Legal and Regulatory Issues Related to Securitization in Mexico: An Analysis

INTRODUCTION

At the Mexico/United States Bi-national Commission meetings in May 1995, the two countries began a collaborative effort to assist where possible in facilitating development of a secondary mortgage market in Mexico. The effort has been led in the US by the Office of Federal Housing Enterprise Oversight and in Mexico by the Secretariat of Social Development (SEDESOL) and by the Institute of the National Housing Foundation for Workers (INFONAVIT).

This paper is an abridged version of a study to explore the legal and regulatory framework of securitization in order to identify obstacles that are preventing the development of securitization as a viable financing mechanism in Mexico. This study is the work of a group comprised of representatives of the Ministry of Finance and Public Credit (Hacienda), the National Banking and Securities Commission (CNBV) and the Banco de México, as well as outside advisors.

This study examines the importance of securitization for the Mexican financial system and explores the history of securitization in Mexico to date. The study goes on to examine the specific legal and regulatory issues affecting securitization. For purposes of this study, the legal and regulatory issues have been divided into the following categories:

A. Issues related to the origination of assets.
B. Issues related to the transfer of assets.
C. Issues regarding the vehicles used to hold assets and issue securities.
D. Issues regarding investment eligibility rules for regulated entities.
E. Issues regarding taxation.
F. Issues regarding attachment and execution.

The Importance of Securitization

Securitization can be characterized as the refinancing of existing income-producing assets by packaging them into a tradable form through the issuance of securities. In a traditional securitization, the securities created are secured by the assets and serviced from the principal and interest which they yield. In addition, securitization can also refer to a variety of different types of secured transactions involving the issuance of securities.

Securitization has developed as a means for channeling different sources of investment capital into consumer lending. Securitization provides the link between the primary market for consumer credit and investors. Most large institutional investors (i.e., pension funds, insurance companies and mutual funds) have restrictions on the types of investments they are permitted to make. Securitization transforms ordinary loan assets such as mortgages, auto loans and credit card balances into a form that can be readily sold to investors that could not otherwise participate as lenders in this market. For institutional investors, securitization provides a means to participate in traditional consumer lending without having to originate or service consumer loans. As a result, banks and other lenders have increasingly become originators and servicers of consumer loans, receiving fee income, rather than acting as lenders.

In Mexico, securitization has yet to develop as a financing mechanism for banks and other financial institutions. Many of the same changes, however, that have led to securitization in other parts of the world are occurring in Mexico today. Most Mexican banks do not have sufficient capital to support sustained growth in their consumer loan portfolios. At the same time, Mexicans are increasingly looking outside the traditional banking system for places to invest their savings, including mutual funds and life insurance contracts. It is anticipated, moreover, that reforms of the SAR (National Savings System) and the IMSS (National Social Security System) will create additional substantial pools of savings outside the traditional banking system. Securitization needs to be developed as a mechanism to channel these other sources of investment capital into consumer lending so that banks and other financial institutions can continue to meet the growing demand for consumer credit.

A Brief History of Securitization in Mexico

Although wide scale securitization of consumer loans does not yet exist in Mexico, there have been a number of different transactions that fall within the broad definition of securitization. These transactions have typically been directed toward the international capital markets.

The majority of securitization transactions that have occurred in Mexico to date are future receivable transactions, generally traveling offshore dollar cash flows. The offshore dollar cash flow transactions are secured financings backed by future dollar receivables that can be isolated outside of Mexico. In these transactions, the rights to receive future dollar cash flows are transferred to a special purpose vehicle outside of Mexico. The securities are issued by the offshore vehicle. As a result, the cash flows will never enter Mexico. Since the dollars never enter Mexico, it is possible to receive a rating on the securities higher than the Mexican sovereign ceiling.

The typical offshore dollar receivables transactions are the credit card securitizations done by several banks. Unlike traditional credit card securitizations that are backed by existing amounts due from card holders, these transactions involve the securitization of the future flow of dollars due to Mexican banks that have processed credit card charges made by foreigners in Mexico.

Because the primary goal in these transactions is to isolate the Mexico risk, offshore dollar receivables transactions are always structured using special purpose vehicles outside of Mexico. The securities that have been issued, moreover, have been dollar denominated and directed to investors outside of Mexico. Consequently, these transactions do not raise the Mexican legal and regulatory issues of a traditional securitization.

Another type of securitization transaction in Mexico is the repackaging of various types of Mexican government securities. In these transactions, Mexican government peso-denominated securities were used to back dollar denominated bonds. Although these transactions were structured as securitizations, they were more in the nature of derivative transactions. The subordinated securities were intended to absorb a devaluation of the peso. The senior securities were protected against a decrease in the value of the peso up to a certain level. This level of protection was a function of the size of the senior security (denominated in dollars) vis-à-vis the total collateral (in pesos). Since the senior security holder would bear the risk of a decline in the value of the peso (after a certain exchange rate was reached), the senior security holder had effectively sold a peso option.

The repackaging transactions were structured using offshore special purpose vehicles, and the securities created were directed to the international capital markets. Therefore, these transactions did not raise many issues with regard to Mexican law.

An example of transactions that have involved a Mexican issuance vehicle have been the toll road securitizations done by Tribasa (Mexico Toluca) and the Mexican government (Mexico Cuernavaca). Toll road securitizations used trusts established under Mexican law (fideicomisos) that issued ordinary participation certificates (CPOs) primarily to investors outside of Mexico. These transactions confronted several issues under Mexican law regarding the use of a trust as a vehicle for securitization, and the issuance of CPOs.

An example of securitization transactions involving a Mexican government agency were the Credibure transactions of Nafin, a development bank. The Credibure transactions involved loans made by Nafin to Mexican banks to fund back-to-back loans to other borrowers as part of various Nafin loan programs. The Credibure transactions packaged these obligations of the banks to Nafin into a trust that issued CPOs.

The Credibure transactions were divided into dollar and peso programs. Where the loans were denominated in dollars, the CPOs were sold to international investors. The first Credibure transactions were guaranteed by Nafin. The subsequent Credibure transactions, however, were not guaranteed by Nafin but were sold based on the credit of the underlying bank obligors.

Overview of Assets in Mexico

Consumer credits have become an increasingly large component of the assets of Mexican banks. Consumer credits (not including residential mortgages) constituted approximately 6% of total bank credits in September 1995. Mortgage credits have gone from approximately 13.7% of total bank credits in 1991 to approximately 27% of total bank credits in 1995.

The growth in the demand for consumer credit has strained the existing sources of funding. As a result, there is at present an acute shortage of consumer credit in the Mexican market. In the long term, it is expected that securitization may play a significant role in funding consumer and mortgage lending in Mexico. There are, however, serious obstacles to securitization in Mexico. The following sections of this paper examine different areas of the law in order to identify and analyze the different legal and regulatory issues affecting securitization.

ISSUES RELATED TO ORIGINATION OF ASSETS

An essential element in the process of securitization is credit origination. Credit-granting is the first stage and the cornerstone of the securitization process. This section reviews the most important aspects of credit origination.

Financial Institutions Involved in Mortgage Credit Origination

Under Mexican law, credit granting alone is not considered as an activity subject to regulation. However, if credit granting is made with resources funded by the public, through deposit taking or securities issuance, then it is considered financial intermediation and is subject to financial regulation.

The Mexican financial system adopts a universal banking approach under which all sorts of financial services can be provided through a financial group. However, unlike other countries like Germany or Spain, where a single financial institution can provide all types of financial services (including commercial and investment banking services, securities intermediation and insurance), under Mexican law each financial entity can only engage in the financial activities expressly authorized for that type of institution. In accordance with the Financial Holding Companies Act, a financial holding company is permitted to have a majority interest in any type of financial institution, and operate using the same branch network for all of the financial institutions of the group.

The financial entities authorized to originate credits in Mexico are banks, limited scope financial institutions (SOFOLs), credit unions and mutual savings and loans.

Mexican financial institutions are regulated exclusively by Federal laws and regulations, and therefore supervised only by Federal regulatory authorities including Hacienda, Banco de México, the CNBV, and the National Insurance and Bonding Commission (CNSF). Financial institutions can operate nationwide without any restrictions. Credits granted by financial institutions are considered as commercial transactions and are regulated by the Commercial Code. However, transactions related to real estate, like mortgages, are regulated by the Civil Code of each State (depending on where the property is located).

Banks. Banks are by far the most important financial institutions involved in credit origination in Mexico. Banks are authorized to take deposits from the public, including demand deposits through checking accounts, and grant credits to all sectors of the economy. After the deregulation process that took place during the late 1980s and the beginning of the 1990s, banks are no longer required to maintain reserve accounts with the Banco de México or channel fixed portions of their funding into specific sectors of the economy. Although the Banco de México still has the authority to regulate credit transactions, there are no limits on interest rates either on deposits or credits. Banks, thereore, are free to grant credits to all sectors of the economy on terms that are a function of the market conditions that prevail at the time of credit origination.

Because banks take deposits from the public, they are highly regulated. There are specific regulations applicable to banks for their credit operations, including capital adequacy (in line with the Basle Accord), credit ratings for loan portfolios, regulatory accounting rules, lending limits and related party lending. The CNBV is in charge of bank supervision. Unlike other financial institutions, all commercial bank liabilities (excluding subordinated debentures) are covered by the Fondo Bancario de Proteccion al Ahorro (FOBAPROA). FOBAPROA is a trust funded by commercial banks and administered by the Banco de México, although, in order to face the current banking crisis, a portion of the funding of FOBAPROA has been provided by the federal government.

Limited scope financial institutions. Limited Scope Financial Institutions (SOFOLs) may fund through issuance of securities or bank credits and may grant loans only to a specific sector or activity of the economy. These financial institutions were created in 1993 through a reform to the banking law. Since then, 28 licenses for domestic controlled institutions and 12 licenses for foreign financial affiliates have been issued. Of the 28 domestic licenses, 16 are authorized to participate in the mortgage sector. Foreign controlled SOFOLs are in both mortgage and consumer lending (including auto finance). It is expected that these financial institutions will play an important role in the securitization of credits.

Unlike banks, SOFOLs are for the most part unregulated. There are no specific regulations for their operations such as capital adequacy, credit ratings, lending limits and related party lending. Their liabilities are not covered by FOBAPROA, and there is no alternative liability protection mechanism available to them. If a SOFOL is part of a financial group that includes a commercial bank or has important economic links with a commercial bank, however, it is subject to the same regulations (including capital adequacy requirements) that are applicable to commercial banks. This is to prevent a regulatory arbitrage between banks and SOFOLs.

The Property Appraisal Process

The issue of the property appraisal process is of particular relevance to the securitization of mortgages. This is because no other type of credit depends as much on the value of the underlying collateral.

In the mortgage origination process, one of the most important factors is the loan-to-value ratio (commonly referred to as LTV). The LTV is considered especially important because borrowers who make larger downpayments (i.e., have more equity in their homes) are statistically less likely to default. The LTV is generally calculated by taking the amount of the loan and dividing by the lower of the purchase price of the home or the appraised value. The appraisal is, therefore, a very important part of the credit analysis process. If the loan is sold or securitized subsequent to origination, investors will look closely at the original LTV. Likewise, they

may have new appraisals done in order to determine the current LTV if they believe that property values have declined dramatically.

In the United States and many other countries it is possible to get very accurate appraisals because large amounts of information are publicly available on the market value of homes. In Mexico, however, the appraisal process is not always reliable because accurate information about home prices is not readily available. The job of the appraiser is made more difficult by the lack of a centralized source of information on the sales price of comparable homes. The sales prices registered with the public registry are often unreliable and difficult to access efficiently. Therefore, the appraisers must rely on more anecdotal knowledge of the local real estate market. As a consequence, the appraisal process is highly localized, as it is difficult for individual appraisers to have accurate information on a large number of different geographical areas.

To address the problem of a lack of a centralized database of home values, the government, through Fondo de Operación y Financiamiento Bancario a la Vivienda (FOVI), is planning to develop a database of home prices. Such a database would facilitate the appraisal process.

The problems with the property appraisal process could, in part, also be addressed with reforms to the regulations governing appraisers. At present, the regulations governing appraisers and the appraisal process are not centralized and there is a resulting lack of standardization and consistency. The system has a large number of different self-regulating associations and several government agencies with overlapping jurisdiction.

An appraiser in Mexico must be a member of one of 13 different appraiser associations. In order to become a member of an association, an individual must have at least a university degree in architecture or engineering. In addition, depending on the type of appraisals to be done, they must register with one or more governmental agencies. Each agency maintains its own registration, testing and reporting requirements.

The criteria for qualifying an appraiser and monitoring performance are, in some cases, inconsistent. There are, moreover, no established criteria for the appraisal process. While there are sanctions with which to punish appraisers that do not comply with regulations, these are rarely enforced. This is partly the result of the number of organizations that have overlapping jurisdiction over appraisers. As a result, appraisers are free to operate with effectively no regulation or supervision.

Availability of Accurate Credit Information

The availability of accurate credit information is important to the credit origination process and consequently to securitization. Prior to 1994, centralized credit information was available either through Central de Informes y Cobranzas, S.A. de C.V. (primarily for individuals) or through Datum, S.A. de C.V. (primarily for businesses). Both of these companies are owned by the commercial banks and administered by the Banco de México.

These institutions were formed to collect and verify credit information on bank customers from the participating banks. As comprehensive credit bureaus, however, they had several shortcomings. Their services were only available to commercial banks that were contributors to the database; and they only collected data on bank credit customers.

With the amendments to the Financial Holding Companies Act in July of 1993 and the issuance of the regulations for credit bureaus in February of 1995, the groundwork was laid for the development of comprehensive national credit bureaus. Three credit bureaus have since been authorized by Hacienda, including TransUnion de México, Comcred and Equifax.

The regulations for credit bureaus provide that any party can have access to the information services granted by the credit bureaus, so long as they have the written authorization of the party to be investigated. The written authorization must include the signature of the investigated subject and must establish that the subject is aware of the nature and consequences of the investigation and the information that will be provided.

Credit bureaus and their officers and employees are subject to the bank secrecy regulations, as are the financial institutions that access the information of the credit bureaus. It is not considered a violation of the bank secrecy laws, however, for financial institutions to provide information on their customers to the credit bureaus. It is considered a violation for the credit bureaus to provide information to any third party without the prior written authorization of the person being investigated, except that credit bureaus may share information among themselves. Credit bureaus are required, moreover, to share with other credit bureaus their primary database of negative credit information (defaults, overdue accounts, etc.).

Although still new to the market, it is anticipated that the recent regulatory changes will permit the development of comprehensive credit bureaus along the same lines as exist in the U.S. These credit bureaus will strengthen the credit origination process, thereby resulting in improved loan portfolios. Ultimately, the improved credit quality of the loan portfolios will make securitization easier and less costly (in terms of required credit enhancement) for lenders.

Standardization

Standardization is generally considered positive for the development of securitization. Standardization in the context of securitization

typically refers to banks and other lenders adopting common formats, practices and procedures for the following:

1. Loan Documentation;
2. Loan Applications;
3. Loan Origination; and
4. Servicing (Administration).

Standardization does not necessarily mean that all lenders must extend credit using the same criteria or on the same terms but rather that certain fundamental aspects of the lending process are standardized among lenders. For instance, lenders may adopt a standard form of mortgage loan agreement that provides adequate legal protection to all lenders. Standardized loan documentation is beneficial to securitization in that it ensures that investors in a pool of loans (or the rating agencies) do not have to analyze the risk of several different legal documents.

Lenders may also agree to use loan applications that request the same information from borrowers. This does not mean that each lender must grant credits on the same criteria but that each lender is obtaining the same basic information from borrowers. If each lender collects the same basic information, it is easier for investors to compare loans originated by different lenders. If applications ask different questions, it is more difficult for investors to evaluate loans originated by one lender against loans originated by another lender.

In certain circumstances (such as government-sponsored loan programs) lenders may adopt the same loan origination criteria.. Such characteristics could include loan-to-value ratio, borrower income, size of loan and interest rate, among other things. This type of standardization also can be very important to securitization because it can generate homogeneous pools of assets from many different originators. A homogeneous loan pool will be easier to analyze by investors. It may also be possible to assemble larger pools of assets because the loans can be originated by different lenders. Having loans from different lenders also means greater diversification of risk. This can diversify risks related to the originator (i.e., poor origination practices) as well as regional risks from a concentration of loans from one part of the country. This type of standardization typically is achieved in cases where a government agency is subsidizing mortgages to a certain sector of the market and wants to ensure that the mortgages all have the same characteristics. It also could occur where a large private institutional investor desires a homogeneous pool of mortgages and has sufficient resources to influence the market.

Another aspect of standardization that is important to securitization is in the servicing of loans. Standardization of servicing makes it easier to transfer loans and change the servicer. The ability to change servicers is important for securitization. Rating agencies will want to ensure that servicing can be transferred to a new servicer if for any reason the originator is unable to service the loans. Otherwise, the transaction could not be isolated from the credit risk of the originator.

Standardization of servicing typically involves the standardization of the type of information that is monitored (i.e., balance, payment history, address, etc.). In addition, there can be standardization of the documents and information that are maintained in each loan file. Standardization of servicing can also refer to the standardization of data processing systems and software. The more that servicing is standardized among market participants, the more straightforward it will be for a new servicer to take over servicing if required.

The Mexican financial system is presently characterized by a lack of standardization in all aspects of the loan origination and servicing process. One exception to this is the FOVI loan program for low- and middle-income housing. FOVI has standardized the type of loan that may be offered by banks. In addition, FOVI has proposed standardized loan documentation and application forms. FOVI requires that banks and SOFOLs that make FOVI loans provide certain basic information on the performance of the loans they originate and service. FOVI, however, has not yet established servicing guidelines or standards. Therefore, putting aside other regulatory obstacles, it would be difficult to transfer servicing for FOVI loans from one servicer to another.

Another example of standardization is for UDI-type loans resulting from the government-sponsored programs for restructuring consumer loans.[1] UDI loans have standardized terms for maturity and interest rates. Each bank, however, uses its own form of contract. Standardization of UDI loans will facilitate securitization of these credits, should the government seek to do so.

ISSUES RELATED TO THE TRANSFER OF ASSETS

The transfer of assets is a very important part of securitization. This is because securitization typically seeks to isolate the risk of the issuance from the risk of the originator. The transfer of assets also has important consequences related to the capital required to be held by the originator where the originator is a regulated financial institution subject to capital adequacy rules.

As a general matter, sale contracts are valid and binding upon the agreement of the parties. There are special rules and formalities, however, pertaining to contracts for the transfer of ownership of certain types of assets, including negotiable instruments and mortgages on real property. In addition, with regard to loan agreements, the law requires that the debtor be notified of any transfer of the loan agreement for the transfer to be effective vis-à-vis the debtor.

Transferring Nonmortgage Assets

The majority of credits that are eligible for securitization, such as credit card receivables, auto loans, trade receivables and other consumer credits, can be transferred easily and inexpensively. This is because they typically are documented as negotiable instruments that can be freely transferred without notifying the account debtor. Credits that are not documented as negotiable instruments require that the debtor be notified of the transfer. Without notification, the debtor could satisfy his obligation by paying his original creditor.

The transfer of a negotiable instrument is very straightforward. All that is required is the signature on the document endorsing it over to the new holder. Notification of the debtor is not required.

Costs Associated With Transferring Mortgages

The transfer of a mortgage has to be done by a contract formalized by a notary public and registered with the public registry in the jurisdiction where the property is located. In addition, the borrower must be notified of the transfer in order for the borrower to be directly obligated to the transferee.

The notarial system and notary public cost. Unlike common law countries that rely more on legal precedents, Mexico is a civil law country where all aspects of the law are governed by specific legislation. As a result, the role of a notary public is much more important than in the United States and other common law countries. In Mexico, a notary public is required to formalize and make valid any contract for the sale of real property. The notary public serves an important function in property transfer by assuring that purchasers obtain a clean title and that their rights are protected against the claims of others. As a result, mortgage title insurance has not developed as a necessary product because most market participants believe that the notarial process provides adequate protection against title problems. This section discusses the requirements for the participation of a notary public in real property transfers.

Transfers of real property are governed by the Civil Code of the state in which the property is located. Under the Civil Code of the Federal District, all mortgages and contracts involving real property with an appraised value of more than approximately N$7,300 must be in the form of what is known as a public deed that is signed in the presence of a notary public and filed with the public registry. As a practical matter, because most homes are worth more than N$7,500, all mortgages and home sales have to be documented as public deeds and formalized by a notary public.

The formality of a notary public is very important to ensure an enforceable contract. The participation of the notary public is a required formality without which the contract is not valid. However, if a contract is valid but for the lack of a required formality, either party may petition a court to order the fulfillment of the formality. To grant a mortgage, the borrower and the lender must appear before a notary public. The notary public will prepare a public deed where the complete background of the transaction is described and documented. The identity and authority of the persons executing the document is verified and described. The notary public then verifies and certifies the existence of liens and unpaid taxes. He will then issue a series of official copies (testimonios) of the public deed and is responsible for the registration of the first deed with the relevant public property registry. The law further provides that subsequent transfers of mortgages must also be documented before a notary public and filed with the public registry.

The problem with the notarial process for the transfer of mortgage credits is not that it does not work as it should but rather that the cost and time involved when dealing with thousands of mortgage loans may be burdensome.

The fees charged by notary publics for their participation in the execution of a mortgage can vary significantly. Notary publics are licensed locally, and their fees and schedules are determined in accordance to local practices. The official rates for notary publics in the Federal District depend on the value of the property being sold or mortgaged. Under the official fee schedule, the notary public fee for the sale of a home of N$100,000 would be approximately 15.5% or N$15,500.

Most notary publics, however, do not charge the official rates. The average notary public fee in connection with the sale of a residential property is approximately 8%. The principal Mexican commercial banks, the largest originators of mortgages, have generally entered into agreements with notary publics fixing the fees that will be charged for a particular transaction. It is possible that similar arrangements could be made for the transfer of mortgages in connection with a securitization.

Registering with the public registry. In order to protect the rights of a purchaser or lender it is essential that any transaction involving real property be registered with the appropriate public registry. Each state and the Federal District maintain a public registry for the registration of real property.

In Mexico, the first person with a properly executed contract to file with the public registry (thereby giving notice) has priority over prior purchasers or lenders, if they have not filed, and subsequent purchasers or lenders, whether or not filed. Public registries in Mexico use either the sheet or the folio system. With the sheet system, the records of transactions are all kept chronologically in a single book. In order to check for transactions related to a particular property, it is necessary to look through the book for all transactions pertaining to that property. With the folio system, a separate file is created for each property and all transactions are recorded in the file pertaining to that property.

The main problems with regard to the public registry system in the context of mortgage securitization is the time and expense involved. The average time required to register a mortgage in the Federal District is approximately four months. This does not mean that the lender is exposed to the risks of intervening creditors or subsequent purchasers, because the notary will file a notice that the transfer is pending, and this notice will give the transferee priority against subsequent filers. The process, however, may still take a very long time. The problem is likely to be exacerbated in the case of securitization where literally thousands of loans are being transferred.

Another problem is that the public registries are not the same in every state. The degree of efficiency and cost vary significantly from one registry location to another. In some jurisdictions the local governments have taken the view that the fees charged for the registration of deeds is one of the few sources of revenue for the municipalities. In such places the registration fees can be quite substantial. Sometimes the financial difficulties of municipal authorities result in registries not having the necessary infrastructure and staff to provide adequate service. These factors result in enormous differences among the public registries. Although some registries may be partially computerized, the majority of records are still kept by hand.

As a result of these differences, it is difficult to predict the time and cost involved in the registration of a pool of mortgages that come from more than one jurisdiction.

In the Federal District, the fees for the public registry are as follows:

Act	*Cost*
Registering the transfer of real property and the creation of any rights in real property (such as a mortgage).	N$2926
Certification of the existence of any liens going back a period of 20 years.	N$100
Certification of the existence of any liens for each preceding 5 year period in excess of 20 years.	N$66.90
Substitution of a creditor on a mortgage.	N$195.63
Consulting the public registry for any preceding registrations.	N$13.03
Inscriptions, annotations or cancellations of existing registrations.	N$292.75

Proposed reforms to the civil code. With the goal of streamlining the mortgage transfer process, reforms were proposed in 1994 to the Federal District Civil Code with regard to the transference of mortgages in connection with a securitization. Although these proposed changes were not adopted in the Federal District, several states, including the Estado de México, Aguascalientes, Durango, Oaxaca and Sonora , have enacted similar legislation. The changes that were previously proposed to the Federal District Civil Code would have provided that when mortgages are transferred by a financial institution to another financial institution or a fiduciary for the purpose of issuing publicly registered securities backed by such mortgages, the transfer of the mortgages need not be documented before a notary public or registered with the public registry. In addition, the proposed legislation provides that if the originator remains the servicer of the loan, the debtor need not be notified of the transfer.

There were several problems with the proposed changes. First, while the changes in the law would permit transfer without registration, this may not protect the transferee against claims of third parties. If a mortgage is transferred to a *fideicomiso* (trust) in connection with a securitization without being registered and subsequently another lien is filed with the public registry, it is unclear who will have priority. While the first mortgage was granted first, the transfer was not filed. Therefore, the subsequent filer was not notified of the transfer or the true creditor. Unless it is clearly established under the law that a mortgage has priority as of the date of its initial filing, regardless of subsequent transfers without notice, the investors in a securitization transaction could be exposed to the claims of subsequent creditors.

Second, the proposed changes to the Civil Code apply only in the case of public securitizations of mortgages. It does nothing to aid the development of a broader secondary market for mortgages.

Effects of Bankruptcy on Transfer of Assets

Generally speaking, the legal provisions outlined above would govern the transfer or sale of credits. There are certain special circumstances, however, where even though a transfer has legally occurred, the transferor or the creditors of the transferor may be able to nullify or cancel the transfer. This is sometimes the case in the event of the bankruptcy of the transferor. This is of particular concern in connection with securitization where the goal is to isolate the assets completely from the credit risk of the transferor/originator. For this reason, it is important to examine exactly what constitutes a "true sale" for bankruptcy purposes (i.e., a sale that cannot be nullified by the transferor or his creditors in the event of a bankruptcy or insolvency of the transferor).

If the transfer of assets is declared invalid, the assets will be considered property of the bankrupt seller. If the assets had been part of a securitization, the investors may end up as creditors of the bankrupt seller.

In the case of a securitization transaction, the originator and the issuer may enter into

administration agreements for the servicing of the assets. Any payments collected by the administrator will be exclusively owned by the issuer. Such cash flow should be registered in a third party account in the name of the issuing vehicle or the trustee (as the case may be) in order to avoid any possible confusion of ownership.

There are rules that protect the assets owned by third parties which are in the possession of an administrator, but there still is the risk of the attachment of assets until the judge rules over the liquidation procedure. This situation could affect the cash flow to the investors. It is important that the issuer file a petition before the judge for the recognition of his property rights once the liquidation resolution has been approved.

In the case of asset securitization using a trust structure, if the trust is granted as a revocable trust, the creditors of the originator may exercise their rights to revoke the trust and take back the assets.

Bank Secrecy Laws

Under Mexican law, banks are required to keep confidential certain information pertaining to bank clients. More specifically, the banking law provides that banks may not provide any detailed information regarding deposits, services or any other operation to third parties unless: (1) there is an express authorization in writing from the client or his legal representative; (2) pursuant to a court order in a trial where the client is plaintiff or defendant; or (3) the fiscal authorities request the information through the CNBV.

Bank secrecy may be an obstacle to credit securitization if the securitization process requires specific loan-by-loan information. However, debtors can on a case-by-case basis authorize the release of information by a bank to third parties.

Restrictions on Bank's Ability to Transfer Assets

Under Mexican banking law, banks are not permitted to transfer any assets (other than to another bank, the Banco de México or a public trust) without the prior authorization of the Banco de México. This restriction has meant that banks cannot securitize assets without the permission of the Banco de México, because securitization involves the sale of assets.

The Banco de México has indicated that it will only permit transfers of assets in connection with a securitization where the transfer of the assets is complete and the transferring bank does not retain recourse on the assets. The Banco de México, however, may permit securitization in the case where the bank retains recourse in the form of a subordinated interest, so long as the bank holds sufficient capital against the subordinated interest.

ISSUES REGARDING VEHICLES

In Mexico, most securitization transactions have used trusts. However, there are several other alternatives, including special purpose corporations and mutual funds.

Trusts

A trust (fideicomiso) is a legal vehicle that has been used successfully in several securitization transactions in Mexico. Although trusts have certain limitations, these have not proven to be insurmountable for the securitization transactions that have been completed to date. Attempts at securitization, however, on a larger scale or with more complex transaction structures could possibly be affected by some of the trust's limitations.

The principal issues with regard to the trust are:

Trustees. Generally, a bank must serve as a trustee of a trust, although the law permits a securities firm (casa de bolsa) to act as a trustee for a trust that holds securities. Because of the relative novelty of the structures required for securitization and the support required from the trustee, the time and cost involved can be substantial.

Instruments. The majority of instruments which have been issued by trusts and registered for public distribution are the ordinary participation certificates, or "CPOs". In the international capital markets, the CPOs have received a mixed reception.

The principal problem with the CPOs is that they resemble an equity instrument more than a debt instrument. As provided for in the law, the CPO entitles the holder of the instrument to an undivided interest in a pool of assets. A debt instrument would typically entitle the holder to the payment of principal in accordance with a repayment schedule and interest at a stated rate. The efforts to transform CPOs into debt instruments have generally resulted in structures that are cumbersome and difficult to explain to investors.

It should be noted that under recent rules issued by Banco de México, if a trust is to issue securities that will be placed with the investor public at large, the Mexican bank acting as trustee must verify that the trust assets are sufficient to meet the payments required to be made. This provision may result in trustees taking a more direct involvement in the structuring of transactions with a consequent increase in time and cost.

Corporations

Another type of special purpose vehicle that may be used in connection with a securitization is a corporation. Although Mexican law provides for several different types of corporations, the one best suited for a special purpose vehicle is a sociedad anonima. There are some disadvantages in using a corporation as a special purpose vehicle.

Establishment and operating costs. Corporations have relatively high establishment and operating costs. The costs tend to be high because the corporation will be required to maintain full accounting records and make regular tax filings. It should be noted, however, that the costs associated with a corporation are not materially different from those associated with a fideicomiso.

Bankruptcy risk. A corporation will always be subject to the risk of bankruptcy, whereas, under Mexican law, a trust is not subject to the bankruptcy law. However, it should be possible to structure the corporation so that it is "bankruptcy remote" by limiting its activities and its ability to incur additional debt. The corporation is, however, vulnerable to tax and labor claims, which under Mexican law come before claims of secured lenders.

Taxation. The corporation would be subject to corporate taxes during its life. Transfers to a corporation, moreover, would in all cases be viewed as transfers for tax purposes resulting in a corresponding gain or loss.

Mutual Funds

Under existing rules from the CNBV, a mutual fund has important investment restrictions. One significant restriction is that, without a specific exemption, a mutual fund may only invest in securities that are registered with the National Registry of Securities and Intermediaries and listed for trading in the Mexican stock exchange. In addition, mutual funds may only issue equity securities. The authorization process for a mutual fund, moreover, can take up to eight months. As a result of this regulatory framework, a mutual fund would not be suitable as a vehicle to securitize assets.

Regulations Regarding the Issuance of Securities

In order to publicly issue securities that are to be traded in the public securities markets, it is first necessary to register with the CNBV. The procedures to register securities with the CNBV are generally the same regardless of the nature of the issuer or the type of security being offered. However, for specific types of securities (such as commercial paper) the CNBV has put forth circulars that provide more specific guidance. It should be noted that there is no such circular for CPOs, which instead have been issued under the general guidelines applicable to equity securities. It may be useful in connection with public securitization transactions to have a specific circular from the CNBV regarding registration of these types of instruments.

IMPACT OF INVESTMENT ELIGIBILITY RULES FOR REGULATED ENTITIES

Restrictions on the types of securities that can be purchased by regulated institutions can have a dramatic impact on the demand for such securities. Some of the most important investors in asset-backed and mortgage-backed securities (including banks, insurance companies and mutual funds) are subject to regulatory rules governing the types of securities they are permitted to invest in.

Insurance and Bonding Institutions

Insurance and bonding institutions are subject to regulation by the CNSF. The legal reserves of insurance and bonding institutions are required to be invested so as to, in general, maintain adequate liquidity and obtain an adequate secure return to meet future obligations. Potentially significant requirements are as follows:

1. The percentage of reserves invested in securities of other issuers may not exceed 30%.
2. No more than 18% of reserves may be invested in securities issued by a group of issuers where the group shares certain business ties.
3. No more than 10% of reserves may be invested in securities issued by a group of issuers, where the group represents the same risk to the institution due to the nature of their business activities.

In general, asset-backed securities would be subject to the 30% restriction unless guaranteed by a bank or by the government. In addition, an originator and a special purpose vehicle could be considered related entities for purposes of the 18% restriction in "2" above. This would mean that asset-backed securities could be aggregated with the debt and equity securities of the originator for purposes of this limitation.

All asset-backed securities, moreover, could be viewed as having the same type of economic risk and therefore be aggregated for purposes of the 10% restriction in "3" above. If interpreted in this way, this would prohibit insurance and bonding companies from investing more than 10% of their total assets in asset- or mortgage-backed securities.

Mutual Funds

Mexican law provides for three types of mutual funds: (a) debt mutual funds; (b) mixed debt and equity mutual funds; and (c) risk-capital mutual funds. Each of these funds has restrictions on the types of securities in which they are permitted to invest.

Both debt and mixed debt and equity funds may only invest in securities registered in the National Registry of Securities and Intermediaries.

Debt funds may invest up to 100% in securities issued or backed by the federal government and/or credit institutions. Otherwise, they may not invest more than 15% in the securities of any one issuer or more than 20% in the securities issued by related companies. In addition, a debt fund may not acquire more than 30% of the debt of any issuer.

Although some issues will need to be resolved, such as the classification of asset-backed securities as debt or equity, the regulations regarding investments by mutual funds do not contain any provisions that should prove problematic for securitization.

Pension Funds

In December 1995, reforms were enacted to the Social Security Law in order to strengthen the pension system and authorize the participation of private pension funds to receive, administer and invest resources given by employers, workers and the federal government for retirement pension accounts.

According to the new Social Security Law, the specific regulation of the organization and operation of pension funds shall be through the Ley para la Coordinación de los Sistemas de Ahorro para el Retiro (SAR) which is expected to be reformed in the next legislative period of the Congress.

The reforms to the SAR will form an investment framework over the resources of the SAR. Once the amendments to the law are enacted, the authorities will be able to issue regulations governing portfolio investments.

The objective of the pension funds is to promote long-term savings. Therefore, it is likely that long-term bonds, such as result from the securitization of mortgages, will be included as eligible investments.

TAX ISSUES FOR SECURITIZATION

A primary goal in structuring any securitization transaction is to avoid any adverse tax consequences. In general, the goal is to avoid an increase in the overall tax liability as a result of the transaction. In some cases, a transaction may be structured to realize a tax saving.

Tax Consequences for the Originator

Income tax. Generally speaking, all transfers of assets are considered transfers for tax purposes, resulting in a corresponding gain or loss to the transferor.

A trust can be structured such that the transfer of assets to it may or may not be recognized as a transfer for tax purposes. By structuring the trust as revocable with the originator as a beneficiary in last place, it is possible to have the securitization transaction viewed as a debt financing for fiscal purposes. On the other hand, if a taxable transfer is more advantageous, so long as the transferor is not a beneficiary of the trust, the transfer will be viewed as a transfer for tax purposes.

If a corporation is used as a special purpose vehicle, the transfer to the vehicle would in all cases be viewed as a transfer for tax purposes. There is a special tax consequence for commercial banks upon the transfer of assets. Banks are allowed a special deduction for reserves created in connection with loan originations of up to 2.5% of the average amount of loan assets that they hold in a given tax year. If the loan asset is sold in the same tax year as it is originated, the deduction is simply disallowed. If the loan assets are sold in a subsequent tax year and because of this sale the average reserves of the bank are less than 2.5%, the reserves created for the loan assets would be released and the amount previously deducted must be included as income.

Asset tax. Corporations and trusts engaged in commercial activities must pay a tax of 1.8% of financial assets, fixed capital, real estate and inventory, owned during the fiscal year. Financial institutions are exempt from the asset tax; therefore the transfer by a financial institution of assets in connection with a securitization would have no effect on the institution. If the lender is a non-regulated entity, however, the transfer would decrease the amount of financial assets held by the lender subject to the asset tax.

Tax Consequences for Borrowers

Income tax. In general, corporations, businesses and individuals engaged in commercial activities are allowed to deduct their interest payments from the interest they receive. However, adjustments are made for inflation such that the gain or loss is only recognized on the "real" component of interest paid or received. The way that inflation is adjusted for depends on whether or not the interest is payable to a financial institution.

The transfer of credits by a financial institution to a special purpose vehicle would affect the calculation of the inflation component for the borrower. The difference in the amount of tax resulting from this calculation, however, may not be substantial.

Tax Consequences for the Issuing Vehicle

Income tax. Generally, a securitization using a corporation or trust would be structured so as to avoid any income tax at the entity level. In Mexico, however, when weighing the impact of income taxes on a special purpose vehicle, it is important to consider the impact of adjustments required for inflation. Under Mexican fiscal law, each individual item of income and expense related to debt must be adjusted for inflation between the date of occurrence and the date of the payment of taxes. Because of this, differences in the timing of payments due on the assets and payments due on the securities could result in inflationary gains or losses to the corporation. Only a true pass-through, where the payments on the assets were immediately passed to investors, would be able to avoid this inflationary gain or loss.

Asset tax. The asset tax would apply to a special purpose vehicle organized as a corporation. Therefore, even if there were no gain

or loss for income tax purposes with a corporation, the asset tax may still be applicable.

If the special purpose vehicle were a trust engaged in commercial activities (as is discussed above), the asset tax resulting would be payable by the beneficiaries. As in the case of income taxes, the trustee must make provisional payments, but the final payment is the responsibility of the beneficiary.

Real property transfer tax. In the event of a default, if the special purpose vehicle were to execute on the property, a real property transfer tax would be payable by the special purpose vehicle. The same tax would, however, apply to any person who executes on a real property guarantee, regardless of whether the loan has been securitized.

Under current law, states are free to set the rates as they choose.

Tax Treatment of Holders of Securities

Income tax. If the vehicle issues debt instruments, the holders will have to pay income tax for the interest income generated by such securities. If the issuer is organized as a trust, and issues CPOs, earnings generated thereby are considered as interest income (as if from debt). This tax will be withheld by the vehicle. If instruments are placed in a securities market, the withholding tax will be 20% of the first 10% of interest paid. If the interest is received by an individual, the amount withheld is considered as payment in full. If the interest is paid to a corporation, the payment is considered a provisional payment against taxes due from the corporation. When the maturity of debt instruments exceeds one year and the holder is an individual, interest payable is not subject to income tax.

If the debt instruments are not considered as issued in the securities market, the issuer has to withhold 20% of the interest payable. Such amounts withheld will be considered as provisional payments only, and the exemption mentioned above for securities with maturities in excess of one year is not applicable.

If the issuer is organized as a corporation and issues equity, profits will be taxed at a rate of 34%. Tax has to be paid by the corporation. Dividends, however, would not be taxable to the recipients.

Profits or losses will be recognized when the shareholder transfers the shares. However, an individual who holds shares issued on a securities market is exempted from recognition of gain or loss on the sale of shares.

In the case of qualified foreign residents, the withholding tax rate would be 4.9% for debt issued in a securities market. To qualify for this rate of withholding, the foreign resident must reside in a country that has a treaty with Mexico to avoid double taxation and the issuer must be registered with Hacienda. In addition, the withholding tax on interest payments to any foreign bank that is domiciled in a country that has a treaty with Mexico to avoid double taxation and is registered with Hacienda will be 4.9%. In either case above, if the required conditions are not satisfied, the withholding tax will be 15%. Other rates of withholding tax may apply to other types of debt instruments not likely to be issued in a securitization.

Dividends payable to foreign residents are not subject to withholding tax, so long as the corporation has paid income tax on the amounts distributed. For capital gains on transactions not done through a securities market, the foreign shareholder will be subject to a 20% flat tax upon the sale of any securities calculated on the principal amount of such transaction. If the buyer is a resident of Mexico, he shall be responsible for withholding this amount. Transactions conducted through a securities market are exempt from this tax.

Foreign pension funds that are exempt from income tax in their own country and register with Hacienda are exempt from any withholding tax.

ISSUES REGARDING ATTACHMENT AND EXECUTION

A critical issue for securitization, as well as any other form of secured lending, is the ability to protect the rights of the creditor in the event of a default on the part of a debtor. The legal means for protection of creditors' rights typically consist of attachment of property or assets in advance of judgment and (upon receipt of judgment) execution. These issues are governed in Mexico by the Federal Commercial Code and, in the case of mortgages for real property, by the Civil Codes and Civil Procedure Codes of each state and the Federal District (depending on where the property is located).

The following analysis is based on the Civil Code and Civil Procedure Code of the Federal District. The laws of each state tend to follow the Federal District, but there are differences in certain cases.

The issues related to attachment and execution relevant to securitization have to do with the difficulty, length of time and cost of these proceedings. While there is little doubt that a creditor will ultimately prevail in a proceeding against a defaulting debtor, the process can be time consuming and costly.

The issues regarding attachment and execution affect the credit risk of a securitization transaction. While strictly speaking these issues are not obstacles to securitization, the uncertainty that they create will make securitization more costly for issuers. Ultimately, someone has to take the credit risk associated with the loan assets to be securitized. An important component of this risk is related to the procedures for attachment and execution in that they affect the creditor's ability to recover value in the event of a default.

Ordinarily in Mexico, consumer credits, credit card receivables and sale receivables have the legal status of titulos de crédito (negotiable instruments). Negotiable instruments grant certain executory rights in an event of default against any asset owned by the debtor. The Commercial Code establishes a special summary procedure to attach and execute against the debtor's assets.

Mortgages of real property are governed by the Civil Code and Civil Procedure Code. Pursuant to the Civil Code and Civil Procedure Code, mortgages that are valid and binding grant certain executory rights in case of default. These laws establish a special procedure in order to attach and execute the mortgage and fulfill the payment obligation of the debtor.

With regard to mortgages, the Civil Code and the Civil Procedure Code grant legal rights to the mortgagee in any event of total or partial default in payment, due performance or observance of any obligation pursuant to the contract constituting the mortgage.

It should be noted that the Mexican Constitution grants hearing and due process of law rights in Articles 14 and 16. The consequence of these provisions is that any legal action to request the fulfillment of any right against any private or public person has to be heard in front of a court of law. Therefore, any legal action pursuing payment of any negotiable instrument or seeking to execute on any mortgage must be heard before a court. As a result, some legal precedents have declared out-of-court sales of property a violation of these due process of law rights.

Attachment

Depending on the legal nature of the assets, a creditor may use the mercantile executory procedure or the mortgage executory procedure to attach property in advance of judgment in order to ensure that the payment obligations of the debtor will be satisfied. In addition, the creditor always has the right to file an action using the ordinary civil or mercantile procedures pursuant to the Civil Procedure Code and Commercial Code. If the loan is backed by a mortgage, the former applies.

The mortgage executory procedure is the procedure through which a creditor can attach and execute on a mortgage. The court will order the public registry where the property is registered to make a notation indicating the attachment of the asset for the benefit of the first mortgagee. The court will then notify the debtor of the action, at which point the debtor will have nine business days to challenge the plaintiff's petition.

With the regard to real property, it is generally not possible to take possession of the property upon attachment. However, pursuant to the Civil Procedure Law, when the court order is registered with the public registry, the owner of the property is transformed temporarily into a depository for the benefit of the attaching creditor until the court renders judgment. As such, the owner of the property has the obligation to conserve and maintain the property for the benefit of the creditor.

When the court renders judgment in favor of the creditor, the depository has the obligation to give possession of the property to the creditor. If the depository does not fulfill this obligation, the creditor has a legal action to enforce the court's resolution in order to take possession of the property. Although this procedure may last a couple of months, the creditor will ultimately prevail since the court's resolution is definitive and the defaulting debtor has no legal basis upon which to challenge the action.

The time required for the mortgage executory procedure theoretically should last no longer than 11 months. In the best case, when the debtor does not challenge the action, the time required could be as short as five months. In both cases, this represents the time from the presentation of the complaint until the execution and payment of the debt or the appropriation of the assets by the creditor. It should be noted, however, that in practice the mortgage executory procedure can last as long as three to four years.

Execution

In both, the mercantile and mortgage executory procedures, after attachment of assets the plaintiff and the defendant will offer proofs, allege their rights and receive the judgment of the court. If the court finds in favor of the plaintiff, the Civil Procedure Code and Commercial Code provide for the sale or appropriation of assets by public auction and payment of the debtor with the funds thereby obtained.

At the same time, in the case of real property, the court requests from the public registry notice of the existence of any lien registered in the real property sheet. The court then notifies all creditors calling for a public auction in order to grant them the opportunity to challenge the validity of the auction and allege the priority of their rights.

Pursuant to the Civil Procedure Code and the Commercial Code the court has the obligation to publish a notice of public auction (three times with three days in between for negotiable instruments and three times with nine days in between for real property assets) in two local newspapers.

NOTES

[1] As part of a mortgage loan restructuring plan instituted after the devaluation, a majority of mortgage loans are indexed to a new unit of account, the UDI (Unidades de Inversión). The UDI designed to maintain a constant real value. The value of the UDI in New Pesos daily based on changes in the national consumer price index. UDI loans have a fixed real interest rate of 9% and have their payments and balances converted from UDIs to New Pesos at the prevailing exchange rate.