The Guide to

Structured Finance & Securitization

in Latin America

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Primed for Growth: Securitization in Latin America

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Securitization made its debut globally in 1970, when the US Government National Mortgage Association, also known as Ginnie Mae, launched the first issuance of mortgage-backed securities. The market moved to the next stage seven years later. This was when Bank of America launched the first securitization in which investors took actual credit risk on the underlying asset pool, rather than relying on a guarantee of the securitized portfolio, as was the case in the earlier deals.

The issuance volume of structured finance, including residential mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities, future-flow securitizations, and collateralized debt obligations, then remained relatively low for the next 20 years. Issuance finally took off in 1995 and has grown quickly since then, with global dollar-denominated issuance reaching about $500 billion in 2000 and about $2 trillion in 2006. Although securitization remained solely a US phenomenon for quite some time, the technology spread to Europe in 1987 and then to Asia and emerging-market countries in the early 1990s.

Latin America

As securitization began to take off in the mid 1990s in Latin America, much of it took place as cross-border deals, or those primarily sold to foreign investors, because the domestic corporate bond markets were virtually non-existent at the time. This issuance was dominated by future-flow securitizations, or those where Latin American corporates and banks were able to secure relatively cheap dollar funding by selling their rights to future offshore payments. This typically includes income from exports, remittances, bank payments handled through the SWIFT global payment and messaging system, credit-card vouchers, income from airline tickets or net settlements between telecommunications carriers.

Contributor: Leslie Hillman

Mexico dominated the issuance of future-flow securitizations during the 1990s, with the majority of transactions involving income from exports. During the early-to-mid 2000s, issuance out of Brazil dominated the market. At the same time, diversified payment rights such as MT-100s and MT-200s, which are SWIFT-based wire payments of hard currency to banks in emerging markets, surpassed export-based securitizations to become the dominant asset class being securitized in the region.

The market for cross-border, future-flow securitizations in Latin America peaked in 1996, with about $10 billion of issuance that year. After that, cross-border deals in Latin America slowed and hovered between $3 billion and $8 billion a year for several years. From 2003 onwards, the cross-border market has seen a steep decline. Reasons for this fall into several categories.

Foreign Interest

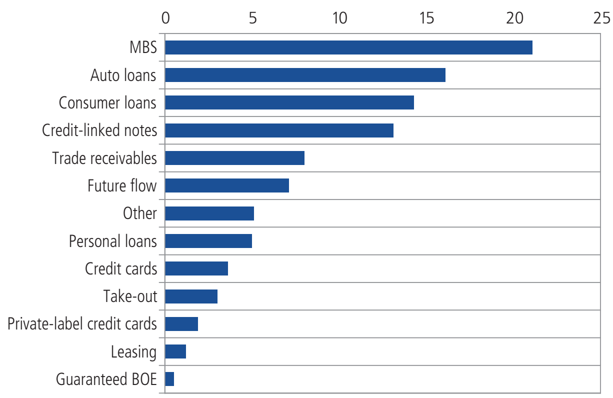
First, foreign investor interest in Latin American or emerging-market securitizations has varied greatly from year to year, which speaks to the downside of relying on foreign investors for funding the growth of a domestic economy. Often the foreign funds are short-term in nature, denominated in foreign currency and volatile, whereas the needs of domestic borrowers tend to be longer-term, in local currency, and constant, regardless of whatever fluctuations might be seen in the international capital markets.

Second, there has been a trend in the region of countries improving their sovereign-bond credit ratings. Several countries now are rated investment grade and many others are only one to two notches away. This phenomenon, coupled with the presence of international investors that are inclined to take on more risk in order to enhance returns, has allowed Latin American borrowers still seeking foreign currency financing to access offshore investors at attractive rates without the need to sell their best assets, as is generally the case when securitizing future flows such as remittances and export income. Finally, domestic demand for local-currency-structured securities has been growing by leaps and bounds in recent years, often eliminating the need for borrowers to seek foreign currency financing abroad.

Although Latin American securitizations were deeply rooted in the cross-border market, the story since the early 2000s has all been about the local markets. While combined Latin American domestic securitizations only totaled about $1 billion in 2000, the domestic markets have seen growth every year since then and reached $13.6 billion in volume in 2006.

Mexico and Brazil have dominated this market in terms of local structured issuance recently and they have supplanted Argentina, whose vibrant domestic markets imploded after the country's sovereign bond default in 2001. However, Argentina has been staging a strong comeback over the past year or so, surpassing the issuance volume seen in Chile, Colombia or Peru to become the region's No.3 securitization market.

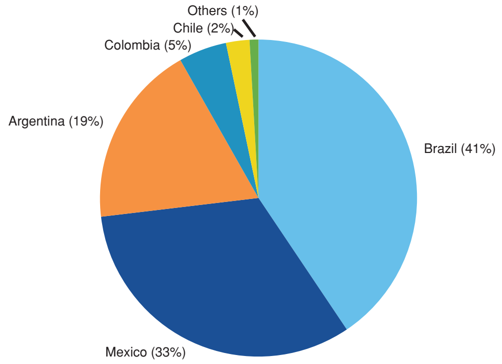
Diversified Portfolio
2006 Latin American securitizations by asset*



**Counts only domestic securitizations; total issuance of US$13.6 billion*

Source: Moody's Investors Service, January 2007 data

Heavily Weighted
2006 Latin American securitizations by country*



**Counts only domestic securitizations; total issuance of US$13.6 billion*

Source: Moody's Investors Service, January 2007 data

Financial Crises

Interestingly, one of the factors spurring the development of domestic-market securitization were the numerous financial crises that occurred in Latin America, including Mexico's currency crash in 1994-1995, Argentina's default in 2001 and Brazil's debt crisis in 2002.

These crises had the effect of forcing Latin American corporate borrowers to focus much more on prudent asset and liability management in order to gain foreign investor confidence or just to obtain loans from local banks that were limited in their financing abilities because they, too, needed to recapitalize following the crisis. As the banks did recapitalize, financial institutions in the region stepped up their efforts to originate new loans to small-and-medium size enterprises and to consumers for purposes such as mortgages, autos, and lines of credit – all excellent fodder for creating securitizations.

Other factors also helped fuel its growth. The positive economic environment and relatively low and stable interest rates seen in much of the region over the past few years have been an important contributing factor. And domestic savings finally reached a critical mass in several Latin American countries. Domestic savings tend to be channeled into pension funds, mutual funds, insurance companies, and banks, and these institutional investors are key to ensuring demand for future domestic securitizations.

As pension funds and mutual funds grew, so did the demand for high-quality alternatives to government paper. Pension funds throughout the region are often restricted from investing in assets rated below AA on a local basis, and there are often relatively few corporates that meet this benchmark in Latin America. Structured products can satisfy this need by creating investment grade securities from a portfolio of unrated assets, and so the steady increase in pension funds throughout Latin America has also increased the demand for – and interest in launching – securitizations that can be sold in local currency to local investors.

The creation of a legal and regulatory environment to facilitate securitization, including clarifications or modifications to bankruptcy, tax, and corporate governance rules or laws to help protect investors, has allowed companies to launch securitizations in many countries throughout the region. As this happened, the markets also achieved a level of infrastructure to facilitate securitizations, such as arrangers with domestic-placement capabilities, trust agents, market makers and rating agencies offering domestic rating scales. This all came together to set the stage for what has become a region of fast-growing domestic securitization markets.

Buyer Beware

With all of this now in place, and following several years of sustained growth, the Latin American securitization market – particularly the domestic securitization market – is primed for further growth. However, these markets are still nascent and lack substantial experience and history, and this poses some potential pitfalls for the market: uncertainty around the application of securitization laws, questions about portfolio quality, and the ever-present threat of macroeconomic volatility in Latin American countries.

In terms of the legal uncertainty, it's important to realize that securitization laws in most domestic markets have not been fully tested. A change in current government sentiment towards the capital markets, a change in administration, or simply a failure in the legal system to interpret securitization law as expected, could lead to adverse rulings and cause reduced investor confidence in this asset class. Even when a perfected true sale of assets has been confirmed, in a nascent market there is still a risk that such a decision may be overturned until such time as the law has been properly tested and precedents set.

Regarding portfolio quality, it is important to highlight that many of the asset classes that have been securitized in the region lack substantial historic data. Management information systems tracking this data may be less robust than systems used in more developed markets. Implementation of credit underwriting and origination policies may not be fully automated. Monitoring and collection of loans may not be entirely consistent, and provisioning and write-off policies for non-performing loans may not be uniformly implemented. Any of these issues could result in investors receiving less value than that which was initially expected.

Macroeconomic volatility is not news for any foreign or local investor in Latin America, but it still needs to be taken into account. Volatility could arise from domestic political and economic events, or from events elsewhere that spook the local market. Whatever the reason, if liquidity dries up, if jobs are lost, if assets decline in value, or if inflation picks up, the current growth in local securitization issuance could run out quickly.

Future Outlook

Fortunately, Latin America's financial markets have proven quite resilient over the years so, despite all of these cautions, the market expectation is that the volume of domestic securitization issuance will continue to experience solid growth, and that domestic securitization will entrench itself further in the region as a preferred means of financing for many borrowers.

This statement is based on a favorable economic outlook for Latin America through the next few years. It is also based on the expectation that banks throughout the region will continue to focus on retail lending, as corporate loan portfolios show few signs of growth and as the number of loans to municipalities contract. At the same time this focus on consumer lending is creating the needed stock to fuel the growth of domestic securitization markets, there is also a growing pool of international investors seeking out high quality, local-currency assets. They, too, will help support increased issuance of local-currency securitizations.

Critical Mass

Institutional investor assets as % of GDP

	Pension	Mutual	Insurance	Total
Argentina	12.0	1.0	4.6	17.6
Brazil	14.8	28.4	2.8	46.0
Chile	59.1	8.8	19.9	87.8
Colombia	10.3	23.3	1.0	34.6
Mexico	5.8	5.8	1.7	13.3

Source: 2005, 2006 IMF staff estimates

In terms of the individual markets in Latin America, Brazil and Mexico, the two largest economies in the region, have also dominated issuance in the domestic securitization markets over the past few years. According to data from Moody's Investors Service, these two countries accounted for 73% of the region's total $13.6 billion in domestic issuance in 2006. Interestingly, although mortgage-backed securities, auto loans, and consumer loans constituted the largest percent of asset classes securitized, the overall composition of assets securitized was actually quite diverse.

Brazil's domestic securitization has seen tremendous growth in recent years. Coming from a base of only $100 million in 2002, total issuance reached about $5 billion in 2006. These transactions have been driven primarily by issuance using a special Brazilian vehicle for securitizations called a fundo de investimento em direitos creditórios (FIDC) for structuring income flows, and to a lesser degree by issuance of certificados de recebíveis imobiliários for real estate. Consumer loans, including those for autos, represented the majority of assets securitized in Brazil, followed by income from trade, future flows, and mortgage-backed securities. Issuance is expected to increase as investors' and companies' use of the FIDC vehicle continues to mature.

MBS in Mexico

The story in Mexico continues to be mortgage-backed securities. There were 18 different residential mortgage-backed securities issuances in 2006, up from eight the year

structured finance introduction

before. These came primarily from Mexico's government-run mortgage lender Infonavit, as well as a number of the sofoles, specialized non-bank financial institutions in Mexico that grant loans and which have also recently been issuing mortgage-backed securities. Whereas the early mortgage securitizations included third-party credit enhancement at the mezzanine risk level, last year some issuances were sold without such credit enhancement as investors are taking on this mezzanine risk directly.

Construction bridge loans, consumer credit, and income flows from trade were among the other asset classes seen in the market, and Mexico should see growth in securitization of these other asset classes in the future. However, mortgage-backed securities are expected to remain the engine of growth there, given the recent success of the sofoles in securitizing their mortgage portfolios, given the recent entrance of banks into the mortgage-backed securities market, given the expectation that Mexican institutions will work toward further standardization of mortgages, and given the country's large housing deficit and its rapidly growing population. Demand for these securities should come from both domestic and international investors alike.

After seeing securitization volumes drop off significantly in 2001, Argentina rebounded in 2005 with just less than $2 billion in issuance, followed by a strong 2006 with $2.5 billion in issuance. Driven by strong economic growth and resurgence in consumer credit, consumer loans, personal loans, and credit cards dominated the securitization landscape in Argentina. This market is expected to grow further over the next few years, and transaction sizes are expected to grow from their current average of only $13 million.

Turnaround for Chile

Chile's domestic securitization market suffered a setback in 2004 and 2005, as a fall in interest rates led to a rapid acceleration in the prepayment of mortgages, resulting in faster than expected prepayments on outstanding mortgage-backed securities. At the same time, many of these deals were undercollateralized because issuers and investors assumed that excess spread – or the difference between the interest due on the underlying mortgages and the interest due on the issued securities – would accrue over time. However, the surge in mortgage refinancing precluded this from happening and many of the issuances were subsequently downgraded and lost value as investments.

As the market continues to digest this, and is now considering a model of overcollateralization as seen in other markets, mortgage-backed securities are expected to rebound in Chile. Additionally, consumer credit, which has been a popular asset class for securitization, is expected to remain robust in Chile.

Colombia continues to be heavily dominated by mortgage securitization issuance. Titularizadora Colombiana, a secondary mortgage company, has played a critical role in creating a secondary market for Colombian mortgages by aggregating mortgage portfolios from originating banks and packaging these together to create mortgage-backed securities sold to the market. Titularizadora has brought several new deals to market each year as well as securitizing pools of non-performing mortgages. The current focus on mortgage securitization and the growth in that market are expected to continue going forward in Colombia.

In Peru, after reaching an all-time high of approximately $300 million in domestic securitization issuance in 2005, the market reverted in 2006 to pre-2004 levels of only about $70 million as only a few deals came to market, all by repeat issuers. Going forward, issuance of mortgage-backed securities in Peru is expected to increase as a result of the growing portfolios of social-interest mortgages held by commercial banks and as a result of this year's creation of a secondary mortgage company – called Titularizadora Peruana – by Banco de Crédito del Perú, Titularizadora Colombiana, and the IFC. **LF**

Abbreviations

ABS	Asset-backed securities
CDO	Collateralized debt obligations
CMBS	Commercial mortgage-backed securities
CRI	Certificados de recebíveis imobiliários (Brazil)
DPR	Diversified payment rights
FIDC	Fundo de investimento em direitos creditórios (Brazil)
MBS	Mortgage-backed securities
RMBS	Residential mortgage-backed securities

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