitting a more efficient use of capital. In general, securitization enables financial institutions to improve their financial/liquidity positions and, at the same time, finance new projects.

There are numerous types of financial assets that can be securitized. The holder of receivables has the opportunity to make them liquid through the sale of those assets to a special purpose vehicle (SPV) that will in turn issue securities to investors, giving the original holder liquidity in those positions.

Securitization has been a very large source of debt finance in developed countries, particularly the United States, for more than twenty years, and in other developed markets for at least a decade. In Latin America, only certain types of businesses have had access to securitization and, unfortunately, they are the same businesses that have had access to other sources of funds, capital markets and foreign lenders as well.

In Mexico, there have been various securitization transactions in the past few years. My understanding is that the first important securitization transaction in Mexico was carried out in 1987 by Teléfonos de México (TelMex), when it securitized its long-distance telephone receivables payable by AT&T and other long-distance carriers in the United States, for US\$420 million.

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1. General Instruction I(b)(5), form 33, SECURITIZATION ACT OF 1937.

Since then, many securitizations have occurred. Both Bancomer, S.A. and Banco Nacional de México, S.A., the two largest Mexican banking institutions, carried out securitizations of credit card receivables in 1990, for the aggregate amount of US\$229 million and US\$130 million, respectively. In 1993, Petróleos Mexicanos (PEMEX), the Mexican oil company, securitized US\$336 million worth of future export receivables. The Federal Electricity Commission (*Comisión Federal de Electricidad*), the Mexican power company, securitized US\$235 million worth of its existing lease collection rights.

Since then, other Mexican banks have securitized other types of financial assets, in particular, one interesting type of assets called "*remesas*" or remittances, such as money orders or travelers checks that are quite liquid. Those transactions have typically been done in the form of future flows.

The structure of securitization allows the original holder of the receivables to transfer title to the underlying receivables, whether existing or future receivables, to a special purpose vehicle (SPV). In order to avoid bankruptcy issues, it is essential to segregate those assets from the estate of the original holder. Therefore, the concept of a true sale, the actual legal transfer of title to those assets to the SPV, and, in the case of an insolvency or bankruptcy of the original holder, the possibility of consolidation of those assets with the estate of the originator of the assets are, without a doubt, the two most important issues that need to be legally addressed in a securitization transaction.

One of the key concepts in a securitization transaction is that the holders of the ultimate securities (i.e., the investors) shall look solely at the quality of the assets (whether existing or future assets), the quality of the obligors thereunder, and the probability that payment will actually be made, rather than at the assets of the originator or the possibility of direct recourse against the original holder of the underlying assets.

In Mexico, there are generally two different types of originators, which originate financial assets that can be securitized thereafter. The first type is basically integrated by financial entities, in particular Mexican banks, and other types of regulated financial entities. In the majority of cases, Mexican commercial banks have been the originators of securitized assets. In fewer cases, there have been successful securitizations by other types of commercial companies that also generate, in the ordinary course of business, receivables that can be thereafter transferred to a SPV and then securitized.

Article 93 of the Mexican banking law presents a regulatory obstacle that inhibits Mexican commercial banks from participating in securitization transactions.² Generally, Mexican banks are disallowed from transferring their assets to any third party except for other Mexican banks, the Mexican Central Bank (*Banco de México*), or trusts created by the Mexican Government for economic development.³ Although sometimes it may be time consuming, *Banco de México* is entitled to and has been open to granting the necessary authorizations to allow Mexican banks to

2. LEY DE INSTITUCIONES DE CRÉDITO [L.I.C], Diario Oficial, [hereinafter D.O.], July 18, 1990, as amended art. 93.

3. *Id.*

transfer assets from their books to a special financing vehicle, thereby allowing such institutions to securitize their assets.

In 1993, the Mexican Government passed legislation authorizing the creation of *Sociedades Financieras de Objeto Limitado*⁴ (Limited Purpose Financial Companies, SOFOLEs), which are regulated entities that have been considered as the equivalent of the US non-bank banks. Unfortunately, these entities, which are excellent candidates for securitization of assets, have not yet engaged in such activities in Mexico. Essentially, SOFOLEs are, as indicated by their name, non-deposit taking entities which are authorized to grant credits to previously determined or established activities and/or sectors. As of today, nobody is certain as to what extent they are regulated, but they are regulated financial entities. Most of these entities are engaged in mortgage lending and, therefore, are anxious to securitize their mortgage loan portfolios. I believe SOFOLEs would be ideal originators of loans that could be securitized in the future, since most of the lending documents are standardized. Mortgage loans, particularly, but also consumer loans are excellent candidates for securitization.

In order to enable securitization of mortgage loans, various laws were amended during 1996. The purpose of those amendments was to set clear rules that will allow the securitization of those credits and foreclosure in the event of default. Even though important advances have been made (law amendments, regulation of new vehicles, etc.) for the establishment of a solid mortgage market, from a legal standpoint, the issue that still needs to be addressed is that relating to recordings with the Registry of Public Property. There are discussions for introducing new rules and a system that will permit recording within hours. As of today, however, there is no public information available relating to this matter. Hopefully, Mexico will get there at some point.

Besides banks and SOFOLEs, there are also candidates for securitization of assets among credit unions and savings and loan associations in Mexico. Some of the credit unions in Mexico have been in some trouble lately. To my knowledge, there are no specific projects for those companies to securitize their portfolios at this time. They are typically very concentrated financial entities that deal only with a very limited group of people who participate in the financial entity. Perhaps that is a project for the next 10 or 20 years.

Finally, there are candidates among what I shall call unregulated entities, typically commercial companies that sell to consumers. Examples are the Sears and Liverpools of the world, and in particular an interesting Mexican company called Elektra, S.A. de C.V. Some readers may be familiar with Elektra, which has successfully securitized its consumer-lending portfolio. It is one of the few companies which has done so locally in peso-denominated securities in the local market. It serves as a good example of a very large group of potential originators of financial assets that can be securitized both in the international markets and domestically in Mexico.

Another important issue is the concept of standardization of the underlying documents. In order for the originator to be able to transfer a pool of financial assets to a SPV, so that the SPV may in turn issue securities that are supported by those

4. LEY DE INVERSION EXTRANJERA [F.I.L.], D.O., December 27, 1993 as amended.

financial assets, it is essential that those financial assets have a common denominator in various areas. The underlying collateral documents must ideally have certain similar elements (e.g., type of loans, interest, maturity date, etc.) in order for the investors to be able to appraise those assets in a reasonable form. The investors must be able to service - probably through third parties - those loans in a reasonable form.

The lack of standardization has led to some of the problems Mexican banks have encountered when attempting to securitize their portfolios. There may be one Mexican bank which issues a loan on a given date, a mortgage loan or a consumer loan or a corporate loan based on certain criteria of credit analysis and documentation of collateral. An officer of the same bank, on the same day, on another floor, issues an equivalent loan with completely different standards, different documents and different ideas behind it. The main problem is that Mexican banks historically have issued loans that are different in nature and therefore cannot be pooled together. On the contrary, SOFOLEs (most of which were created during 1994 and did not start operations until 1995) have been very successful in standardizing their loan documents, probably without originally intending to securitize them. Because they were new companies, and were smaller, better and more tightly managed, they have more standardized documents, which could be pooled more easily.

Although standardization is certainly a very important component of securitization, I do not intend to assert that loan documents need to be identical, with the same types of maturity, coupons or other related components. But, certain fundamental components of those loan documents need to be similar so they can be bundled into tradable securities and sold.

The concept of a "true sale" is probably the most challenging and the most interesting in the securitization process. In my opinion, no securitization transaction will ever be successful if legal opinions are not rendered in a way that confirms that legal title to the assets is being transferred to the SPV, which will ultimately securitize them. The rationale behind this true sale concept is that the ultimate investor will need to look at the assets that are held (in property) by that SPV, and in particular, to the cash flows that will arise from those assets. The investor will not be relying on direct recourse against the assets of the originator of the loans. Therefore, title to the underlying assets needs to be legally transferred to a SPV and not consolidated with the potential bankrupt or insolvent estate of the originator.

The concept of true sale is not always easy to accomplish. Under Mexican law, certain formalities need to be satisfied, depending on the nature of the assets. Most of the securitization that has taken place in Mexico has been made with respect to future flows or future assets that the originator will receive without relying on existing assets.

Once future assets have been distinguished from existing assets, we must consider the actual nature of the assets that can be securitized. We discussed assets such as mortgage loans, consumer loans, tax refund rights and leases. In order to understand what the requirements are for a true sale, it is imperative to divide the assets into three different types. Those include negotiable instruments, ordinary collection rights, and mortgages.

The first, negotiable instruments (or at least the concept of the negotiable instrument) as defined by the Mexican laws, are the documents that incorporate all

necessary requirements to exercise the right inherent thereto and that are created to be readily and easily transferred once and again.⁵ They are documents that typically, as far as requirements are concerned, can be transferred either by simple physical delivery of the document or by endorsement and physical delivery of the document to the transferee.

The first case, what Mexican law calls the "*cesión*," is nothing more than actual physical delivery of a negotiable instrument that is in bearer form. Only certain types of negotiable instruments in Mexico can have that form. In the case of *pagarés* (promissory notes), which are the most common negotiable instruments used in Mexico, the requirement is simply an endorsement in the instrument itself and the physical delivery thereof. Such endorsement and delivery will perfect, for Mexican law purposes, the transfer of an ownership interest in that instrument to the transferee. Generally, no specific notice to the issuer of the negotiable instrument is required; no particular formality or registration needs to be accomplished in order to perfect such a transfer.

However, the issue becomes very interesting when it comes to future assets, assets that the originator does not yet own but is agreeing to transfer in the context of a future receivables securitization. An example of the various securitization transactions that have been done in Mexico is the concept of remittances or *remesas*. There is a huge market of money orders and different kinds of instruments that are transferred from the United States to Mexican residents in dollars, most of which are actually payable in the United States and in dollars. In those cases, typically what are sold are expected flows from those instruments to the Mexican originator. The question here would be how does one accomplish a true sale of assets that do not yet exist. In that regard, there are certain provisions in the Mexican Civil Code that can be referred to.⁶ But, in my personal opinion, someone cannot sell an asset until the time at which he or she owns it. It is perfectly valid for someone to agree to sell a future thing;⁷ however, it is my opinion that the sale of that asset is not perfected until the seller actually holds legal title to the asset or is legally entitled to sell such asset. When the seller agrees to sell future assets, he or she agrees to immediately transfer title to that future asset to the buyer upon becoming the owner thereof. In the case of a negotiable instrument that is not in bearer form, where we have the requirement of endorsement and delivery, the seller or the originator of the asset, upon obtaining ownership of the asset or property, must immediately endorse the instrument in favor of, and deliver it to the transferee, at which time the sale will be perfected.

The following example better illustrates this problem. What happens if someone who has validly agreed in a future flow securitization to transfer US\$50 million of assets in the next five years suddenly becomes insolvent in year number three? Even though there is a valid agreement to transfer those assets as they are generated, if

5. LEY GENERAL DE TÍTULOS Y OPERACIONES DE CRÉDITO [L.G.O.T.C.], D.O., August 27, 1932, as amended art. 2.

6. CODIGO CIVIL PARA EL DISTRITO Y TERRITORIOS FEDERALES EN MATERIA COMÚN Y PARA TODA LA REPÚBLICA EN MATERIA FEDERAL [CIVIL CODE FOR THE FEDERAL DISTRICT AND TERRITORIES IN ORDINARY MATTERS AND FOR THE ENTIRE REPUBLIC IN FEDERAL MATTERS, hereinafter C.C.D.F.] D.O. December 24, 1996, arts. 2309, 2792-2793.

7. *Id.*

those assets have not been transferred via (in the case of negotiable instruments that are not in bearer form) endorsement and delivery, then technically, upon the issuance of a decree of bankruptcy or insolvency, those assets would not have been transferred for bankruptcy purposes. Therefore, they will be consolidated into the bankrupt estate as they are generated, not being able to flow through to the SPV as originally intended. This problem is an enormous obstacle that must be worked out in order to allow for such securitizations. In any case, the issue that needs to be looked into is the possibility of declaring null and void the conveyance of assets to the SPV under the concept of a fraudulent conveyance.

The second category of assets, ordinary collection rights, may be in the form of, among others, a lease agreement that generates the right of the lessor to receive rental payments on a monthly, quarterly or annual basis, but which right is not documented through a negotiable instrument or some other kind of instrument that allows the simple transfer. Generally, under Mexican law, the transfer of a document that is not in the form of a negotiable instrument and therefore cannot be transferred by endorsement and physical delivery, requires the fulfillment of two main requirements. The Civil Code for the Federal District provides that the creditor may assign its right to a third party without the consent of the debtor.⁸ Furthermore, the Civil Code provides that in order for the assignee to exercise its rights against the debtor, the assignee must notify the debtor of the assignment either in the presence of a notary public who, generally speaking, has what is called public faith (*fe pública*) under Mexican law, or in the presence of two witnesses.⁹ In the case of thousands and thousands of loans that are being securitized in Mexico, this makes securitization very difficult if not impossible. In the context of a large securitization of thousands of loans, being required to actually go to the domicile of each of the debtors and notify them in the presence of two witnesses (or a notary who has a monopoly and tends to be quite expensive) throws the securitization out the window before it even begins.

So, there is a problem with one of the typical Mexican law or general Civil law formalities that must be satisfied, a problem that does not exist in other jurisdictions. It is a problem that impedes, in a very serious way, the efficient flow of financial assets to benefit everyone, particularly the originators of those loans.

The third class of assets is mortgages (*hipotecas*). In the case of mortgage loans, there are other issues to deal with in addition to those that have already been discussed. There are additional formalities under Mexican law relating to public registries, in particular those pertaining to real property. Mortgages are regulated in the Civil Codes of each of the States of the Mexican Republic, the applicability of which will depend on the location of the real estate property subject to the mortgage. However, generally such regulation is modeled on the Civil Code for the Federal District. The Civil Code provides that a mortgage is a guarantee *in rem* created on assets which are not delivered to the creditor, that grants the latter the right, in the event of default of the secured obligations, to be paid with the value of such assets in the order of preference established by the law.¹⁰ A mortgage will only

8. C.C.D.F., Art. 2030.

9. C.C.D.F., Art. 2036.

10. C.C.D.F., Art. 2893.

be valid and enforceable provided that the mortgagor is competent under the law to execute the document and also that the property offered as security can be freely mortgaged.¹¹

Generally, mortgages must be formalized before a Notary Public, and thereafter recorded with the Public Registry of Property within the jurisdiction where the property is located in order to be effective against third parties.¹² The lien of a duly recorded mortgage takes priority over all other liens, with the exception of previously perfected liens, and liens for unpaid taxes and labor claims. Non-recorded mortgages have no legal value against third parties, and are merely private contracts between the parties thereto and do not rank with other recorded mortgages or *inter se*.¹³

The Mexican Civil Codes of all jurisdictions provide that assignment of the collection rights under a mortgage loan must satisfy the same formal requirement that the mortgage loan itself originally had to satisfy. In other words, the notary must be employed and then the registration process must be followed. Efforts have been made since at least the beginning of this decade to change this and it has become an urgent problem. There is a huge demand for housing in Mexico today and therefore for mortgage loans, and securitization is one of very few alternatives available to allow funds to flow into that particular sector.

Based on my review, I believe that all but four of the State Civil Codes of Mexico have been amended in order to provide that the assignment of a mortgage loan will not require these difficult formalities. The following amendment to the Civil Code of the Federal District illustrates this change with respect to the assignment of mortgage obligations:

If a mortgage is created to secure obligations to the order of, they may be transferred by endorsement of the instrument without notifying the debtor or recording an instrument regarding the transfer. The mortgage created to secure an obligation to bearer shall be transferred by simple delivery of the instrument, without any further requirements.

Mexican banking institutions while acting on their own behalf or as trustees, other financial enterprises and public social service institutions may assign credit obligations secured by a mortgage without notice to the debtor nor a public notarial instrument and without recording in the Public Registry as long as the assignor shall continue to administer the credits. If the assignor stops administering the credit, the assignee need only notify the debtor in writing.

In case of the two preceding paragraphs, the recording of the mortgage in favor of the original mortgagee shall be deemed to be in favor of the assignee(s) referred to therein, who shall have all the rights and causes of actions derived therefrom.¹⁴

In other words, notification of the debtor in the presence of two witnesses or a notary public, certification by a notary, the actual assignment of documents, and registration of the assignment document in the public registry for perfection purposes, are no longer as strictly construed in order to make it binding vis-a-vis

11. C.C.D.F., Art. 2906.

12. C.C.D.F., Art. 2919.

13. *Id.*

14. C.C.D.F., Art. 2926.

third parties. Typically, the rationale behind this notice to the debtor was that the debtor needed to know whom he or she was going to pay. If there was an assignment of that collection right, the debtor needed to know whom the holder of the credit right was in order to make the payments. To the extent that the originator of the loan continues to service that loan, Mexican civil laws now allow for the development of mortgage-backed securities, or mortgage securitization.

I am afraid that these modifications have not helped the securitization process for mortgages as much as people expected, but it is a step toward that goal. There are a few issues that still need to be addressed, but people are working on it. The local legislatures of quite a few states in Mexico have agreed with the concept of promoting the ability to securitize future assets as well as existing assets. So we are walking, not running, toward that end and hopefully sometime in the near future we will get there with the help of some multi-national organizations that have put in a lot of work and a lot of effort on this point.

So, generally speaking, that covers the concept of transferring these assets. Again, the concept of true sale, which in many instances can be accomplished under Mexican law, cannot be accomplished in other jurisdictions. Based on my experience, it is a lot more complicated to get to a true sale in the context of a securitization in the United States than it is in Mexico.

I have discussed the problems of the originator of the assets and the transfer of the underlying financial assets. Now I would like to review the problems relating to the purchaser of the assets, which typically is in the form of a SPV. Most of the securitization transactions in Mexico that have taken place have happened with Mexican banks or large Mexican corporations that satisfy certain specific requirements. The first of those requirements has typically been that the currency in which the creditors' rights to the financial assets that are being transferred be similarly denominated.

The most successful securitization transactions that have occurred in the past ten years by Mexican issuers have been in dollar-denominated receivables. Again, I mention long-distance receivables payable outside of Mexico, export receivables and remittances denominated in a hard currency and payable outside of Mexico, and other assets of that nature. It is easier to look at a securitization in the context of something that isolates the Mexican risk and the Mexican peso currency risk from the securitization transaction. So those cross-border transactions which are the most successful are the ones in which the Mexican issuer or originator is transferring title to assets that are denominated in another currency, typically a hard currency, and are payable outside of Mexico. The SPV is typically created or incorporated outside of Mexico as well. Again, the point is to try to isolate the SPV from the Mexican risk. That is a very broad concept - bankruptcy, currency, political and other types of risk are very important in the risk analysis of a securitization transaction.

In cross-border transactions, the SPV is set up outside of Mexico and, at least in my experience, is typically in the form of a trust that is set up in another jurisdiction. In some circumstances, an additional step has been taken to actually create an interim vehicle, typically in the form of a special purpose company outside of Mexico. This typically occurs in a tax-haven jurisdiction to avoid negative tax consequences. The actual Mexican originator transfers title to the financial assets to an offshore corporation, a special purpose corporation, in a place like the Cayman Islands. That special purpose corporation in turn transfers those financial assets to

a SPV, typically a trust in the United States. The trust (SPV), in turn, issues the securities that will ultimately be purchased by the investors. This interim structure provides an additional layer of comfort to the investors to isolate the Mexican risk from the rest of the transaction.

In the case of the very few domestic securitizations that have occurred, typically the SPV will take the form of a *fideicomiso*, a Mexican trust, which is the most flexible vehicle that the Mexican legal system allows. A *fideicomiso* is like a box where you can put in and take out whatever you want to the extent that it is legal; therefore, it is probably the most efficient and flexible vehicle that can be used for securitization in Mexico. Legal title to the assets are transferred to a trustee (acting in such capacity under the *fideicomiso*) as an independent estate, that is, independent from the estate of the bank or insurance company acting as trustee, and also independent of the estate of the originator that transfers title to such assets. Bankruptcy issues become extremely relevant in this analysis.

Once the *fideicomiso* is created, the trustee will issue special types of instruments called Ordinary Participation Certificates (*Certificados de Participación Ordinaria*, "CPOs"), which are really nothing more than certificates that evidence an ownership interest or an equivalent collateral interest in the assets held in property by the trustee. Therefore, the investor would ultimately be buying these instruments, which may qualify as securities under Mexican securities laws, and would have an ownership or collateral interest in the assets of the trust.

Additional matters also need to be addressed; first of all, the concept of collateral and other credit enhancement techniques typically used in securitization transactions. It is hard to picture an investor buying a security that is only supported by certain assets that are held in a trust or in a SPV, that represent the right to collect certain future cash flows, and assume the risk of collection of those cash flows without having recourse against the originator or third parties or other assets. Typically, this is dealt with via the creation of a credit enhancement mechanism in the transaction to compensate for the increased credit risk that the investor assumes in buying the securities. As far as credit enhancement mechanisms go, I would divide them into internal credit enhancements and external credit enhancements. In the case of internal credit enhancements, what typically occurs is that the SPV issues different types of securities to investors that have different types of risk philosophies, or want to assume different types of risks in the context of their investment. The concept behind this mechanism is that, to the extent that the trust issues senior securities that have a preference in payment from other junior or subordinated securities, it will be easier to place those senior securities among certain types of investors. Consequently, the holders of junior securities would be assuming a larger level of risk. Therefore, the coupon or interest rate payable under those securities would be larger.

Over-collateralization is another concept worth discussing. Over-collateralization is characterized by the transfer of a larger principal amount of financial assets than appears to be necessary. For example, US\$100 million of assets is transferred to the trust, and then US\$50 million of securities are issued so that there is a two to one collateral ratio to secure the payment of the issued securities. The excess principal amount is treated as a reserve. These reserves typically constitute cash collateral accounts. To the extent that payments are being made, typically in the

context of over-collateralization, monies are withheld by the trust before making distributions to any third party in order to secure the payment to the investors.

External credit enhancement techniques are typically limited to third party guarantees. They are generally provided by some insurance companies in the United States that are authorized to "wrap up" a securitization transaction, in other words, guaranteeing payment to the investors or at least to the senior investors, in consideration of the payment of a fee. In the absence of a third party guarantee, letters of credit or other typical forms of guarantees could also be incorporated into the concept of a securitization to offset the credit risk that investors would be assuming.

In conclusion: I started by saying that securitization has been available in Mexico to the same kinds of entities that have access to other sources of debt finance through international capital markets, foreign lending institutions, Mexican lending institutions and equity from shareholders. These companies have been the only companies that have had real access to securitization. I strongly believe that the project right now is to expand the securitization market in order to make it available to those companies or persons that do not typically have access to those forms of financing. I know that a lot of work has been done to expand this market, so that is where the trend should be. Let us look at securitization for mid-size companies, for small-size companies, for housing and things of that nature. Everybody knows that Mexico is in desperate need of financing, particularly for low-income housing. That is the sector in which capital is needed the most and there is no reason for securitization not to help in a major way in that sector. Again, SOFOLEs and some Mexican banks have assets sitting in their books that, to the extent the requirements we discussed are satisfied, could easily be securitized to allow those companies to transfer those assets from their books and provide funds for housing. The Fondo Bancario de Protección al Ahorro (FOBAPROA), which is a public trust in Mexico, and other government agencies have been working intensively on this project.