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Erica W. Stump

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SECURITIZATIONS IN LATIN AMERICA

ERICA W. STUMP*

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I. INTRODUCTION

Securitizations,¹ or asset-backed transactions, have matured into a \$400 billion per year industry in the United States.² These transactions have picked up fervor in Latin America as well.³ Companies in Mexico, especially midsize and small companies, have trouble raising capital to fund their expenses, to expand, and remain competitive in the global market. Securitization transactions can be a solution to this problem. Securitizations offer funds to companies at a lower cost because of the lower transaction costs. Large companies, however, have traditionally only had access to these markets because of the large amount of funds needed to take advantage of the lower transaction costs and lower interest rates.

The financial market was especially favorable to securitization transactions until the Asian financial crises. Although the Latin American market's initial reaction was a dramatic reduction in liquidity, higher interest rates, and shorter repayment terms, there has been increased awareness of asset-backed transactions in this region.⁴ This, however, has been dampened by the devaluation of the Brazilian Real, which may lead to a downward spiral for all of Latin American economies, including Mexico, the focus of this article.

In the past, only large companies have had access to the securitization market, offerings over \$100 million. "[F]oreign banks are comfortable lending to only about 100 companies" in Mexico because of their track record and substantial amount of exporting.⁵ This excludes the smaller and midsize companies, even those that are suppliers to the giant companies.⁶

Securitization transactions would enable the smaller to midsize companies in Mexico to obtain much needed finance to help them compete in the global economy. This, in turn, would boost Mexico's economy and prevent a devaluation of their currency.

This article discusses securitizations generally in Part I and compares securitization transactions in the United States to those originating in Mexico

¹ Securitizations generally are transactions converting cash generating assets into marketable securities. *See infra* Part III.

² *See* Timothy C. Leixner, Address to the *Forbes Magazine and Council of the Americas*, The Latin American Market, Asset Securitization Overview and Current Issues (November 17-19, 1998) (on file with author).

³ *See id.*

⁴ *See Trade Finance a Supplement to Project Finance, Latin American Structured Trade Finance, Working out the Right Recipe*, PROJECT & TRADE FIN., Sept. 10, 1998, at 24. (hereinafter "Trade Finance")

⁵ Thomas S. Heather & Martha Traudt Collins, *Secured Financing of Machinery and Equipment, Including Cross-Border Leasing and Conditional Sales Contracts*, 5 U.S.-MEX. L.J. 23, 25 (1997).

⁶ *See id.*

in Parts II and III. Finally in Part IV, this article discusses the future of these securitization transactions in Mexico.

A. *What is an Asset-backed Securitization?*

An asset-backed securitization may be defined as a transaction whereby an entity ("Originator") "securitizes" its future cash flows or receivables by conveying them to another entity often a trust ("Trust") set up specifically for this purpose and is typically owned by the firm.⁷ The trust structure is beneficial because it avoids taxation at the entity level.⁸ This can be in the form of a true sale or a secured loan, depending on the desires of the Originator in terms of accounting purposes and bankruptcy protection.⁹ The Trust ("Issuer") issues debt and/or equity securities (often commercial paper) in a public or private offering.¹⁰ Investors purchase the debt or equity sales and the funds flow back from the investors, through the Issuer/Trust and back to the Originator to repay the loan.¹¹ This is the simplest way to structure an asset-backed securitization.¹²

The payments on the receivables (for example, car payments) are collected by a servicing entity ("Servicer") that is often the Originator.¹³ The payments are deposited and invested in accounts under the control of a trustee, usually a bank, and disbursed to the security holders in payment of the securities.¹⁴ A more complicated structure involves the use of a conduit Issuer, maintained by banks and investment bankers.¹⁵ The Issuer/conduit aggregates receivables purchased from Originators that do not have large enough receivables to do a "stand alone" transaction on their own.¹⁶ Standard and Poor's established criteria for and assigned a rating to the first asset-backed commercial paper conduit, Commercial Industrial Trade Receivables Investment Co. (Ciesco).¹⁷ There are two types of conduits: multiseller conduits that aggregated unaffiliated originators and single seller conduits that finance the assets of a

⁷ See Leixner, *supra* note 2, at 1.

⁸ See *id.* at 2.

⁹ See *id.* at 1.

¹⁰ See *id.* at 2.

¹¹ See *id.* at 2.

¹² See *id.* at 1.

¹³ See Leixner, *supra* note 2, at 2-3.

¹⁴ See *id.* at 2.

¹⁵ See *id.* at 3.

¹⁶ See *id.*

¹⁷ *Standard & Poor's Asset-Backed Commercial Paper Criteria*, available at <http://www.standardandpoors.com/ratings/definitions/compaper.htm> (last visited Jan. 26, 1999) (hereinafter *Standard & Poor's Criteria*).

single originator.¹⁸ Conduits enable smaller to midsize companies in Latin America to take advantage of the securitization market because they can pool their funds together.

Credit enhancements are necessary in every transaction to reduce the risks to the investors and increase the rating of the transaction.¹⁹ Credit enhancements include a reserve fund, cash collateral account, security bond, early amortization, letters of credit, senior/subordinated structure, liquidity provider, and overcollateralization.²⁰ Overcollateralization involves transferring to the issuer more money than required to pay the securities.²¹ The amount varies, usually from 5% to 20%, and is determined by the quality of the receivables, risk of the structure, economic conditions, and nature of the industry.²²

B. *What Assets can be Securitized?*

Any asset providing a predictable cash flow can be securitized.²³ For example, residential mortgages, home equity loans, commercial and construction loans, auto loans and leases, credit card receivables, student loans, trade receivables (i.e. toll road receipts and receivables from petroleum production in Mexico), and record album receivables (i.e. David Bowie and Pavarotti) have all been securitized.²⁴

David Bowie's \$55 million "David Bowie bonds" were the first music royalties future receivable securitization; they were backed by royalties on a catalogue of Bowie's recordings and song copyrights.²⁵ This was an especially attractive deal since the coupon interest rate is 7.9% for the life of the deal as opposed to 6.37% on the new 10-year Treasury note.²⁶ Moody's rated the offering at A3.²⁷ Almost anything can be securitized!

C. *What are the Benefits of Securitization?*

A benefit of a securitization transaction is that the Originator's balance sheet improves because the assets have been sold to another entity and

¹⁸ See *id.* at 4, 7.

¹⁹ See Leixner, *supra* note 2, at 4.

²⁰ See *id.* at 4-5.

²¹ See *id.* at 4.

²² See *id.*

²³ See *id.* at 1.

²⁴ See *id.*

²⁵ See Sam Adler, *David Bowie \$55 Million Haul, Using a Musician's Assets to Structure a Bond Offering*, 13 ENT. L. & FIN. 1 (1997).

²⁶ See *id.*

²⁷ See *id.*

replaced by cash.²⁸ This is similar to factoring of account receivables.²⁹ Securitization differs from factoring accounts receivables because a company securitizes their future flows, as opposed to past flows, or money already due. The Originator then has immediate access to those funds, instead of waiting for the payment of the future flow, the mortgage or auto loan, for example.³⁰ This can be very beneficial to small and midsize companies that need immediate access to liquid funds and cannot wait for the future flows.

If the Originator were to raise the funds by selling the securities directly, the Originator would be subject to the claims of security holders, at least in the case of bankruptcy. Only the Trust is subject to the bankruptcy claims and is "bankruptcy-proof".³¹ Moreover, the securities are rated higher by the rating agency because the company's entire balance sheet is not subject to the rating agency's scrutiny so as to reduce the cost to the Originator when compared to traditional forms of financing, like a simple loan.³² In the same respect, the Originator, if privately held like JM Family Enterprises, as discussed in *infra* in IIB, does not have to make public their company's financial condition. In addition, since the Originator acts as Servicer, there is no need to give notice to the obligors.³³ This is especially beneficial to Latin American companies that need to raise capital, but cannot because of the Mexican peso rating ceiling and the rating problems due to the inherent risk in a foreign entity.

Foreign entities, especially those in Latin America trying to raise capital in the United States can obtain a lower interest rate. Many Latin American firms that are solid in structure have had trouble attracting investors because of the defaults in the early and mid-1980s.³⁴ The result was that Latin American firms often had to pay higher interest rates because of the market.³⁵ Securitizations allow the entity, or Originator to obtain more attractive interest rates because they raise capital in the United States instead of in their country.

In addition, political and currency risks are diminished. The investors are repaid from the future cash flows, or funds never located in the politically risky country or its currency.³⁶ Despite the recent devaluation of the Brazilian real and the Mexican peso financial crises of the 1980s and 1994/1995,

²⁸ See Leixner, *supra* note 2, at 2.

²⁹ See *id.*

³⁰ See *id.*

³¹ See *id.* at 3.

³² See *id.*

³³ See *id.*

³⁴ See Claire A. Hill, *Latin American Securitization: The Case of the Disappearing Political Risk*, 38 VA. J. INT'L L. 293, 294 (1998).

³⁵ See *id.* at 296-97.

³⁶ See *id.* at 297.

securitizations offer a viable option in raising capital in Latin American countries.

The most attractive feature to a securitization transaction is the large spread between the percent paid on commercial paper and the company's financing alternative, often a loan from a bank.³⁷

II. NATURE OF SECURITIZATIONS ORIGINATING IN THE UNITED STATES

A. *Typical Structure*

Securitizations in the United States generally take two forms: mortgage backed and asset-backed securitizations. Mortgage backed securities were the beginning of the modern securitization transaction beginning in the early 1970s.³⁸

Domestic securitizations can take place in one of two ways, generally: with the use of a conduit or without. The basic structure, described *supra* in Section I is without a conduit, also known as a stand-alone securitization. A conduit is a limited-purpose finance company, often a large bank issuing commercial paper to finance the purchase of assets.³⁹ Standard & Poor's established the first conduit, Commercial Industrial Trade Receivables Investment Company (Ciesco).⁴⁰ Standard & Poor's now commands a 100% market share of asset-backed commercial paper ratings.⁴¹ The advantage to using a conduit lies in the fact that the allocation of legal and structural risks is spread among the liquidity banks.⁴²

1. SECURITIES ACT AND GOVERNMENT INTERVENTION

The Securities Act of 1933 ("1933 Act") makes it unlawful for any person to sell a security through instruments of interstate commerce unless a registration statement is in effect with respect to such security.⁴³ As a result, the commercial paper the Trust issues is defined as a security.⁴⁴ However, the majority of the commercial paper issued as a result of the securitization is an

³⁷ See *id.*

³⁸ See *id.* at 294.

³⁹ See *Standard & Poor's Criteria*, *supra* note 17.

⁴⁰ See *id.*

⁴¹ See *id.*

⁴² See *id.*

⁴³ See 15 U.S.C. §77e (1999).

⁴⁴ See *id.* § 77b.

exempt transaction within the 1933 Act because it is privately placed.⁴⁵ Section 4(2) of the 1933 Act exempts transactions “by an issuer not involving any public offering.”⁴⁶ However, this transaction exemption is not used often since the introduction of Regulation D.⁴⁷

Regulation D has three exemptions: Rule 504 exempts offerings up to \$1 million;⁴⁸ Rule 505 exempts offerings up to \$5 million;⁴⁹ and Rule 506 exempts offerings with no dollar limit, but the offering can only be sold to thirty-five non-accredited investors and an unlimited amount of accredited investors.⁵⁰ Accredited investors include banks, insurance companies, investment companies, savings associations, corporations, partnerships and business trusts with total assets in excess of \$5 million, among others.⁵¹

Resales of exempt securities must find an exemption within the 1933 Act or be subject to registration.⁵² Rule 144A solved some of the uncertainty in this area by creating a safe harbor from the registration requirements of Section 5 for resales to “Qualified Institutional Buyers” (QIBs).⁵³ QIBs are defined in Rule 144A to include investment companies and business development companies, corporations, partnerships, employee benefit plans, among others, having a net worth of \$25 million or more.⁵⁴

Those transactions that are not privately placed must be registered under both the 1933 Act and the 1934 Act.⁵⁵ Section 13 of the 1934 Act requires the issuer to file annual reports, quarterly reports, and special events reports.⁵⁶ The securitization transactions are subject to the 1934 Act anti-fraud rules, most importantly Rule 10b-5.⁵⁷ Both the privately and publicly sold commercial paper are subject to the 1934 Act.⁵⁸

⁴⁵ See *id.* § 77d.

⁴⁶ *Id.*

⁴⁷ See Michael S. Gambro & Scott Leichtner, *Selected Legal Issues Affecting Securitization*, 1 N.C. BANKING INST. 131, 134 (1997).

⁴⁸ See 15 U.S.C. § 77d.

⁴⁹ See *id.*

⁵⁰ See 17 C.F.R. §§ 230.504-.506 (1999).

⁵¹ See *id.* § 230.501.

⁵² See Gambro & Leichtner, *supra* note 47, at 136.

⁵³ See 17 C.F.R. § 230.144A (1999).

⁵⁴ See *id.*

⁵⁵ See Gambro & Leichtner, *supra* note 47, at 136.

⁵⁶ See 15 U.S.C. § 78m (1999).

⁵⁷ See 17 C.F.R. § 240.10b-5 (1999).

⁵⁸ See Gambro & Leichtner, *supra* note 47, at 141.

2. RATING AGENCY – STANDARD & POOR’S

The rating agencies – Moody’s, Standard & Poor’s, Fitch IBCA, and Duff & Phelps play an active role in the structure of the transaction and often require changes in structure and servicing procedure.⁵⁹ Standard & Poor’s commands a 100% market share of asset-backed commercial paper ratings.⁶⁰ The rating process begins with the company approaching Standard and Poor’s (hereinafter “S & P”) and ends when S & P issues a rating letter.⁶¹ In addition, S & P conducts ongoing management reviews and surveillance to monitor the receivable pools.⁶² If at any time S & P feels that there is a substantial decline in the performance of assets, S & P can downgrade the rating.⁶³

B. World Omni Financial Company

World Omni Financial Company (WOFCO) is a subsidiary of JM Family Enterprises, a privately held automobile company.⁶⁴ WOFCO handles consumer loans for automobiles, auto leases, dealer floor plans, and other financing techniques.⁶⁵ In one recent transaction, WOFCO securitized these auto leases by assigning the lease contracts and leased vehicles to the origination trust, World Omni LT, which issued an undivided trust interest to Auto Lease Finance L.P. (ALFI).⁶⁶ The trustee of the origination trust creates a separate portfolio within World Omni LT and a SUBI is sold to the transferor, World Omni Lease Securitization, L.P. (WOLSI).⁶⁷ WOLSI contributes 99.8% of the SUBI to World Omni 1997-B Automobile Lease Securitization Trust and retains a .2% interest in the assets.⁶⁸ The trust can now issue notes.

In this transaction, WOFCO has employed a multitrache setup with four senior classes and one subordinate class.⁶⁹ The four senior classes are publicly

⁵⁹ See Leixner, *supra* note 2, at 4.

⁶⁰ See Standard & Poor’s Criteria, *supra* note 17.

⁶¹ See *id.*

⁶² See *id.*

⁶³ See *id.*

⁶⁴ See World Omni Automobile Lease Securitization Trust 1997-B, Structured Finance Asset-Backed New Issue, available at <http://www.fitchibca.com> (last visited Jan. 26, 1999).

⁶⁵ See *id.*

⁶⁶ See *id.*

⁶⁷ See *id.*

⁶⁸ See *id.*

⁶⁹ See *id.*

placed, and the fifth is privately placed, due to the lower rating.⁷⁰ There is a one-year revolving period where the noteholders receive interest only, and thereafter receive principle in monthly payments.⁷¹ The initial contracts consist of 49,166 fixed rate, closed end lease contracts with an approximate initial value of \$1.2 billion with an aggregate residual value of \$833 million.⁷² There is a 1% servicing fee and the coupon pays 6.2% to investors.⁷³

1. RATING AGENCY - FITCH IBCA

Fitch IBCA rated the class A securities AAA, in part due to credit enhancement because of the subordination of the 5.25% class B principle, the over-collateralization that builds up as the senior classes pay down, and the residual value insurance policy provided by AISLIC.⁷⁴ Investors are also protected by the subordination of the 1% servicing fee and servicer advances on schedules payments past due for thirty-one days or more.⁷⁵

2. RISK OF DEFAULT

As with any financing, there is always risk of default. However, WOFCO has not yet defaulted on their obligations.⁷⁶ S & P ensures that there is no default by monitoring the delinquency rate for three months and if it is greater than 1.75% or the charge-off exceeds 2.75%, then the reserve account will grow to the lesser of 100% of the current certificate balance, or 2.0 times the initial reserve requirement.⁷⁷

III. NATURE OF SECURITIZATIONS ORIGINATING IN MEXICO

A. *Typical Structure*

The Mexican legal structure has many problems that create impediments to securitization transactions. It is virtually impossible to structure a transaction in the Mexican market, and is still complicated to structure a transaction through the United States' market. Mexico's difficulties include

⁷⁰ *See id.*

⁷¹ *See id.*

⁷² *See id.*

⁷³ *See id.*

⁷⁴ *See id.*

⁷⁵ *See id.*

⁷⁶ *See id.*

⁷⁷ *See id.*

the length of adjudication, the lack of trust law, problems with possession and security interests, including the lack of a comparable U.C.C. Article 9, and bankruptcy law.

Mexico follows a civil law tradition, as opposed to a common law tradition. The code is the first place that a lawyer looks to find the meaning of or a solution to a legal problem.⁷⁸ When there is a trial in Mexico, it is very unlike the United States' common law trial, and tends to take much longer.⁷⁹ The end result is that when there is a problem interpreting Mexican Civil Code, the process could take years, thus the company or entity cannot proceed with transactions.

The most prevalent problem for Mexican securitizations is the difficulty with trust law, or trust law similar to that in the United States. This presents a problem because the Originator needs to sell the assets to the bankruptcy remote Trust. By law, trusts in Mexico cannot issue debt, therefore the paper would have to be issued through securities called *Certificados de Participacion Ordinaria*, or CPOs, with Nafin evaluating the assets backing the CPOs and certifying that the value of the assets is equal to the mortgage-backed security.⁸⁰ Argentina and Venezuela have limited the use of trusts to alleviate this problem.⁸¹

Mexico does recognize security interests and the most common method is to take a mortgage, or "hipoteca" that creates a lien in favor of the creditor.⁸² Mexican law defines real property broadly and a mortgage is "a proper method to take a security interest . . . from livestock to aircraft."⁸³ However, Mexico does not favor self-help remedies, as in the United States, and foreclosures must be carried out judicially.⁸⁴ This is problematic because of the duration of time to carry out judicial remedies in Mexico, as noted above.

An alternative to a secured creditor in Mexico is the use of a trust, or a "fideicomiso," which can be used in real or personal property.⁸⁵ A trust is different than a mortgage because the debtor must convey the property to a trust administered by a bank and the creditor is the beneficiary.⁸⁶ Trusts are also not practical because of the costs and the registration fee varies depending

⁷⁸ See *Proceedings of the Ninth Annual Conference on Legal Aspects of Doing Business in Latin America: New Approaches: Looking to the Twenty-First Century*, 11 FLA. J. INT'L L. 1, 70 (1996).

⁷⁹ See *id.* at 72.

⁸⁰ See *id.*

⁸¹ See Leixner, *supra* note 2, at 6.

⁸² See John A. Barrett, Jr., *Mexican Insolvency Law*, PACE INT'L L. REV. 431, 437 (1995).

⁸³ *Id.*

⁸⁴ See *id.* at 438.

⁸⁵ See *id.* at 439.

⁸⁶ See *id.*

on the property.⁸⁷ For personal property, a pledge, or “prenda” can be used to grant a security interest to the creditor, but like the trust, the assets covered usually must be given to the creditor.⁸⁸ This creates problems when the assets are inventory or equipment, because the debtor cannot give up possession of their inventory or equipment since it is necessary in their business transactions. This problem with possession has resulted in few United States’ banks lending money under these circumstances.⁸⁹ In addition, the security agreement must be registered and is expensive, in part because of the registration duties that must be paid.⁹⁰ However, Mexican banks can perfect their interest simply by delivering invoices and naming the company as the depository.⁹¹ This advantage should be made available to all banks, not just Mexican banks, providing Mexican companies with needed access to funds.

There is also a problem with industrial mortgages issued in favor of non-Mexican banks.⁹² Mexican law clearly disfavors non-Mexican banks.⁹³ These outdated laws must be changed to provide for more equal footing for non-Mexican banks. Allowing more non-Mexican banks to participate would be beneficial to companies in Mexico because they would have the ability to borrow more money and with more competition, the rates would be more favorable to the companies.

Under Mexican Bankruptcy Law, proceedings are considerably longer than in the United States, often spanning many years.⁹⁴ Due to the extensive length of bankruptcy, trustee and investigator fees can be considerable.⁹⁵ Mexican Bankruptcy Law is “old and relatively poorly constructed. It has not been updated . . . complex multi-national corporations and sophisticated commercial financing . . . and is time consuming and expensive”⁹⁶ In addition, the Bankruptcy Law is ambiguous which has led to its inconsistent application by the courts.⁹⁷ Because of the difficulty in obtaining secured collateral and proceedings against such collateral, creditors are hesitant to extend credit to Mexican businesses.⁹⁸

⁸⁷ See Heather & Collins, *supra* note 5, at 27.

⁸⁸ See Barret, *supra* note 82, at 440.

⁸⁹ See Heather & Collins, *supra* note 5, at 25.

⁹⁰ See *id.*

⁹¹ See *id.* at 26.

⁹² See *id.* at 27.

⁹³ See *id.* at 28.

⁹⁴ See Barrett, *supra* note 82, at 460.

⁹⁵ See *id.* at 461.

⁹⁶ *Id.* at 462.

⁹⁷ See *id.* at 436.

⁹⁸ See *id.* at 434.

Sovereign risk is also a prominent problem. Mexico could intervene in the flow of funds, the ability of the collection of receivables, and other aspects of the transaction.⁹⁹ Sovereign risk also includes the additional tax burdens, government instability, the ability of the servicer and trustee to enforce the collection of receivables, restrictions on transfer of funds out of the country, and the unpredictable nature of the Mexican court system.¹⁰⁰ This has blocked the ability to have in-country securitizations.¹⁰¹

Because of these impediments in the Mexican market and Mexican laws, Mexican securitization transactions are typically set up through the United States, using American banks, currency denominated in dollars, and the American securities market.

B. Mexican Securitization - TelMex

The first Latin American securitization transaction was by the Mexican telephone company, TelMex. TelMex securitized its future telephone receivables from AT&T.¹⁰² AT&T billed the calls made from the United States to Mexico and TelMex billed for the calls made from Mexico to the United States.¹⁰³ Because more phone calls originated in the United States, AT&T owed TelMex a substantial amount every month.¹⁰⁴ TelMex securitized the future amounts owed to it by AT&T in a transaction that was not considered risky because the receivables were payable in dollars and the likelihood of people in the United States not calling Mexico was remote.¹⁰⁵ The transaction was a private transaction.¹⁰⁶

C. Mexican Securitization - Mexican Toll Roads

Mexico securitized future tolls in the early 1990's by issuing three toll road bonds.¹⁰⁷ One of the bonds, MC Cuernavaca Trust, was lowered from BBB to BBB- by S & P in 1997 and the ratings outlook is negative.¹⁰⁸ Some of the problems were due to currency fluctuations, while other problems were

⁹⁹ See Leixner, *supra* note 2, at 6.

¹⁰⁰ See *id.*

¹⁰¹ See *id.*

¹⁰² See Hill, *supra* note 34, at 307.

¹⁰³ See *id.*

¹⁰⁴ See *id.*

¹⁰⁵ See *id.*

¹⁰⁶ See *id.*

¹⁰⁷ See Marissa C. Wesely, *Securitizing Project Debt*, 747 PLI/COMM 335, 371 (1995).

¹⁰⁸ See Salomon Still Sweet on Tolls, ASSET SALES REP., Oct. 13, 1997, at 1.

due to trickling traffic levels and local corruption.¹⁰⁹ In an attempt to bail the bond issuers out, the government nationalized the roads and negotiated with the creditors who held the securitization notes.¹¹⁰ This transaction, which was the only one denominated in pesos, was negatively affected by currency fluctuation brought about by the peso collapse in late 1994 and early 1995.¹¹¹

However, it has been argued that these bonds have not "performed markedly worse than Mexican corporate issues post-devaluation, although their market is far more illiquid."¹¹² In addition, supporters of toll roads argue that these transactions provide a fast track to infrastructure in emerging markets and this gives the private sector the opportunity to step in where the government cannot be as efficient.¹¹³

D. Mexican Securitization - Pemex

In 1993, Pemex (Petroleos Mexicanos), a Mexican oil company that sells Mexican Maya crude oil to U.S. based oil companies, securitized future oil sales. PMI, a majority owned subsidiary of Pemex, generated receivables from its sales to U.S. customers.

The structure of the transaction involved a limited liability company, Pemex Finance. Pemex Finance was established by Pemex under Cayman Island law and sought to raise \$366 million in a private placement transaction in the United States.¹¹⁴ Pemex Finance issued the debt and used the proceeds to purchase current and future receivables.¹¹⁵ The assets were a "true sale" so as to avoid non-payment of the investors in the event of bankruptcy.¹¹⁶

Mexican transactions require a carefully designed structure so as to assure a high rating by the rating agency. Sovereign risk is mitigated by the structure of the transaction so that Mexico would have to either "redirect the product to other customers who have not signed a designated customer notice, or cause designated customers to make payments directly to an account other than the collection account established for the benefit of the note holders."¹¹⁷

¹⁰⁹ See *id.*

¹¹⁰ See *id.*

¹¹¹ See *id.*

¹¹² Wesely, *supra* note 107, at 372.

¹¹³ See Salomon Still Sweet on Tolls, *supra* note 108, at 1.

¹¹⁴ See Charles E. Harrell et al., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 BUS. LAW. 885, 904 (1997).

¹¹⁵ See Standard & Poor's, *Structures Finance Presale Report, Pemex Finance Ltd.*, Dec. 3, 1998.

¹¹⁶ See *id.*

¹¹⁷ *Id.* at 4.

Pemex Finance is required to maintain a ratio of total senior indebtedness to equity of less than or equal to seven to one.¹¹⁸ If a customer defaults on payment of a receivable, the amount to pay the debt service will be reduced, and the senior note holders must absorb the losses if the aggregate loss exceeds the amount of subordination.¹¹⁹ This is unlikely, however as PMI has not suffered any losses as a result of a customer defaulting in payments from 1993 until 1998.¹²⁰ Pemex Finance must also maintain a debt-service-coverage ratio of at least three to one to maintain its over collateralization.¹²¹

Pemex Finance must retain a retention account, which becomes relevant if a specified event has been declared, and there is a financial guarantee insurance policy that unconditionally and irrevocably guarantees timely payment of interest and principal.¹²² Moreover, S & P gets opinions that the transfer of receivables from PMI to PMI Services and the transfers from PMI Services to Pemex Finance constitute a true sale under Mexican, Dutch, and Cayman Island law.¹²³

Standard & Poor's rated the securities A; this was the first time that "foreign currency debt securities indirectly issued by an agency of the Mexican government have been rated higher than Mexico's foreign currency senior debt rating of BB+."¹²⁴ Pemex is proof that securitization transactions, if properly structured, can be rewarding.

E. Mortgage Backed Securities

Bancomer, a commercial bank in Mexico, offered Mexico's first mortgage-backed security in 1998.¹²⁵ S & P and Fitch IBCA have given the mortgage pool the 'AAA' rating.¹²⁶ The civil code has prolonged the delay in this type of transaction because real estate-backed assets, until recently, "could not be transferred due to limitations in the foreclosure civil code."¹²⁷ Many states have adopted foreclosure laws that make it easier for banks to seize assets on non-performing loans.¹²⁸ Foreclosure proceedings used to take up to

¹¹⁸ See *id.* at 5.

¹¹⁹ See *id.*

¹²⁰ See *id.*

¹²¹ See *Standard & Poor's, Structures Finance Presale Report, supra* note 115.

¹²² See *id.* at 6.

¹²³ See *id.*

¹²⁴ *Id.*

¹²⁵ See Leslie Moore, *A Kick in the Fannie for Mexican Mortgages*, *LATIN FINANCE*, Sept. 1, 1998, at 57.

¹²⁶ See *id.*

¹²⁷ *Id.* at 58.

¹²⁸ See *id.* at 59.

two years, and the government is hoping to reduce this time to six months to one year.¹²⁹ Purchasers will be Mexican pension funds and local insurance companies.¹³⁰

The Mexican mortgage-backed securities market is proof that with proper government action such as changing laws to functionally execute transactions, the government can effectuate change in the asset backed securitization market.

In addition, federal housing fund, Fovi, is planning an offering for mid-1999.¹³¹ Although the set-up of a Mexican mortgage-backed securities market has taken a long time, these transactions have laid the foundation for a securitization market in Mexico; and if successful, those transactions could pave the way for more transactions in the future. Moreover, JP Morgan is considering securitizing hotels and industrial properties and has shown confidence that the mortgage backed security market will take off by investing \$20 million for a 20% stake in a Mexican homebuilder.¹³² However, Mexico still lags behind Argentina, Columbia, and Brazil probably because of the government's intervention in the banking system in the late 1980's.¹³³

If "mortgage-backed securities get off the ground, [a Mexican attorney] maintains, the whole range of cash flows securitized in other countries could be securitized in Mexico as well."¹³⁴

F. *What is the Difference Between Securitizations Originating in Mexico and those in the United States?*

The differences between Mexican and U.S. transactions can be summed up as follows in the following categories: currency and foreign exchange risk, country and sovereign risk/political risk, as discussed *infra*, the sovereign ceiling and the structure of the transaction.

The so called "sovereign ceiling" is a policy by the rating companies whereby firms located in a country cannot be assigned a rating higher than that of their sovereign. This policy has hindered Mexican companies from being rated higher than whatever Mexico's rating was at the time of rating.¹³⁵ However, S & P no longer constrains the ratings of firms based on the

¹²⁹ See Sara Kandler, *Mexico to Sell Guarantees for MBS*, ASSET SALES REP., July 14, 1997, at 1.

¹³⁰ See Moore, *supra* note 125, at 59.

¹³¹ See *id.* at 57.

¹³² See *id.* at 60.

¹³³ See *id.*

¹³⁴ Brendan M. Case, *A Future of Security and Securities*, LATINFINANCE, Apr. 1997, at 86.

¹³⁵ See Hill, *supra* note 34, at 313.

sovereign ceiling.¹³⁶ This was apparent when, in the Pemex offering, S & P rated the company 'A' despite Mexico's 'BB' rating, proof that Pemex rose above Mexico's sovereign ceiling of 'BB.'¹³⁷ The disappearance of the sovereign ceiling is imperative for Mexican companies seeking securitization financing at a profitable rate.

Securitized originating in Mexico have historically been dollar-denominated revenue flows, thus eliminating the foreign exchange risk.¹³⁸ The only peso-denominated securitization, the toll roads, ran into problems and had to be restructured.¹³⁹ There are few Mexican companies with access to large dollar flows necessary to facilitate securitization.¹⁴⁰

Mexican companies, however, may overcome these impediments by restructuring the financing transaction, as demonstrated by Pemex. However, the foreign exchange risk and the country/political risks are problems that companies cannot directly affect and therefore cannot control. Therefore, the Mexican economy and government must control these areas.

IV. FUTURE OF SECURITIZATIONS IN MEXICO

A. *Disappearing Effects of the Debt Crisis of the 1980's and the Peso Collapse of 1994/1995*

The devaluation of the peso in the early 1980s and the subsequent debt crisis devastated the Mexican economy.¹⁴¹ The peso devaluation of 1994 led billions of dollars of foreign investment to leave Mexico.¹⁴² This exodus led to a downward spiral of problems because the Mexican economy was too dependent on foreign investment.¹⁴³ However, there are signs that the economy is rebounding. Specifically, Duff & Phelps Credit Rating Company upgraded its rating of the U.S. \$50 million Nylmex Export Receivables Master Trust, Series 1996-A 8.57% to 'BBB', from 'BBB-' in 1997.¹⁴⁴ The improved

¹³⁶ See *id.* at 312 n.76.

¹³⁷ See *supra* Part III.D.

¹³⁸ See Case, *supra* note 134.

¹³⁹ See *id.*

¹⁴⁰ See *id.*

¹⁴¹ See *id.*

¹⁴² See *id.*

¹⁴³ See *id.*

¹⁴⁴ See *DCR Upgrades Nylmex Receivables Trust Certificates to 'BBB'*, <http://www.standardandpoors.com> (last visited Jan. 26, 1999).

rating was due to the improved credit of Nylmex and the favorable outlook for Mexican textile and apparel exports.¹⁴⁵

In late 1998, Duff & Phelps issued another improved rating for the proposed U.S. \$5 billion PEMEX Finance Ltd. Note Program from 'A-' to 'AAA'.¹⁴⁶ It is unusual to have an offering rated higher than the currency rating of Mexico, at 'BB+'. The higher rating was due to the low risk of sovereign intervention in the transaction.¹⁴⁷ These are all factors that indicate that the Mexican economy is rebounding from the 1980s debt crisis.

Moreover, a Mexican attorney, Albert Saavedra, noted that "[t]he country is in the process now of building good, efficient markets."¹⁴⁸ With a strong economic foundation, Mexico may be able to rebound from the effects of the Asian and Brazilian financial crises. He also notes that Mexico's future lies with their ability to specialize by providing services to Latin America.¹⁴⁹

B. The Effect of the Asian Financial Crisis and the Devaluation of the Brazilian Real

All of Latin America felt the impact of the Asian financial crisis, which led to a dramatic reduction in liquidity, higher interest rates, and shorter repayment terms.¹⁵⁰ In addition, risk enhanced structures, including securitization transactions were replaced by bank credits and debt securities.¹⁵¹ Although Latin America has rebounded somewhat from this setback, the recent devaluation of the real by Brazil is likely to cause a much more long term problem that all of Latin America, including Mexico, will not be able to rebound from without serious ramifications.

Although most of Latin America has experienced tighter structures and reduced repayment terms with higher financing for export-backed transactions, Mexico seems to be affected the least, with Brazil affected the most (this was written before the Brazilian devaluation of the Real).¹⁵²

The effect of the devaluation of the Brazilian currency by 8% is unknown at this time, but "capital markets investors typically retreat more quickly from the emerging markets whenever the environment (political, economic, or

¹⁴⁵ See *id.*

¹⁴⁶ See *DCR Rates PEMEX Finance Limited's US \$5 Billion Note Program*, available at <http://www.standardandpoors.com> (last visited January 26, 1999).

¹⁴⁷ See *id.*

¹⁴⁸ Case, *supra* note 134.

¹⁴⁹ See *id.*

¹⁵⁰ See Leixner, *supra* note 2, at 7.

¹⁵¹ See *Trade Finance a Supplement to Project Finance, Latin American Structured Trade Finance, Working Out the Right Recipe*, *supra* note 4.

¹⁵² See *id.* at 4.

financial) take a negative turn."¹⁵³ In addition, there is speculation that this devaluation is the first of a series of devaluations that could resonate around the Americas, including Mexico.¹⁵⁴ As of January 24, 1999, the real had already lost 30% of its value in dollar terms, compared to two weeks earlier.¹⁵⁵ Such devaluation could send all of Latin America into a recession, thereby affecting the entities that are already having trouble raising money and the entities that have debt and/or equity securities outstanding. This would lead to default on existing notes and start a downward spinning cycle.

There is already speculation that Mexico, in order to compete in the export market, will devalue the peso.¹⁵⁶ This would be devastating not only to securitizations originating in Mexico, but also to those originating in the United States. The rating of the Mexican currency would likely fall from its current Duff & Phelps rating of 'BB+'.

C. How Should Mexican Companies Proceed?

1. CAREFUL STRUCTURING

Mexican companies can issue more securitization transactions in Pesos, instead of dollar denominated securities. Such issuance would encourage more investors in Mexico and other Latin American countries to become more involved in the Mexican securitization market.

2. SOVEREIGN/POLITICAL RISK

As noted above, it has been argued that political and sovereign risk has diminished significantly in Mexico. This makes it easier for companies to structure securitization transactions since the biggest hurdle for companies to overcome is the risk of government intervention. Mexico's court system is also troubling because of its unpredictable nature.

Sovereign risk can be avoided by structuring a deal as NylMex did by directing proceeds from the sale of export products to a collection account in the United States that is administered by a United States trust.¹⁵⁷ Such a structure avoids Mexico's foreign currency rating of 'BB' and the so-called

¹⁵³ *Id.* at 5.

¹⁵⁴ See David E. Sanger, *As Economy Sinks, So Does a Strategy*, N.Y. TIMES, Jan. 14, 1999, at A5.

¹⁵⁵ See Doreen Hemlock, *Florida: Real Concerns About Brazil*, SUN-SENTINEL, Jan. 24, 1999, at F1.

¹⁵⁶ See Pierre Belec, *Experts: Don't bet on Fed Chief in Global Crisis*, SUN-SENTINEL, Jan. 24, 1999, at F8.

¹⁵⁷ See S&P Affirms Rating on Pemex ABS, ASSET SALES REP., Mar. 25, 1995, at 1.

“sovereign ceiling.”¹⁵⁸ In addition, Pemex’s rating of A on the Pemex Receivables U.S. Master Trust, Series 1993-1, surpassed the Mexican BB rating because of its structure.¹⁵⁹ Payments are made in New York offices of the Bank of Mexico and are dollar denominated.¹⁶⁰ Similarly, Mexican companies may avoid the ‘BB’ rating of Mexico by properly structuring their deal, having the transaction and payments denominated in dollars, or setting up an offshore trust to collect payments. Generally, making sovereign interference more difficult will minimize sovereign risk.¹⁶¹

3. CONDUIT

Mid-sized and small Mexican companies may be active players in the securitization market by taking advantage of conduits, such as Ciesco, discussed *infra* Part IIA. Even unaffiliated originators can combine their assets into one diverse portfolio and attract investors. Multiseller conduits rely on program administrators to run the program properly, much like a mutual fund manager.¹⁶² Smaller companies would not need the financial sophistication that the larger companies like Pemex and NylMex have acquired by doing these transactions because they can rely on a sophisticated multiseller conduit with vast experience.

4. PAYMENT STRUCTURE

If Mexico adopted the trust concept similar to that in the United States or the same as recently adopted in Argentina,¹⁶³ these transactions could be done in-country. Moreover, with the adoption of the trust, the companies would not have to go “offshore” to set up a transaction. The use of a corporation would result in taxation at the Issuer level, instead of the pass-through treatment that the trusts in the United States benefit from.¹⁶⁴

5. CREDIT ENHANCEMENT

Credit enhancement is necessary for every transaction, and is especially important because Mexican companies are inherently riskier than domestic

¹⁵⁸ See *id.*

¹⁵⁹ See *id.*

¹⁶⁰ See *id.*

¹⁶¹ See Hill, *supra* note 34, at 317.

¹⁶² See Standard & Poor’s Criteria, *supra* note 17, at 4.

¹⁶³ See Hill, *supra* note 34, at 317.

¹⁶⁴ See Leixner, *supra* note 2, at 7.

transactions. The amount of over collateralization may be required to be higher than the normal 5%-20% to compensate for the risk of the general economic conditions in Mexico and the sovereign risk, including the effect of the devaluation of the Brazilian real and the general instability of the Mexican peso.

Rating agencies and underwriters may also require a reserve fund to be retained by the trustee. A letter of credit may be required for the portion of amounts due on securities, but these are not used as much today because of their high costs.¹⁶⁵ The originator may have to guarantee all or a portion of payments due on the securities or post a security bond.

In cases where there are two classes of securities issued, the structure may be set up so that the senior securities receive payment before the subordinated securities in the event of problems.¹⁶⁶

Although more costly, insurance is probably unavoidable for Mexican companies. There is an increase in demand for political risk insurance and the Export Credit Agency's support of long and medium term financing.¹⁶⁷

As underwriters, rating agencies, lawyers, and accountants become more familiar with securitization structures and issues specific to Mexico, some of these problems will be overcome.

V. CONCLUSION

All of Latin America, Mexico included, is a market that is ripe for securitization transactions. This type of financing is appealing to both large and midsize companies in Mexico and should be taken advantage of by companies due to the fact that the alternative costs of financing are so high. In light of the financial crisis in Brazil, and the likely domino effect in Mexico, these transactions will probably be put on hold. When the economic conditions improve in Latin America, the securitization market is likely to improve as well.

¹⁶⁵ See *id.* at 5.

¹⁶⁶ See *id.*

¹⁶⁷ See *id.* at 4.