Mexican Mortgage Market – Access to Housing

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THE MEXICAN HOUSING SECTOR

Mexico has a large housing deficit which is not being attended due to a rapidly growing population and the decreasing availability of funds. The Federal Government estimates a current housing deficit of around 5 million units with new household formation adding to this demand roughly 750,000 units annually. To address this problem, the administration of President Vincente Fox has specified the government's formal role through the creation of a National Housing Council, development of a National Housing Program as part of its National Development Plan and the establishment of the Federal Mortgage Bank ("Sociedad Hipotecaria Federal" or "SHF") as well as increasing the promotion of national and foreign investment in the housing sector. The administration's goal is to finance over 750,000 new houses per year by 2006.

The development of the Mexican Housing Sector has been a function of three issues relating to the demand of housing.

1. **Population Dynamics.** Mexico has experienced historically high growth rates with respect to population and family unit creation. As of 2000, 22 million households existed, with a forecast of 27 million by 2010[1] and a decreasing growth rate from 2.0% in 2002 to an estimated 1.76% by the year 2010 as a result in the drop of fertility rates and an increase in emigration.

2. **Underlying Housing Deficit.** The Federal Government estimates a current housing deficit of around 5 million homes, made up of 2.1 new houses and 2.9 home improvements[2] calculated as the difference between exisiting family units and existing houses[3].

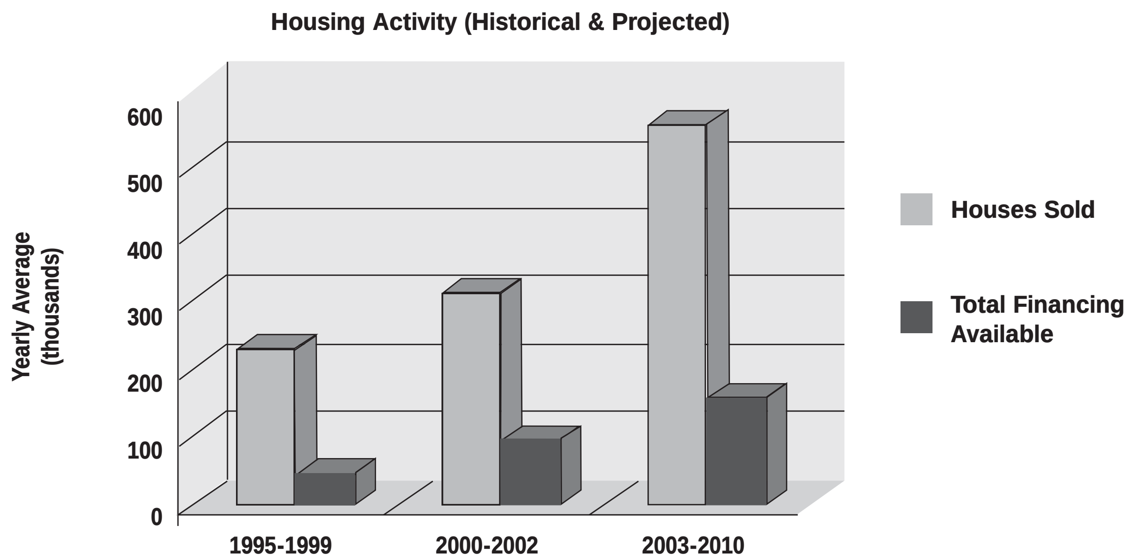
3. **Affordability.** 27.5% of households cannot participate in the formal housing market because of their inability to pay current mortgage rates, both subsidized and market rate financing. 20.3% of household require agency subsidies in order to obtain housing finance.

Government sponsored financing for the housing sector comes from three designated agencies. Infonavit, the largest of the three is an administrator of private sector employee payroll deductions, comprised of government, labor and employers. Infonavit financed over 280,000 homes during 2002. FOVISSSTE is a similar entity as the Infonavit, but for public sector employees, with a financing program of nearly 100,000 homes for 2003. Finally, SHF, the newly created Housing Development Bank and administrator for FOVI[4] has a 50,000 yearly home financing program for the upcoming years and a guarantee program targeted at the development of a secondary mortgage market. Historically, both agency and private sector financing have financed up to 20% of yearly houses sold[5] , with this amount increasing to 25-30%, after considering those homes financed through either cash purchases and self-construction.

While the 750,000 new houses per year goal could be attainable, current market conditions, particularly the lack of access to alternative sources of funding for mortgage financing, suggest that this could be a difficult possibility. For example, in 2002, financing for new built houses and previously owned homes represented only 60% of the government's 750,000 yearly housing goal[6]. As a frame of reference, agency financing[7] represented only 57% or US$9.5[8] billion during 2002 resulting in an additional need for financing from alternate sources such as increasing agency, private sector and the capital markets financing.

In summary, to sustain current growth levels and demand, required financing should increase by more than 60% in real terms.

[1] XII Nacional Population Census
[2] Nacional Housing Plan 2000-2006
[3] April 2002 Bancomer Real Estate Report
[4] FOVI. "Fideicomiso de la Vivienda", financing trust created jointly by the Mexican Central Bank and the World Bank to finance low income sector housing.
[5] 1995-2002 Federal Government reported amounts, 2003-2010 Softec estimates
[6] The remaining 300,000 houses comprises selfconstruction and housing with less than 90 sf.
[7] There are three government agencies that provide financing for the housing sector, namely Infonavit (administrator of the private employees' retirement fund), FOVISSSTE (administrator for public sector employees' retirement fund) and SHF the administrator for FOVI ("Fideicomiso de la Vivienda" - a fund created jointly by the Mexican Government and the World Bank to finance low income housing).
[8] Vicente Fox's second State of the Union Address

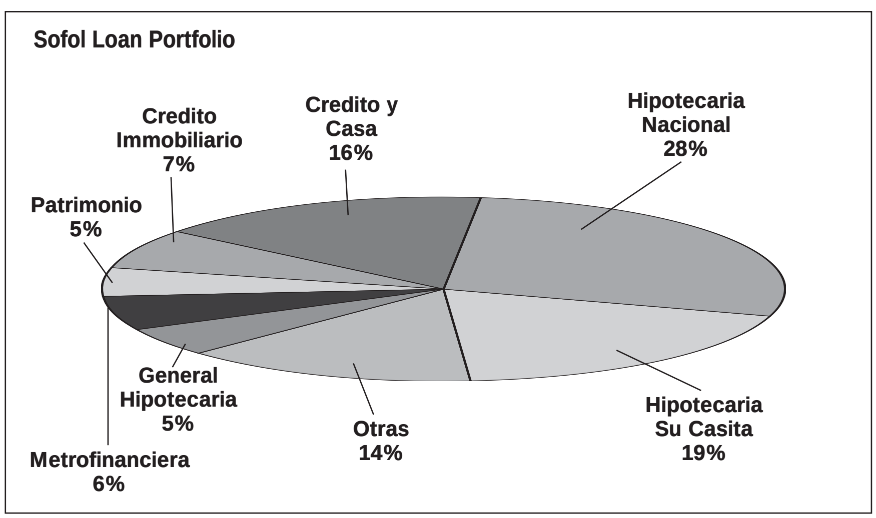


SOFOLS AND THEIR ROLE IN HOUSING DEVELOPMENT

The ray of hope in the Mexican Mortgage Market is the Sofols[9] sector. Sofols have been the epitome of success in a market where banks have been conspicuously absent after the 1995 Mexican banking crisis. The Sofols, which were created in response to the exit by banks from the mortgage sector, are non-bank financial institutions authorized to originate and service mortgages and also provide bridge financing for developers. With the backing of SHF and an importance in meeting the housing finance needs especially of the low-income segments, Sofols have realized market share increases from 2% in 1996 to 20% of the market as of December 2002. At end December 2002, there were 18 mortgage Sofols with an aggregate mortgage portfolio of 264,553 mortgages worth over US$4.4 billion.[10]

A key underlying success factor for the Sofols has been their low delinquency rates[11] compared to both current Mexican bank mortgages and international standards. This is particularly noteworthy in light of the low-income market segment the Sofols target. The performance of the mortgage portfolios held by the Sofols is linked to several factors including: (1) the high efficiency in their collection methodologies (2) good underwriting standards, (3) the non-conventional methods of servicing, and (4) the quality of the management teams.

A Sofol's collection procedure starts before payment is due, and includes continuous contact with the borrower, including hand delivery and acknowledgement of receipt of monthly statements. Servicing typically includes reminder calls to borrowers which have demonstrated payment inconsistency in the past. Formal collections begin within a week after due payment through telephone calls and on-site visits depending on the delinquency status. A key element is to ensure that the mortgage holder has adequate payment capacity through demonstrated sufficient debt-to-income ratios. More than ninety percent of



[9] SOFOL - Sociedad Financieras de Objeto Limitado
[10] AMSOFOL December 2002
[11] The average default rate is 2.4% of total outstanding mortgage balance

	Collateralized	Uncollateralized	Total
Hipotecaria Nacional	74.4	134.7	**209.1**
Su Casita	99.0	76.9	**175.9**
Credito y Casa	96.2	34.6	**130.8**
Metrofinanciera	96.2	30.8	**126.9**
Hipotecaria México	0.0	9.6	**9.6**
Patrimonio	0.0	7.7	**7.7**
Op. Hipotecarias	0.0	1.4	**1.4**
Total	**365.7**	**295.8**	**661.5**

collections are made through cash payments, so Sofols provide easy access to make their mortgage payment through various means and locations, both in banks and Sofol branches typically located near the customer. Given the low average size of the mortgage, elevated costs of delinquency and time to foreclose, high efficiencies in forbearance are required. Also, Sofols utilize expedited processes to increase probability of payment and avoid further deterioration of a loan.

Financial Innovation to meet Financing Needs

Sofols are making a concerted effort to tap new sources of funding in order to expand their reach in mortgage lending activities. At present, most Sofols source in excess of 90% of their funding for mortgages from SHF. However, specific factors are emerging which are prompting the Sofols to find alternative sources of funding that will ultimately lead to the market pricing of the sector's assets. Most Sofols are focusing on the capital markets as a viable source of funding and some have already been successful in tapping the capital market through debt issuances. As of July 2003, total outstanding debt issued by mortgage Sofols was US$661 million[12] consisting of collateralized and uncollateralized debt.

Sofols have also been key players in the nascent structured finance market of Mexico. For example, issuances by Sofols accounted for over 30% of the structured finance market[13] in 2002. To date, the structured issues by Sofols have been used to finance housing construction through short and medium term issuances (up to 7 years). However, some Sofols are working on true mortgage-asset securitization as well which could pave the way for accessing much needed long-term funds.

The structured debt finance sector in Mexico has succesfully re-developed during the last couple of years in part due to the favorable economic environment and to the regulatory changes created by National Banking and Securities Comission ("CNBV"). Both inflation and interest rates have dropped during the fourth quarter of 2003 attaining historical minimum levels for Treasury Certificates as well as benchmark rates. Furthermore, both guarantee and foreclosure laws that apply to mortgaged assets have changed, making both debtors and investors more comfortable with attaining a true recovery value on pledged assets providing them with both measurable losses and probabilistic recovery rates and times.

Having attained favorable conditions in a regulatory environment, economic stability and acceptable legal transparency, the first pure Mortgage Backed Security was placed in the market on December 2003. Two Sofols, Hipotecaria Su Casita and GMAC, a subsidiary of US based GMAC-RFC succesfully placed an UDI based transaction of approximatelly US$55 million out of a US$150 million program. This first issue consists of almost 2,000 loans, sold to a bankrupcy remote trust. Mortgages sold to the trust include both social interest and residential type loans consisiting of outstanding balances as low as US$8,000 up to US$200,000. Although the average mortgage remaining term is 22 years, the legal final of the securities is 16 years. Both prepayment and a percentage of the excess spread are passed on to the senior security holders, reducing the expected life of the securities to approximatelly 10 years. The securities have a 3% first loss overcollaterization and a 9% ultimate principal and timely payment of interest partial guarantee provided by the Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. ("FMO") a Dutch development bank.

Although this has been the first pure RMBS transaction, three key achievements have been attained:

- Provide institutional investors with a high quality asset that meets both their term and currency (UDI[14]) needs considering that over 70% of the loan pool is comprised of social interest loans.
- Both credit and prepayment risk have been transferred to the investor. Although statistical data exist to determine the expected prepayment and credit default levels, available historical data only includes the Sofol sector and is only avaliable for the past 7 years.
- A true secondary mortgage market has been created, increasing the probability of funding relief from government agencies by having the capital markets fund the future development of the residential mortgage market.

[12] Mexican Stock Exchange
[13] Mexican Stock Exchange, 2002
[14] Unidad de Inversión. A real-rate currency pegged to inflation created after the 1994-95 Mexican crisis.

LOOKING TO THE FUTURE

Mexico indeed faces a challenge in trying to reduce its housing deficit. However, several factors bode well for the housing sector in general. For example:

- Financial innovation by the Sofols and their increased access to funding can go a long way to realizing the government's objectives to financing 750,000 new houses per year by 2006.
- There is ample capacity for developing and placing new asset classes to finance the housing sector. For instance, the debt maturity profile in Mexico is fairly short, with large amounts maturing within the next four years and a potential demand for new issues with longer terms maturing after 2008. Moreover, there is a large untapped institutional investor base in the SIEFORES[15] which have assets that are growing at a rate of approximately US$650 million per month and have less than 15% of their total portfolios invested in private and banking issuances.
- Recent improvements in the underlying financial structure of the mortgage market such as reforms in bankruptcy, guarantee and transparency laws could provide a momentum for mortgage financing and ongoing residential mortgage backed securities sold in the debt capital markets.

[15] SIEFORES are private pension funds in Mexico.